SEC Adopts “Pay-to-Play” Rule for Investment Advisers

Introduction

The Securities and Exchange Commission (“SEC”) on June 30, 2010 unanimously voted to adopt a new rule under the Investment Advisers Act of 1940 (“Advisers Act”) that is designed to prevent political contributions to certain persons who may improperly influence investment selection decisions of public pension funds and other government entities.1

The new rule, Rule 206(4)-5 under the Advisers Act (“Rule”), narrowly limits political contributions by investment advisers and their employees. Failure to comply with the Rule will result in lost advisory fees and foreclose business opportunities with governmental entities. The Rule will become effective on September 13, 2010. However, depending upon the nature of their services, advisers will have until either March 14, 2011 or September 13, 2011, respectively, to come into compliance. At that time, advisers should have appropriate compliance policies in place.

Executive Summary

The Rule will prohibit:

- any adviser2 from providing advisory services for compensation to a “government entity” within two years following a “contribution” to an “official” of the government entity by the adviser or its “covered associates.”
- any adviser or its covered associates from making or agreeing to make (directly or indirectly) a “payment” to any person for soliciting advisory business from a government entity, unless the person is either (1) an adviser subject to the limits under the Rule, or a registered broker-dealer; or (2) an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the adviser.
- any adviser or its covered associates from coordinating or soliciting any (1) contribution to an official of a government entity to which the adviser is providing or seeking to provide advisory services or (2) payment to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity.

The SEC also adopted rule amendments that require a registered adviser to maintain certain records regarding the political contributions made by the adviser and its covered associates.

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2 The Rule applies to advisers registered (or required to be registered) with the SEC, as well as advisers currently exempt from registration in reliance on the exemption available under Section 203(b)(3) of the Advisers Act. See Rule 206(4)-5(a)(1) and (2). Section 203(b)(3) currently exempts from registration any adviser that has had fewer than 15 clients during the last 12 months and does not (i) hold itself out as providing advisory services or (ii) provide advisory services to a registered investment company or business development company. State registered advisers are not subject to the Rule.
Background

The SEC’s decision to adopt the Rule was, in large part, due to a number of high-profile investigations and criminal and civil actions conducted by law enforcement authorities in New York, New Mexico, Illinois, Ohio, Connecticut, and Florida, as well as the SEC itself, involving the alleged payment of kickbacks by advisers seeking mandates from state pension and retirement funds.3

Many of the most significant elements of the Rule are based directly on the provisions of Municipal Securities Rulemaking Board (“MSRB”) Rules G-37 and G-38 (“MSRB Rules”), and both the MSRB Rules and the MSRB’s interpretations of the MSRB Rules are cited extensively in the Proposing and Adopting Releases. To the extent the Rule or Adopting Release are unclear, the MSRB Rules and the MSRB’s interpretations of the MSRB Rules may provide additional guidance.

Two-Year “Time Out” for Impermissible Contributions

General Provisions of the Final Rule

The Rule prohibits any adviser from providing advisory services for compensation to a “government entity”4 within two years after a “contribution” to an “official”5 of the government entity by the adviser or its “covered associates.” The SEC refers to such period as a “time out.”

Covered Associates and Executive Officers

The Rule limits contributions by an adviser and its covered associates. The Rule defines the term “covered associate” as (1) a general partner, managing member or “executive officer” of the adviser (or a person with a similar status or function); (2) an employee who solicits a government entity on behalf of the adviser and any direct or indirect supervisor of the employee; and (3) a political action committee (“PAC”) controlled by the adviser or a person described in (1) or (2) above.6 Furthermore, the term “executive officer” is defined as (1) the president; (2) a vice president in charge of a principal business unit, division or function (e.g., sales, administration or finance); (3) any other officer of the adviser who performs a policy-making function; or (4) any other person who performs similar policy-making functions for the adviser.7

While the Rule appears straightforward, in larger advisory firms determining which individuals within the organization are covered associates is likely to be a complex task. Careful analysis of the individuals that may be deemed covered associates under the Rule will be necessary to prevent potential violations of the ban on contributions to officials and to comply with the Rule’s additional recordkeeping requirements.

Direct and Indirect Contributions

The term “contribution” is broadly defined under the Rule to include “any gift, subscription, loan, advance, or deposit of money or anything of value” for the purpose of influencing a federal, state or local office election.8 The


4 The Rule defines the term “government entity” as “any state or political subdivision of a state, including: (i) any agency, authority, or instrumentality of the state or political subdivision; (ii) a pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a ‘defined benefit plan’... or a state general fund; (iii) a plan or program of a government entity; and (iv) officers, agents, or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.” See Rule 206(4)-5(f)(5).

5 The Rule defines the term “official” as “any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.” See Rule 206(4)-5(f)(6).

6 See Rule 206(4)-5(f)(2). The definition of covered associate was intended to capture “officers and employees of the [adviser] who have a direct economic stake in the business relationship with the government client.” See Adopting Release, at Section II.B.2(a)(4).


8 See Rule 206(4)-5(f)(1). The term “contribution” is broadly defined. A general discussion of the term and some of the potential compliance challenges that advisers may face are discussed in an article by Edward Pittman and Brenden Carroll of this firm. See Edward L. Pittman & Brenden P. Carroll, “Pay-to-Play” in the Financial Services Industry, 42 SEC. REG. & L. REP. (BNA) No. 19, at 921 (May 10, 2010), available at www.dechert.com/library/"pay_to_play_in_the_financial_service_industry_Pittman_Carroll_5-2010.pdf

Rule also views a contribution as the payment of campaign debt and any transitional or inaugural expenses of a successful candidate for state and local office. With respect to volunteer activity, the SEC stated in the Adopting Release that it “would not consider a donation of time by an individual to be 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.”9 The SEC further noted in the Adopting Release that it would 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 a foreign jurisdiction, at the request of an official of a government entity, to be a contribution for purposes of the Rule.

The Rule also prohibits acts done indirectly which, if done directly, would result in a violation of the Rule.10 The prohibition is designed to prevent an adviser and its covered associates from circumventing the Rule by directing or funding contributions through third parties, including “consultants, attorneys, family members, friends or companies affiliated with the adviser.”

Official

The restrictions on contributions under the Rule apply to any contribution made to a state or local elected official, or candidate, whose public office would offer him the ability to directly or indirectly influence the outcome of the hiring of advisers by a government entity, or the ability to appoint any person who, directly or indirectly, could influence the hiring of advisers by a government entity.11 For example, an impermissible contribution to the governor of a state may prohibit the adviser from doing business with a public pension fund that is subject to oversight by a board with a member appointed by the governor. While the focus of the Rule is primarily on state and local entities, contributions to a federal campaign also are included if the candidate for federal office currently is an official of a state or local government entity.

Covered Advisory Services

The types of advisory services covered by the Rule are very broad and include traditional money management services; consulting services offered to public pension plans; and management of “covered investment pools.” The Rule defines the term “covered investment pool” to include hedge funds, private equity funds, venture capital funds and collective investment trusts, as well as investment companies registered under the Investment Company Act of 1940 (“1940 Act”) that are “an investment option of a plan or program of a government entity”12 (e.g., college savings plans (“529 plans”) and retirement plans (“403(b) plans”)) or (2) any company that would be an investment company under Section 3(a) of the 1940 Act but for the exclusions in Sections 3(c)(1), 3(c)(7) and 3(c)(11).13

The SEC makes clear in the Adopting Release that a registered investment company would be considered a “covered investment pool” only if the investment company has “been pre-selected by the government sponsoring or establishing the plan or program as part of a limited menu of investment options from which participants in the plan or program may allocate their account.”14 In other words, only if a registered investment company is an investment option for a participant-directed plan of a government entity, would such fund be covered by the Rule. The Adopting Release notes that narrowing the Rule in this way “strikes the right balance” in guarding against situations where there is potential for abuse, while “recognizing the compliance challenges relating to identifying government investors in registered investment companies that may result from a broader application of the Rule.”15

Two-Year “Look Back”

The contribution prohibitions in the Rule apply to contributions made by an adviser and its covered

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9 See Adopting Release, at Section II.B.2(a)(3). However, the donation of a covered associate’s time may be considered a contribution if, among other things, the volunteer activity occurred during work hours for which the individual was paid by the adviser.

10 See Rule 206(4)-5(d).


12 The phrase “plan or program of a government entity” means “any participant-directed investment program or plan sponsored or established by a state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to, a ‘qualified tuition plan’ authorized by section 529 of the Internal Revenue Code ..., a retirement plan authorized by section 403(b) or 457 of the Internal Revenue Code ..., or any similar program or plan.” See Rule 206(4)-5(f)(8) (emphasis added).

13 See Adopting Release, at Section II.B.2(e)(1).

14 Id.

15 Id.
associates over the prior two years (or, in some cases, six months), regardless of whether the covered associate is currently an associated person of the adviser, or whether the covered associate was an associated person of the adviser at the time the contribution was made.

For example, if an adviser hires a new covered associate, any contributions made by such person (i.e., the new covered associate) to an “official” during the prior two years will be attributed to the adviser. Similarly, if a person within the adviser’s organization is promoted and becomes a covered associate, any contributions made by such person to an “official” during the prior two years will also be attributed to the adviser. However, under the Rule, an adviser is only required to “look-back” at an individual’s contributions for the prior six months, unless the individual, after becoming a covered associate of the adviser, solicits government entities on behalf of the adviser.16

In each case, the contributions made by a person who (1) wasn’t a covered associate of the adviser at the time of the contribution (but currently is a covered associate of the adviser) or (2) is no longer a covered associate of the adviser (but was a covered associate at the time of the contribution), could have a material effect on the services the adviser offers to government entities.

“For Compensation”

A violation of the Rule occurs only if the adviser provides services “for compensation” after an impermissible political contribution has been made to an official. Thus, if an impermissible contribution is made, to avoid a violation of the Rule, the adviser may (1) resign from any engagement by the relevant government entity or (2) continue to provide services to an existing client, but forego any compensation.17 The SEC made clear that it believes that an adviser’s fiduciary duty may require it to provide uncompensated services “for a reasonable period of time” following an impermissible contribution.18

This provision of the Rule may present challenges, particularly in the context of structured products. The SEC specifically acknowledged in the Adopting Release some of the concerns of commenters.19 For example, in the context of registered investment companies with many different investors, the SEC stated that an adviser may continue to provide services to the government entity, and either rebate the portion of the advisory fees attributable to the government entity among all investors, or to the government entity directly.20

Another issue considered by the SEC was the use of sub-advisory and fund of funds arrangements. The Adopting Release provides guidance with respect to such arrangements:

First, by the terms of the rule, if an adviser or sub-adviser makes a contribution that triggers the two-year time out from receiving compensation, the sub-adviser or adviser, as applicable, that did not make the triggering contribution could continue to receive compensation from the government entity, unless the arrangement were a means to do indirectly what the adviser or sub-adviser could not do directly under the rule. Second, advisers to underlying funds in a fund of funds arrangement are not required to look through the investing fund to determine whether a government entity is an investor in the investing fund unless the investment were made in that manner as a means for the adviser to do indirectly what it could not do directly under the rule.21

Exceptions and Exemptions

The Rule contains two exceptions from the two-year time out and a provision under which an adviser may apply to the SEC for an order exempting the adviser from the two-year time out.

- **De Minimis** – The Rule permits covered persons to make contributions of up to $350, per election, to an official for whom the covered person is entitled to vote, as well as $150, per election, to an official for whom the covered person is not entitled to vote.22

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16 See Rule 206(4)-5(b)(2). See also Letter from Dechert LLP to Elizabeth M. Murphy, Secretary, SEC (Oct. 22, 2010), available at www.sec.gov/comments/s7-18-09/s71809-246.pdf (“Dechert Comment Letter”) (arguing that the two-year look back period is unduly excessive).

17 See Adopting Release, at Section II.B.2(e)(2).

18 See Adopting Release, at Section II.B.2(a)(1). The Adopting Release also makes clear that the adviser may not be reimbursed for its expenses or costs incurred in connection with providing advisory services during the two-year time out. Id.

19 See Dechert Comment Letter, supra note 16 (discussing in greater detail the structural and legal issues of covered investment pools in seeking to comply with the Rule).

20 Possible corrective actions by a registered fund may require additional SEC relief to be implemented.

21 See Adopting Release, at Section II.B.2(e)(3) (internal citations omitted).
The term “payment” is defined as any gift, subscription, loan, advance, or deposit of money or anything of value.

**Certain Returned Contributions** – The Rule also provides an exception for inadvertent contributions to an official for whom a covered associate is not entitled to vote, provided (1) the adviser discovers the impermissible contribution within four months of the date of the contribution; (2) the contribution did not exceed $350; and (3) the contribution was returned within 60 calendar days from the date the adviser discovered the contribution was made. However, an adviser may not rely on this exception more than twice in a 12-month period, or more than once per covered associate, regardless of the time period.

**Exemptive Order** – The Rule provides an additional avenue for relief if an adviser discovers an impermissible contribution. Under the Rule, the SEC may provide broader exemptive relief on a case-by-case basis in instances in which the adviser is able to demonstrate, among other things, that it had adequate compliance procedures in place prior to the impermissible contribution being made. Furthermore, the SEC will consider whether, after the impermissible contribution, the adviser had taken (1) all available steps to cause the return of the contribution and (2) other appropriate remedial or preventive measures. Pending the SEC’s consideration of the exemptive order, the adviser may continue to offer advisory services to the government entity, with advisory fees placed in an escrow account.

**Prohibition on Use of Third-Party Placement Agents, Finders, and Solicitors**

The SEC had initially considered a ban on the use of third-party intermediaries to market to public pension plans. However, after adverse comments from many corners of the industry, including this firm as well as public funds, the SEC determined to prohibit an adviser from making “payments” to any person for soliciting advisory business from a government entity, unless the person is (1) a “regulated person” or (2) an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the adviser. In effect, the Rule permits advisers to continue a commonly used practice of hiring third-party intermediaries to act on their behalf in soliciting government entities, as long as the particular third-party intermediary qualifies as a regulated person under the Rule.

A regulated person under the Rule includes any third-party placement agent, finder, and other solicitor that is registered with the SEC as an adviser under the Advisers Act or as a broker-dealer under the Securities Exchange Act of 1934, or as an associated person of an investment adviser or registered representative of a broker-dealer.

Any third-party investment advisers that are retained to market advisory services to public funds must themselves be in compliance with the Rule. Registered broker-dealers or their registered representatives, acting as the placement agents for hedge funds and private equity funds, will be expected to comply with a new rule to be promulgated by the Financial Industry Regulatory Authority (“FINRA”), the self-regulatory organization of the brokerage industry, limiting political contributions. This FINRA rule, which the SEC anticipates will be submitted for public comment and adoption during the next 12 months, will likely be patterned after the Rule.

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27 See Proposing Release, at Section II.A.3(b). Note, however, that despite the modifications to these provisions of the Rule, a few state and local governments have undertaken actions to prohibit or regulate pay-to-play practices involving placement agents in response to concerns about pay-to-play activities in their jurisdictions. See Proposing Release, at Section II.B.2(b) at n. 262.
28 See Rule 206(4)-5(f)(9)(i) and (ii).
29 Id. In connection with the adoption of these provisions, a technical amendment to the “cash solicitation rule” under the Advisers Act is also being adopted. See Rule 206(4)-3. Paragraph (iii) of the cash solicitation rule contains general restrictions on third-party solicitors that cover solicitation activities directed at any client, including any government entity client. In order to alert advisers and others that the prohibitions of the Rule are applicable to the solicitation of government entity clients, a new paragraph is being added to the cash solicitation rule to clarify that special prohibitions apply to the solicitation activities involving government entities. See Rule 206(4)-3(e).
30 Id. We understand that the SEC has been informed by FINRA that they are in the process of preparing pay-to-play...
**Recordkeeping Requirements**

Amendments to the provisions of the "recordkeeping rule" under the Advisers Act are being adopted in order to facilitate examination by the SEC for compliance with the Rule. The amended recordkeeping requirements require advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government entity is an investor, to maintain records regarding the contributions made by the adviser and its covered associates to government officials, and of payments to state or local political parties and PACs.

The adviser’s records of contributions and payments must be listed in chronological order, identifying (1) each contributor and recipient, (2) the amounts and dates of each contribution or payment and (3) whether a contribution was subject to the Rule’s exception for certain returned contributions. The amended recordkeeping requirements also require an adviser that has government clients to maintain a list of its covered associates, and the government entities to which the adviser has provided advisory services in the past five years.

Similarly, advisers to covered investment pools must maintain 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 529, 457 or 403(b) plans. In addition, an adviser, regardless of whether it currently has a government entity as a client, must also keep a list of the names and business addresses of each "regulated person" (as defined in the Rule) to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity on its behalf.

**Effective and Compliance Dates**

The Rule and the amendments to the recordkeeping and cash solicitation rules under the Advisers Act are effective as of September 13, 2010 ("Effective Date"). However, except as provided below, advisers must comply with the terms of the Rule by March 14, 2011. Thus, political contributions made prior to March 14, 2011 will be "grandfathered" and will not be counted against an adviser for purposes of the two-year look forward or look back provisions under the Rule. In addition, advisers may no longer use third-party inter-

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31 See Rule 204-2(a)(18). As drafted, the amended recordkeeping requirements do not apply to unregistered advisers, although, as noted above, unregistered advisers are subject to the prohibitions of the Rule. So, unregistered advisers subject to the prohibitions of the Rule will be required to put in place sufficient policies and procedures to assure their compliance with the Rule’s prohibitions (which may include the maintenance of records to support their compliance with the Rule). In addition, advisers maintaining substantially the same records under rules adopted by the MSRB are not required to maintain duplicate records under the amended recordkeeping requirements of the Advisers Act. See Rule 204-2(h)(1).

32 See Rule 204-2(a)(18)(ii).

33 An adviser must maintain a list of the name, title(s), and business and residential addresses of each covered associate. See Rule 204-2(a)(18)(i)(A).

34 See Rule 204-2(a)(18)(i)(B). Only advisers that provide advisory services to a government entity (including government entities invested in a covered investment pool) are required to maintain records of their covered associates, and their own and their covered associates’ contributions. Advisers with no government entities as clients are not required to maintain records related to covered associates and contributions and, as a consequence, do not need to have their employees report their political contributions. See Rule 204-2(a)(18)(ii). See also Dechert Comment Letter, supra note 16 (arguing that requiring advisers with no government clients to maintain such records could be unnecessarily intrusive to employees and burdensome on advisers).

35 Id. An adviser to a covered investment pool that is an option of a government plan or program is not required to maintain a list of all participants in the plan or program, but only the government entity.

36 See Rule 204-2(a)(18)(i)(D).

37 Although the intended goal of the Rule has been viewed very favorably, the SEC, in response to concerns regarding the constitutionality of the Rule, removed and/or reduced the scope of certain prohibitions of the Rule with respect to political contributions prior to adoption. Along these lines, it should be noted that MSRB Rule G-37, a rule upon which the Rule was largely based, was challenged as an impermissible infringement on the First Amendment. MSRB Rule G-37 was ultimately upheld by the U.S. Court of Appeals for the District of Columbia. See Blount v. SEC, 61 F.3d 938 (D.C. Cir. 1995), cert. denied, 517 U.S. 1119 (1996). Nevertheless, the impact on the Rule of the Supreme Court’s most recent First Amendment decision in this area – and therefore the likelihood of an appeal – remains unclear. See Citizens United v. Federal Election Commission, 558 U.S. 50 (2010). In addition, the Supreme Court of Colorado recently rendered unconstitutional a very broad pay-to-pay law that, among other things, prohibited contributions by public contractors, their employees, and family members. See Dallman v. Ritter, No. 09SA224 (Colo. Feb. 22, 2010).
mediaries to solicit government business except in compliance with the Rule beginning on September 13, 2011.38

Advisers to registered investment companies that are covered investment pools (as defined in the Rule) must comply with the Rule by September 13, 2011.39 Advisers subject to the recordkeeping rule under Rule 204-2 under the Advisers Act must comply with the amended recordkeeping requirements by March 14, 2011;40 provided, however, that if an adviser provides investment advisory services to registered investment companies that are covered investment pools, the adviser has until September 13, 2011 to comply with the amended recordkeeping requirements with respect to those registered investment companies.

Conclusion

The Rule will likely present compliance challenges to those advisers that interact with public pension funds and other pooled government investment vehicles.41 The greatest challenges will be encountered in larger, integrated organizations with dotted line reporting. Chief compliance officers of advisory firms will need to (1) learn the new requirements of the Rule and (2) develop new policies and procedures that are similar to those employed by government contractors. In addition, chief compliance officers of advisory firms will need to engage in a significant education and training process to alert their officers, directors and employees of potential problems that may arise from inadvertent activities on their part. However, the SEC has provided a lengthy compliance period. Moreover, it is likely that prior to the compliance dates, additional guidance will be made available by the SEC or its staff.

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An overview of compliance measures that many advisers will need to consider is provided in Pittman & Carroll, “Pay-to-Play” in the Financial Services Industry, supra note 8.

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

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