

**SEC PROPOSES NEW RULE INTENDED TO ADDRESS PAY-TO-PLAY ACTIVITIES
BY INVESTMENT ADVISERS**

On August 3, 2009, the Securities and Exchange Commission published a sweeping and controversial rule proposal under the Investment Advisers Act of 1940 intended to curb what the SEC perceives to be undue influence associated with political contributions and undisclosed payments from securities firms seeking to do business with public pension funds.¹ Among other things, the proposal would ban outright the payment by certain investment advisers to third parties that solicit government entities for investment advisory services.

The proposed rule reflects the SEC's growing concern with pay-to-play arrangements involving investment advisers. It follows soon after a series of cases brought by the SEC and the New York Attorney General against investment advisers, placement agents and government officials allegedly involved in an undisclosed kickback scheme with the New York State Common Retirement Fund (the "Retirement Fund").² The SEC's Division of Enforcement is currently conducting an industry-wide investigation into pay-to-play practices, and on August 5 announced the creation of a Municipal Securities and Public Pensions Unit within the Division.³ Some of the nation's largest public pension funds, including the California Public Employees Retirement System (CalPERS) and the Retirement Fund, have already responded to regulators' enforcement initiatives by instituting new policies that severely restrict the use of placement agents by investment advisers seeking to conduct business with them.⁴

The rule proposal

The SEC's proposed rule, Advisers Act Rule 206(4)-5, would apply to all registered investment advisers. It also would apply to unregistered hedge fund advisers, private equity fund advisers and other investment advisers that rely on the private adviser exemption from registration in Section 203(b)(3) of the Advisers Act.⁵ The rule proposal would implement three significant new limitations on the ability of those investment advisers to manage money on behalf of a

¹ Political Contributions by Certain Investment Advisers, SEC Release No. IA-2910, available at <http://www.sec.gov/news/press/2009/2009-168.htm>.

² See *People v. Henry "Hank" Morris and David Loglisci*, Defendants, Indictment No. 25/2009 (March 19, 2009); *SEC v. Henry Morris, David J. Loglisci, et al.*, No. 09-CV-2518 (S.D.N.Y. March 19, 2009).

³ See Remarks by Robert Khuzami, Director of the SEC's Division of Enforcement, before the New York City Bar Association, available at <http://www.sec.gov/news/speech/2009/spch080509rk.htm>.

⁴ For more information on these policies, please see our client memorandum, *CalPERS, Nation's Largest Public Pension Fund, Adopts New Policy on Placement Agents*, available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2973/CalPERS_Adopts_New_Policy_on_Placement_Agents.pdf.

⁵ Section 203(b)(3) of the Advisers Act exempts from the requirement to register under the Advisers Act investment advisers that have had fewer than 15 clients during the course of the prior 12-month period and that generally do not hold themselves out to the public as investment advisers. Legislative proposals have been introduced recently to largely eliminate this exemption.

public pension plan or any other “government entity.”⁶ The limitations would apply when an investment adviser subject to the rule seeks to manage government entity assets or seeks to solicit government entities as investors in certain pooled vehicles, including registered investment companies, private investment funds and bank collective trust funds. Comments on the proposed rule are due October 6, 2009.

The SEC said it based its rule proposal on rules G-37 and G-38 of the Municipal Securities Rulemaking Board (“MSRB”), which address pay-to-play practices in the municipal securities markets, and also on a rule the SEC proposed in 1999 to address pay-to-play practices by investment advisers, which was subject to harsh criticism by industry participants. Following is a summary of the limitations under the current rule proposal:

- **Two-year “time out” for contributors.** The proposed rule generally would prohibit an investment adviser subject to the rule from receiving compensation for the provision of investment advisory services to a government entity for two years after the adviser or any of its “covered associates” makes a contribution to any state treasurer or comptroller or other elected official who can influence the selection of the adviser. The SEC proposes to define “covered associates” to include any of the adviser’s general partners, managing members and executive officers, and any employee who solicits a government entity for the investment adviser.⁷ The two-year “time out” resulting from a political contribution would follow an employee if he or she moved to a different adviser or was promoted within the firm to become a covered associate. That no doubt could create a difficult oversight challenge for many advisers. An investment adviser seeking to hire or promote an individual would have to “look back” at the potential employee’s history of political contributions to determine whether he or she had made any donations within the prior two years.

The SEC proposes two narrow *de minimis* exceptions from the two-year time-out provision. One exception would be available for contributions by a covered associate who is a natural person made to an official for whom the covered associate was entitled to vote at the time of the contributions that, in the aggregate, do not exceed \$250 to any one official per election. The other exception would be available, subject to certain timing restrictions, if a covered associate made a contribution of less than \$250 to an official for whom the covered associate was *not* eligible to vote if that contribution were later returned to the covered associate. An

⁶ Under the proposal, the term “government entity” would be defined as “any State or political subdivision of a State, including any agency, authority, or instrumentality of the State or political subdivision, a plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof; and officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.” This term would include any public pension plan, any 529 college savings plans and any tax-deferred retirement plans established under Section 403(b) or Section 457 of the Internal Revenue Code of 1986.

⁷ A political action committee controlled by the investment adviser or any of its covered associates also would be a covered associate.

adviser could not rely on the second exemption more than twice within a year and only once per year for any one covered associate.

- ***Ban on payments to third parties who solicit government entities for investment advisory services.*** The proposed rule would ban the common practice of paying a third party, such as a placement agent, solicitor or other intermediary, to solicit investment advisory business from government entities. In explaining why it was taking such a drastic approach, the SEC stated that its enforcement investigations revealed in some instances that third-party solicitors played a significant role in alleged pay-to-play arrangements and noted the “apparent difficulties for advisers to monitor the activities of their third-party solicitors.” This aspect of the rule proposal would, in practice, prohibit entirely a current and important industry function and may be subject to criticism by industry participants that it is not proportionate to the problems the SEC claims it is seeking to address.
- ***Prohibition on soliciting or coordinating contributions.*** The proposed rule would prohibit an investment adviser from soliciting or coordinating contributions for an official of a government entity to which the investment adviser is seeking to provide investment advisory services, or soliciting or coordinating payments to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

In addition to restricting the conduct described above, the SEC’s rule proposal would require an investment adviser to monitor and retain records relating to the political contributions of its employees and would provide that an investment adviser could not do indirectly anything it would be prohibited from doing directly.

The comment process

As noted above, comments on the rule proposal are due by October 6, 2009. We anticipate that the proposal will elicit harshly critical comments from industry participants who will raise significant objections to the proposal, as they did when the SEC initially proposed the earlier “pay-to-play” rule in 1999. Some investment advisers with smaller operations argued in 1999 that the rule proposal had an anti-competitive effect, making it more difficult for pension fund managers to become aware of those advisers. These arguments may be buttressed by a recent decision by the U.S. Court of Appeals for the District of Columbia Circuit remanding to the SEC a rule adopted by the SEC regarding situations in which certain equity-indexed annuities are securities. In remanding the rule to the SEC for reconsideration, the Court noted that the SEC had failed to properly consider the competitive effects of the rule.⁸

The SEC proposed the rule under Section 206(4) of the Advisers Act.⁹ We can envision that some industry participants will question the SEC’s use of its authority under Section 206(4) of

⁸ American Equity Investment Life Insurance Company, et al. v. SEC (D.C. Cir. 2009), No. 09-1021.

⁹ Section 206(4) of the Advisers Act authorizes the SEC to adopt rules “reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.”

the Advisers Act – an anti-fraud provision – to ban entirely payments to third-party solicitors of government entities even in instances in which there is no indication of fraud. We also anticipate some industry participants questioning whether aspects of the rule proposal are consistent with Constitutional rights of freedom of speech. Investment advisers with large operations may point to the logistical difficulties involved in monitoring the two-year look-back provision relating to potential employees’ history of past political contributions.

Whether the SEC adopts a final rule or revises its rule proposal significantly, SEC examiners have already begun to increase their scrutiny of investment advisers that do business with public pension funds and use third-party solicitors or placement agents to solicit government entities. Investment advisers should consider, in light of the increased regulatory scrutiny, implementing policies intended to provide transparency to their relationships with public pension funds and placement agents, including (1) carefully monitoring and recording political contributions made by officers, directors and employees to the campaigns of officials who might influence public investments, and (2) performing due diligence on, and obtaining appropriate representation from, any placement agents used to obtain investment advisory business from public pension funds. Investment advisers should also be aware that certain political contributions that may be legal at the time they are made may result in increased regulatory scrutiny or become the basis for subsequent allegations of conflicts of interest.

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If you have any questions concerning the SEC’s rule proposal or would like additional information, please contact Elizabeth P. Gray (202-303-1207, egray@willkie.com), Gregory S. Bruch (202-303-1205, gbruch@willkie.com), Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Gordon Caplan (212-728-8266, gcaplan@willkie.com), Maria Gattuso (212-728-8294, mgattuso@willkie.com), Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com), David W. Blass (202-303-1114, dblast@willkie.com), or the Willkie attorney with whom you regularly work.

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