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Investment Advisers Subject to New SEC Pay-to-Play Restrictions

On June 30, 2010, the United States Securities and Exchange Commission (the SEC) approved by a unanimous vote a new rule to curb so-called "pay-to-play" practices.

"Pay-to-play" generally refers to instances in which individuals make campaign contributions to officeholders who are in a position to award government contracts or other opportunities to the donor or the donor's business enterprise. In this specific instance, pay-to-play involves instances in which investment advisers make campaign contributions to elected officials in order to influence the award of contracts for the management of public pension plan assets and similar government investment accounts.

New Rule 206(4)-5 (the Rule) applies to registered investment advisers and certain advisers exempt from registration. In particular, it applies to any investment adviser registered (or required to be registered) with the SEC, or unregistered in reliance on the exemption available under section 203(b)(3) of the Investment Advisers Act of 1940 (the Advisers Act).[i] According to the SEC, the Rule would not apply to most small advisers that are registered with state securities authorities instead of the SEC, or advisers that are unregistered in reliance on exemptions other than section 203(b)(3) of the Advisers Act.

In addition, the Rule, where indicated, applies to "covered associates" of investment advisers. These are defined as (a) any general partner, managing member or executive officer or other individual with a similar status or function; (b) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (c) any political action committee (PAC) controlled by the investment adviser or by any of its covered associates.

The Rule, adopted under the Advisers Act and modeled after similar Municipal Securities Rulemaking Board (MSRB) rules, includes the following provisions:

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- **Two-Year Time Out**. The Rule makes it unlawful for an adviser to ***receive compensation*** for advisory services to a government entity for a two-year period after the adviser or any of its covered associates makes a political contribution to a public official of a government entity or candidate for such office who is or will be in a position to influence the award of advisory business.

  Note that the Rule does not require a government entity's withdrawal of its investment or cancellation of any commitment it has made. The Rule permits advisers to provide advice subsequent to a triggering political contribution but prohibits them from receiving compensation for that advice.

  - **Look Back/Look Forward.** The Rule attributes to an adviser contributions made by a person within two years of becoming a covered associate of that adviser. That is, when an employee becomes a covered associate, the adviser must look back in time and examine his or her prior contributions to determine whether the time out applies to the adviser. The SEC clarifies this concept with the following example:

    - *If a covered associate made a contribution more than two years prior to the employee becoming a covered associate, the time out has run; if the contribution was made less than two years from the time the person became a covered associate, the Rule prohibits the adviser that hires or promotes the contributing covered associate from receiving compensation for providing advisory services from the hiring or promotion date until the two-year period has run.*

    An exception exists to this look back requirement: The two-year look back does not apply to those contributions made by a natural person more than six months prior to becoming a covered associate of the investment adviser unless such person, after becoming a covered associate, solicits clients on behalf of the investment adviser.

    In addition, a look forward requirement applies as well. In order to prevent an adviser from channeling contributions through departing employees, an adviser must look forward with respect to covered associates who cease to qualify as covered associates or leave the firm. The covered associate's employer at the time of the contribution would be subject to the Rule's prohibition for the entire two-year period, regardless of whether the covered associate remains one or remains employed by the adviser.

What Types of Contributions Are Involved?

A "contribution" is defined to include a gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such an election. It also includes transition or inaugural expenses incurred by a successful candidate for state or local office.

A donation of time by an individual is not a contribution, provided the adviser has not solicited the individual's efforts and the adviser's resources, such as office space and telephones, are not used. Similarly, the SEC does not consider a charitable donation made by an investment adviser to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code, or

its equivalent in another jurisdiction, at the request of an official of a government entity, to be a contribution for purposes of the Rule.

Contributions to political action committees or local political parties, that is, committees independent of elected officials, are not considered contributions for purposes of the time out provision of the Rule. However, they may violate the provision of the Rule which prohibits an adviser or any of its covered associates from indirect actions that would result in a violation of the Rule if done directly, for example, if the contributions are earmarked or known to be provided for the benefit of a particular political official.

- **De Minimis Exceptions**. The Rule permits individuals to make aggregate contributions without triggering the two-year time out of up to $350 per election to an elected official or candidate for whom the individual is entitled to vote, and up to $150 per election to an elected official or candidate for whom the individual is not. These exceptions are available only for contributions by individual covered associates, not the investment adviser itself. Primary and general elections are considered separate elections.
- **Exception for Certain Returned Contributions**. The Rule provides an adviser with the ability to cure the consequences of an inadvertent political contribution to an official for whom a covered associate making it is not entitled to vote. This exception applies to contributions that, in the aggregate, do not exceed $350 to any one official, per election. The adviser must have discovered the contribution which triggered the prohibition within four months of the date of the contribution and, within 60 days after learning of the triggering contribution, the contributor must obtain the return of the contribution. Further, the Rule limits an adviser's reliance on this exception to no more than two or three per 12-month period, depending on the size of the adviser, and no more than once for each covered associate, regardless of the time period.
- **Exemption Order.** An adviser may apply to the SEC for an order exempting it from application of the two-year ban. Under this provision, the SEC can exempt advisers from the time out requirement where the adviser discovers triggering contributions only after they have been made, and when imposition of the prohibition is unnecessary to achieve the Rule's intended purpose. In determining whether to grant an exemption, the SEC will take into account the varying facts and circumstances that each applicant presents and will consider additional factors, including, for example, whether the investment adviser has adopted and implemented policies and procedures reasonably designed to prevent violation of the Rule, including whether the adviser had a training and compliance program in place. *See* "Recommended Actions for Compliance", below.

- **Third Parties**. Advisers are prohibited from paying third parties to solicit government entities for advisory business, unless such third parties are registered broker-dealers or registered investment advisers ("regulated persons") and subject to pay-to-play restrictions as well.
- **Bundling**. Advisers are prohibited from soliciting or coordinating (a) contributions to an official of a government entity to which the investment adviser is seeking to provide investment advisory services; or

(b) 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.

- **Indirect Violations**. The Rule prohibits an adviser or any of its covered associates from doing anything indirectly which, if done directly, would result in a violation of the Rule.
- **Pooled Investments**. An investment adviser to certain pooled investment vehicles in which a government entity invests or is solicited to invest will be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity. This provision will generally apply to two common types of arrangements: (a) the investment of public funds in a hedge fund or other type of pooled investment vehicle; or (b) the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a "529 plan."

Recordkeeping

The SEC also adopted amendments to Rule 204-2 of the Advisers Act to require registered investment advisers that have government clients, or that provide investment advisory services to a covered investment pool in which a government entity investor invests, to make and keep certain records that will allow the SEC to examine for compliance with the Rule. The following is required:

- Registered advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government entity is an investor, must make and keep records of contributions made by the adviser and covered associates to government officials (including candidates), and of payments to state or local political parties and PACs;
    - The records of contributions and payments must be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment and whether a contribution was subject to the Rule's exception for certain returned contributions;
- An adviser that has government clients must make and keep a list of covered associates and the government entities to which the adviser has provided advisory services in the past five years;
- Advisers to covered investment pools must make and keep a list of government entities that invest, or have invested in the past five years, in a covered investment pool, including any government entity that selects a covered investment pool to be an option of a plan or program of a government entity, such as a 529, 457 or 403(b) plan;
- An investment adviser, regardless of whether it currently has a government client, must also keep a list of the names and business addresses of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity on its behalf.

Technical Amendment to Cash Solicitation Rule

Finally, the SEC adopted a technical amendment to Rule 206(4)-3 under the Advisers Act, the "cash solicitation rule." Rule 206(4)-3 makes it unlawful, except under specified circumstances and subject to

certain conditions, for an investment adviser to make a cash payment to a person who directly or indirectly solicits any client for, or refers any client to, an investment adviser.

Paragraph (iii) of the cash solicitation rule contains general restrictions on third-party solicitors that cover solicitation activities directed at any client, regardless of whether it is a government entity client. New paragraph (e) to Rule 206(4)-3 alerts advisers and others that special prohibitions apply to solicitation activities involving government entity clients under new Rule 206(4)-5.

Key Dates

- Effective Date. September 13, 2010.
- Compliance Dates.
  - Investment advisers subject to the Rule must be in compliance on March 14, 2011.
  - Investment advisers may no longer use third parties to solicit government business except in compliance with the Rule on September 13, 2011.
  - Advisers to registered investment companies that are covered investment pools must comply with the Rule by September 13, 2011.
  - Advisers subject to Rule 204-2 must comply with amended Rule 204-2 on March 14, 2011. Note, however, if they advise registered investment companies that are covered investment pools, they have until September 13, 2011, to comply with the amended recordkeeping rule with respect to those registered investment companies.

Recommended Actions for Compliance

Due to the complexity of these changes, we recommend that investment advisers establish a program in order to ensure compliance as soon as possible. Firm policies and procedures should be developed to ensure a thorough understanding of the requirements of the Rule, as well as the consequences for non-compliance. A system for identifying covered personnel should be developed and each should be informed of their status. Training should be provided to these relevant officers and employees. A program for tracking and monitoring political contributions by covered associates, including contributions made pre- and post-employment in a position with solicitation responsibilities, should be developed. Finally, a program that enables the investment adviser to readily collect, maintain and report the information required of the amended recordkeeping rules must be put in place.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.

[i] The Advisers Act sets forth the following key definitions:

> "**Investment adviser**" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 [12 U.S.C. § 1841 *et seq*.] which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934 [15 U.S.C. § 78c(a)(12)], as exempted securities for the purposes of that Act [15 U.S.C.§ 78a *et seq*.]; (F) any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 [15 U.S.C. § 78c(a)(62)], unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others; or (G) such other persons not within the intent of this paragraph, as the [SEC] may designate by rules and regulations or order. 15 U.S.C. § 80b-2(11)(emphasis added).
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> "**Person**" means a natural person or a company. 15 U.S.C. § 80b-2(16)(emphasis added).
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> The term "**person associated with an investment adviser**" means any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, except that for the purposes of section 80b–3 of this title (other than subsection (f) thereof), persons associated with an investment adviser whose functions are clerical or ministerial shall not be included in the meaning of such term. The [SEC] may by rules and regulations classify, for the purposes of any portion of portions of this subchapter, persons, including employees controlled by an investment adviser. 15 U.S.C. § 80b-2(17)(emphasis added).