SEC ADOPTS NEW RULE DESIGNED TO DETER PAY-TO-PLAY ACTIVITIES BY INVESTMENT ADVISERS

In light of recent publicized occurrences in states such as New York, California, New Mexico and Connecticut implicating "pay-to-play" practices by investment advisers, the Securities and Exchange Commission unanimously voted to adopt a new rule under the Investment Advisers Act of 1940.[1] According to the SEC, pay-to-play practices include making campaign contributions or payments to elected officials in order to influence the awarding of contracts for the management of public pension plan assets and other government investment accounts. The restrictions under the new rule, designated Rule 206(4)-5 under the Advisers Act (the "Rule"), will apply to all investment advisers registered with the SEC and to unregistered investment advisers that rely on the private adviser exemption from registration in Section 203(b)(3) of the Advisers Act (including money managers of hedge funds and private equity funds).[2] Although several commenters to the proposed pay-to-play rule voiced concerns relating to restrictions on political speech and association as guaranteed by the First Amendment, the SEC asserts that the Rule constitutionally balances the goal of preventing pay-to-play practices while avoiding unnecessary burdens on speech and associational rights.[3]

The Rule will be effective 60 days after it is published in the Federal Register, which could be as early as September 2010. Compliance with most aspects of the Rule will be required within six months of the effective date. Compliance with provisions related to the restrictions on third-party solicitations will be required one year after the effective date.

Overview

The Rule includes several new restrictions on the activities of investment advisers and their "covered associates." "Covered associates" is defined to include the adviser's general partners, managing members and executive officers, any other individual with a similar status or function, and any employee who solicits a government entity for the investment adviser, including any person who supervises directly or indirectly such employee. A political action committee ("PAC") controlled by the investment adviser or any of its covered associates is also a covered associate.[4]

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1 *See Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 3043 (July 1, 2010) (the "Release"), *available at* http://www.sec.gov/rules/final.shtml.

2 Section 203(b)(3) of the Advisers Act currently 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. Pending legislation is expected to largely eliminate this exemption.

3 The Release includes a significant discussion of the SEC's considerations of First Amendment concerns. *See* Release at Section II.A.

4 Rule 206(4)-5(f)(2).

- ***Two-year "time out" for contributors.*** For two years after an investment adviser or any of its covered associates makes a contribution to any elected official of a "government entity"[5] who can influence or is directly or indirectly responsible for the selection of the adviser, the adviser cannot receive compensation for providing investment advisory services to the government entity. There are *de minimis* and other limited exceptions from this "time out" provision.

- ***Third-party solicitor restrictions.*** The Rule generally prohibits payments by an investment adviser or any of its covered associates to a third party that solicits government entities for investment advisory services. However, unlike the original proposal,[6] the Rule permits the use of a third-party solicitor if the solicitor is a "regulated person." This generally includes an investment adviser registered with the SEC (subject to certain limits discussed below) or a broker-dealer that is a member of a national securities association with pay-to-play restrictions substantially equivalent to Rule 206(4)-5.

- ***Prohibition on soliciting or coordinating contributions.*** To prevent advisers from circumventing the Rule's restrictions on direct contributions, the Rule prohibits advisers and covered associates from soliciting others to contribute to or coordinating contributions for an official of a government entity to which the adviser seeks to provide investment advisory services, a practice the SEC calls "bundling."

- ***Recordkeeping requirements.*** In amendments to Rule 204-2 of the Advisers Act, investment advisers registered under the Advisers Act that have government clients or that provide investment advisory services to a covered investment pool in which a government entity invests will be required to monitor and retain records relating to the political contributions of the adviser and its covered associates.

- ***Catch-all provision.*** The Rule specifically precludes an investment adviser and its covered associates from doing anything indirectly that they would be prohibited from doing directly.

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5 Rule 206(4)-5(f)(5) defines the term "government entity" as any state or political subdivision of a state, including: any agency, authority, or instrumentality of the state or political subdivision; a pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof; a plan or program of a government entity; 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 plan, any tax-deferred retirement plan established under Section 403(b) or Section 457 of the Internal Revenue Code of 1986 and any defined benefit plan defined in Section 414(j) of the Internal Revenue Code of 1986.

6 A pay-to-play rule was proposed by the SEC in August 2009. *See Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 2910 (proposed Aug. 3, 2009), *available at* http://www.sec.gov/rules/proposed.shtml. *See also* the Willkie Client Memorandum, "SEC Proposes New Rule Intended to Address Pay-to-Play Activities by Investment Advisers" (Aug. 12, 2009), *available at* http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3075%5CSEC%20Proposes%20New%20Rule%20Intended%20To%20Address.pdf.

Two-Year "Time Out" for Contributors

Modeled after the Municipal Securities Rulemaking Board Rule G-37[7] applicable to municipal securities dealers, the "time out" provision of the Rule provides that an investment adviser subject to the Rule may not receive compensation for providing investment advisory services to a government entity (any state or political subdivision of a state) for two years after the adviser or any of its covered associates makes a contribution to an "official" of that government entity.[8] The term "official" includes any person who, at the time of the contribution, was an incumbent candidate or successful candidate for elective office of a government entity that is or can appoint a person who "is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser."[9] Thus, the two-year "time out" is triggered by making contributions to elected officials who may directly or indirectly be responsible for hiring an adviser or to elected officials who may influence the hiring of an adviser. Complicating compliance, however, the Rule does not provide guidance on how much "influence" or "indirect" responsibility an elected official must have in order to trigger the "time out" for contributors or how an adviser can identify those elected officials with the requisite influence or responsibility.

Further complicating compliance is the fact that contributions to officials running in a federal election may violate the Rule in certain circumstances, even though the Rule does not apply to federal officials. For example, a federal election contribution to a governor running for the U.S. Senate would violate the Rule if the official has influence over the hiring of investment advisers in his or her role as a governor.

The two-year "time out" begins to run once the contribution is made and not when the adviser becomes aware of the contribution.[10] The Release notes that an adviser will not have to terminate its relationship with a government entity client after making a triggering contribution, but rather may provide uncompensated advisory services for a period of time to allow the client to replace the adviser.[11]

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. In response to comments on its initial proposal, the SEC modified this "look back" so that an investment adviser seeking to hire or promote an individual would, in most cases, only "look back" six months at an employee's political contributions to determine whether any contributions would preclude doing business with a covered governmental entity, and not the originally proposed two years. However, the shortened six-month "look back" is not available

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7 Municipal Securities Rulemaking Board, Rule G-37, *available at* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx?tab=1.

8 Rule 206(4)-5(a)(1).

9 Rule 206(4)-5(f)(6).

10 *See* Release at Section II.B.2.(a)(1).

11 *See id.*

for an employee who, after becoming a covered associate, solicits clients for the investment adviser.[12]

In the Release, the SEC points out that "to prevent advisers from channeling contributions through departing employees," advisers must also "look forward" so that an employer of a covered associate at the time of the covered associate's contribution would continue to be subject to the prohibitions in the Rule for two years thereafter, whether or not the covered associate remains a covered associate or an employee of the firm. So dismissing a covered associate who made a contribution triggering the Rule would not relieve the adviser of the two-year "time out."[13]

The Rule provides *de minimis* exceptions from the "time out" provision for contributions by covered associates of up to $350 to any one official per election if the contributor is entitled to vote for the official, and of up to $150 to any one official per election if the contributor is not entitled to vote for the official.[14] The Rule also excepts other contributions of $350 or less if they are returned to the donor under certain circumstances, and grants the SEC the authority to issue orders exempting advisers from the two-year compensation ban under certain circumstances.

Under the Rule, an investment adviser to a "covered investment pool"[15] in which a government entity invests or is solicited to invest is treated as providing or seeking to provide investment advisory services to the government entity. Thus, a contribution by such an adviser in violation of the Rule would trigger the two-year "time out" provision and the adviser would not be able to receive an advisory fee from the government entity with respect to the covered investment pool. In addressing concerns raised in several comment letters and consistent with the treatment of government entities whose assets are directly managed by the adviser as discussed above, the Release notes that the adviser may have multiple options available to comply with the Rule in light of its fiduciary duties and disclosure to investors. For instance, the adviser could seek to cause the pool to redeem the investment of the government entity. For less liquid pools, such as venture capital and private equity funds, or in other instances where the government entity is not redeemed, the adviser may waive or rebate a portion of its fees attributable to the government

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12 Rule 206(4)-5(b)(2).

13 See footnote 206 of the Release at Section II.B.2.(a)(5).

14 A person is entitled to vote for an official if the person's principal residence is in the locality in which the official seeks election. *See* Release at Section II.B.2.(a)(6). The *de minimis* exception of the original proposal was up to $250 an election per candidate if the contributor was entitled to vote for the candidate, and there was no *de minimis* exception for a contribution to a candidate if the person was not entitled to vote for the candidate.

15 Rule 206(4)-5(f)(3) defines a "covered investment pool" as an investment company as defined in section 3(a) of the Investment Company Act of 1940, and any company exempted from section 3(a) by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act. A "covered investment pool" is also any registered pooled investment vehicle, such as a mutual fund, but only if the pool is an investment option of a participant-directed plan or program of a government entity such as a 529, 403(b) or 457 plan.

entity client.[16] Commenters also voiced concerns relating to contributions made by an adviser to underlying tiers within a multi-tiered product, such as a fund of funds, and whether the contribution would implicate the adviser to the top tier. The Release clarifies that the two-year "time out" would not apply to the adviser to the top tier, unless the arrangement were a means to do indirectly what the adviser could not do directly under the Rule.[17]

Third-Party Solicitor Restrictions

The SEC backed away from its proposal for a blanket ban on the hiring of a third party, such as a placement agent, solicitor or other intermediary, to solicit investment advisory business from government entities. The Rule instead permits the use of a third party that is a "regulated person," which is a term defined to include certain SEC-registered broker-dealers and SEC-registered investment advisers.[18]

An SEC-registered broker-dealer is a regulated person if the broker-dealer is a member of a national securities association subject to pay-to-play restrictions that the SEC, by order, finds to be substantially equivalent to or more stringent than Rule 206(4)-5. At the SEC open meeting last week adopting the Rule, Andrew (Buddy) Donohue, the Director of the SEC's Division of Investment Management, said that the Financial Industry Regulatory Authority, Inc.[19] intends to adopt pay-to-play regulations "at least as stringent" as Rule 206(4)-5. An SEC-registered investment adviser is a regulated person if, within two years of soliciting a government entity, the adviser has not made contributions to the government entity, its covered associates have not made contributions that exceed the *de minimis* amounts allowed under the "time out" provision, and the adviser and its covered associates have not violated the prohibition on soliciting or coordinating contributions.

Prohibition on Soliciting or Coordinating Contributions

In order to prevent indirect pay-to-play contributions, the Rule also prohibits an investment adviser and its covered associates from soliciting or coordinating contributions from any person or PAC for an official of a government entity, such as by "bundling" a large number of small employee contributions to influence an election.[20] The Rule also prohibits soliciting of contributions from others or coordinating payments to a political party of a state or locality.[21]

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16 *See* Release at Section II.B.2.(e)(2).

17 *See* Release at Section II.B.2.(e)(3).

18 Rule 206(4)-5(f)(9).

19 FINRA regulates the activities of most registered broker-dealers.

20 Rule 206(4)-5(a)(2)(ii) and Release at Section II.B.2.(c).

21 *Id.*

New Recordkeeping Requirements

The SEC adopted amendments to Rule 204-2, which sets out recordkeeping requirements for all investment advisers registered with the SEC under the Advisers Act. SEC-registered investment advisers that have government entity clients or provide investment advisory services to a covered investment pool in which a government entity invests must maintain records of contributions made by the adviser and covered associates to government officials and payments to state or local political parties and PACs.[22] The recordkeeping requirements encompass payments that do not themselves trigger the application of the two-year "time out," in part due to SEC concerns that contributions to political parties or PACs could be used by advisers to indirectly funnel contributions.[23]

The adviser must also maintain a list of its covered associates and of government entities to which the adviser has provided advisory services in the past five years. An investment adviser to a covered investment pool must maintain a list of government entity investors if the investments are made as part of a plan or program of a government entity. An investment adviser must keep a list of names and business addresses of each regulated person that it pays or agrees to pay for soliciting government entities for investment advisory services, whether or not it currently has any government clients.

Catch-All Provision

The Rule provides that an investment adviser and its covered associates cannot do indirectly anything they would be prohibited by the Rule from doing directly.[24] For example, an adviser could not funnel contributions through third parties such as consultants, family members, friends or companies affiliated with the adviser to circumvent the Rule's restrictions on contributions. However, without a showing of intent to circumvent the Rule, contributions by these other third parties would not trigger the two-year "time out" provision.[25]

Conclusion

Absent any successful challenge to the Rule on First Amendment grounds, compliance with the Rule will be required in early 2011. Investment advisers are encouraged to consider their existing policies and procedures regarding political contributions and use of placement agents.

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22 Rule 204-2(a)(1)(18).

23 *See* Release at Section II.D.

24 Rule 206(4)-5(d).

25 *See* Release at Section II.B.2.(d).

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