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SEC Proposes Prohibitions Against Investment Adviser Pay-to-Play Practices

The SEC is seeking to curb perceived abuses in the management of public pension funds and other government pools of money by essentially restricting political contributions made by investment advisers to certain political officials and prohibiting the use of third parties, such as solicitors and placement agents, to gain access to decision makers. The SEC has proposed a rule under the Investment Advisers Act of 1940 which would address these "pay-to-play" practices. The rule, Rule 206(4)-5, would apply to investment advisers that are registered under the Investment Advisers Act and those exempt from registration that have fewer than fifteen clients and do not hold themselves out to the public as investment advisers, the so-called private investment advisers. The rule would not apply to most state-registered investment advisers.

Pay-to-Play Practices

Pay-to-play practices, which seek ways to gain access to, and receive lucrative business from, government entities, may take a variety of forms, including an adviser's direct contributions to government officials, an adviser's solicitation of third parties to make contributions or payments to government officials or political parties in the state or locality where the adviser seeks to provide services, or an adviser's payments to third parties to solicit (or as a condition of obtaining) government business.

Proposed Rule

The proposed rule would take three approaches to address pay-to-play practices:

- **Making Political Contributions.** The proposed rule would make it unlawful for an adviser to receive compensation for providing advisory services to a government entity for a two-year period after the adviser or any of its "covered associates" (the adviser's general partners, managing members, executive officers, or other individuals with a similar status or function) makes a political contribution (any gift, subscription, loan, advance, deposit of money, or anything of value) to a public official of a government entity that is in a position to influence the award of advisory business. The proposing release points out that the proposed rule does not ban or limit the amount of political contributions an adviser or its covered associates may make; rather, it would impose a two-year "time out" on conducting compensated advisory business with a government client after a contribution is made. (The adviser could continue to provide uncompensated services and may be required to provide uncompensated services for a reasonable time to allow for a smooth transition.) To limit advisers' ability to circumvent the rule, this two-year "time out" would apply

Questions or Assistance?

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even if the contributor has left the advisory firm, and it follows new hires that have previously made contributions as they change firms. The proposed rule would also allow individual covered associates to make *de minimis* contributions of up to $250 per candidate for each primary and general election campaign (for a total of $500) if the person would otherwise be entitled to vote for the candidate.

- **Arranging Political Contributions.** The proposed rule would make it unlawful for an adviser itself or through any of its covered associates to solicit or to coordinate contributions for an official of a government entity to which the investment adviser is seeking to provide investment advisory services, or 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.

- **Using Paid Solicitors.** The proposed rule would prohibit advisers from paying third parties (solicitors, finders and placement agents) to solicit government entities for advisory business.

Government Investments in Covered Investment Pools

The proposed rule would also generally apply to investment advisers that manage a "covered investment pool," in which the investment adviser seeks to have the government entity invest, and would constrain their pay-to-play practices as described above. The proposed rule would generally define "covered investment pool" as: (i) any investment company as defined in section 3(a) of the Investment Company Act of 1940; or (ii) any company that would be an investment company under section 3(a) of that Act but for the exclusions provided from that definition by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act. The companies referred to in those exclusions are private investment funds and collective investment trusts, which can serve as funding vehicles for, or investments of, government-sponsored savings plans, such as college savings plans (529 plans) and retirement plans (403(b) plans and 457 plans). Not only would the constraints apply to contributions prior to a government entity's investment in the covered investment pool, they would apply to contributions made while the government entity is an existing investor in the pool such that the investment adviser would have to forgo any compensation related to the assets invested or committed by that government entity if such a contribution occurred. Therefore, constant vigilance would be in order.

Record-Keeping Requirements

The SEC is also proposing amendments to Rule 204-2 of the Investment Advisers Act to require an investment adviser that is registered or required to be registered with the SEC and (i) has or seeks government clients or (ii) provides investment advisory services to a covered investment pool in which a government entity investor invests or is solicited to invest to make and keep certain records about covered associates, government clients, and contributions made by the adviser and its covered associates so that the SEC has a basis for determining compliance with Rule 206(4)-5, if adopted, in examinations the SEC may conduct.

Comments

The proposing release poses a number of questions about the appropriate scope and parameters of all facets of the rule, inviting comments. So far, most of the comments received by the SEC take issue with the proposed rule. The comment period runs through October 6, 2009.

History

Similar rules were proposed in 1999 but did not result in final rules. Portions of the currently proposed rules are modeled 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. These MSRB rules have withstood constitutional challenges. The proposing release points out a number of times that the proposed rule is narrowly crafted to address the perceived abuses, surely in an attempt to respond to various criticisms leveled at the 1999 proposal and likely to be raised again that the proposed rule violates First Amendment protections for free speech and rights of association.

Final Rule

Given various recent and not so recent scandals involving public pension funds in New York and Connecticut, among other places, and related criminal prosecutions and civil enforcement actions, the time may be ripe for SEC rulemaking in this area, but we will have to stay tuned for the formulation of any final rules.

For more information, please contact Donna Brooks at (860) 251-5917 or dbrooks@goodwin.com or Peter Bilfield at (203) 324-8151 or pbilfield@goodwin.com.

To view the full proposing release, see: http://www.sec.gov/rules/proposed/2009/ia-2910.pdf.

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