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SEC Adopts Prohibitions Against Investment Adviser Pay-To-Play Practices

Questions or Assistance?

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The Securities and Exchange Commission (SEC) has adopted final rules under the Investment Advisers Act of 1940 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 unregulated third parties, such as unregistered solicitors and placement agents, to gain access to decision makers in the public money management arena, so-called "pay-to-play" practices. As adopted, Rule 206(4)-5 under the Investment Advisers Act applies to investment advisers that are registered (or required to be 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. (This private adviser exemption, however, has been eliminated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.) 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.

Final Rule

The final rule would take three approaches to eliminate pay-to-play practices:

- **Making Political Contributions.** Beginning March 2011, the final rule would make it unlawful for an adviser to receive compensation (e.g., carried interest or management fees) for providing 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 who is in a position to influence the award of advisory business or has authority to appoint a person who can award such business.
    - "Covered associates" include
        - the investment adviser's general partners, managing members, executive officers and other individuals with a similar status or function;
        - any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and

- any political action committee controlled by the investment adviser or by other covered associates.

- "Contributions" include any gift, subscription, loan, advance, deposit of money, or anything of value.

The proposing and final releases point 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 imposes 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 even if the contributor has left the advisory firm, and it follows new hires that have previously made contributions as they change firms as well as employees of the adviser that were not covered associates at the time they made the contribution but become covered associates later due to a promotion or otherwise. If an adviser does not do business with government entities, none of the prohibitions would apply.

De Minimis Contributions. The final rule, differing somewhat from the proposed rule, would also allow individual covered associates (but not the investment adviser itself) to make *de minimis* contributions of up to $350 per candidate for each primary and general election campaign (for a total of $700) if the covered associate would otherwise be entitled to vote for the candidate and also allows individual covered associates to make contributions of up to $150 per candidate for each primary and general election campaign (for a total of $300) if the covered associate is not entitled to vote for the candidate.

- **Arranging Political Contributions ("Bundling").** Beginning March 2011, the final rule, substantially following the proposed rule, would make it unlawful for an adviser itself or through any of its covered associates to solicit or to coordinate contributions (from third parties such as attorneys, family members, friends, etc.) 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.

- **Restricting the Use of Paid Solicitors.** The proposed rule would have prohibited advisers from paying third parties (solicitors, finders and placement agents) to solicit government entities for advisory business. The final rule backed off of that absolute prohibition so that, beginning September 2011, investment advisors may only use "regulated" third parties which are themselves SEC registered investment advisers and in compliance with the rule (i.e., the two-year "time out" will apply if the solicitor has made an improper contribution) or registered broker-dealers subject to similar "pay-to-play" rules adopted by the final rule. The Financial Industry Regulatory Authority (FINRA) is in the process of proposing similar pay-to-play prohibitions that would apply to broker-dealers.

Government Investments in Covered Investment Pools

The final 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

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invest, and would constrain their pay-to-play practices as described above. The final rule defines "covered investment pool" as: (i) any investment company registered under the Investment Company Act of 1940 that is an investment option of a plan or program of a government entity that is participant-directed (the qualifier acting to narrow the proposed rule); or (ii) any company that would be an investment company under section 3(a) of the Investment Company Act but for the exclusions provided from that definition by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of the Investment Company Act. The companies referred to in those exclusions are private investment funds (including hedge funds, private equity funds and venture capital 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 do the constraints apply to contributions prior to a government entity's investment in the covered investment pool, they 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 will be in order, especially for private investment funds where unwinding an investment by a government entity may not be feasible, resulting in the fund's adviser and general partner having to forgo management fees and carried interest with respect to the investment of the government entity.

Penalties

Violations of the bundling prohibitions and the use of unregistered placement agents or solicitors by an investment adviser or its covered associates could result in an administrative action, including penalties, as well as disclosure of the violation to clients. In addition to the two-year time-out and related compensation forfeiture, a violation of the political contribution restrictions could result in a similar administrative action against the investment adviser or its covered associates, especially if the violation is intentional and/or continuous.

Record-Keeping Requirements

The SEC also adopted amendments to Rule 204-2 of the Investment Advisers Act. The revised rule requires an investment adviser that is required to be registered with the SEC and that provides investment advisory services to a government entity or to any covered investment pool in which a government entity is an investor to make and keep certain records about covered associates, government clients, and contributions made by the adviser and its covered associates. These records will provide the SEC with a basis for determining compliance with Rule 206(4)-5 in examinations that it may conduct.

Exemption Process

Rule 206(4)-5 does provide a mechanism for an adviser to apply to the SEC for an order exempting it from the two-year compensation ban. The SEC can exempt advisers from the rule's time out requirement where the adviser discovers contributions that trigger the compensation ban only after they have been made, and when imposition of the prohibition is unnecessary to achieve the rule's intended purpose. The SEC will use a facts and circumstances analysis to determine the appropriateness of granting an exemption. The SEC will likely consider the adviser's policies and procedures and its compliance with those policies and procedures and what remedial and preventive steps it has taken to address the issue at hand.

Compliance Dates

The effective date for the final rules is **September 13, 2010** (60 days after they were published in the Federal Register). Investment advisers subject to Rule 206(4)-5 must be in compliance with the rule 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.** This delayed effectiveness was designed both to give the industry time to adjust to the new rules and to give FINRA time to enact a similar rule with pay-to-play prohibitions that would apply to broker-dealers. Advisers to registered investment companies that are covered investment pools must comply with the rule by **September 13, 2011** (advisers to other covered investment pools must comply on **March 14, 2011**). Advisers subject to the Rule 204-2 record-keeping requirements must comply with amended Rule 204-2 on **March 14, 2011**. However, if they advise registered investment companies that are covered investment pools, they have until **September 13, 2011** to comply with the amended record-keeping rule with respect to those registered investment companies.

Constitutional Challenges

Portions of the final 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 and adopting releases point out a number of times that the final rule is narrowly crafted to address the perceived abuses, surely in an attempt to stave off constitutional challenges which may be raised that the rule violates First Amendment protections for free speech and rights of association. We will have to stay tuned to see if there are any challenges to the new rules.

In the meanwhile, private investment advisers would be well advised to begin implementation of policies and procedures to ensure their compliance with the pay-to-play restrictions. Registered investment advisers should revisit their compliance policies to make sure that they have procedures in place which will assure compliance with the rules so that they do not run the risk of losing clients that are government entities and the business revenue those clients generate.

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To view the full adopting release, see http://www.sec.gov/rules/final/2010/ia-3043.pdf.

To view our previous article on the proposed rules, see http:www.shipmangoodwin.com/files/upload/PayToPlayProposal.pdf.

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

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