SEC Adopts Rules to Curtail "Pay to Play" Practices

On June 30, 2010, the US Securities and Exchange Commission (SEC) unanimously adopted Rule 206(4)-5 under the Investment Advisers Act of 1940, as amended (Advisers Act) and certain other amendments to the rules under the Advisers Act (collectively, the Rule Amendments) to deter "pay to play" practices among registered investment advisers and certain unregistered investment advisers as well as their key principals and employees.[1] An investment adviser engages in "pay to play" practices when it directly or indirectly makes political contributions to government officials for the purpose of influencing their decisions to direct advisory business from government entities to such investment adviser. For investment advisers that provide (or seek to provide) advisory services directly or indirectly to state or local government entities (including public pension plans, 529 plans, and other state or local government-sponsored investment programs or plans), the Rule Amendments will likely affect such investment advisers' operations, hiring and employment practices, and relationships with third party solicitors and placement agents.

I. Summary of the Rule Amendments

The Rule Amendments were adopted following recent "pay to play" scandals, including one involving an alleged scheme by New York state officials and placement agents to extract kickbacks in the form of sham placement agent fees from investment advisers in exchange for procuring advisory business from the New York State Common Retirement Fund.[2]

Rule 206(4)-5 contains the following principal prohibitions and restrictions designed to curb pay to play practices among investment advisers:

- **Political Contributions and Two-Year Cooling-Off Period.** A covered adviser will be prohibited from receiving compensation for advisory services rendered to a "government entity" for two years after such investment adviser or any of its "covered associates" makes a "contribution" to certain "officials" (two-year cooling-off period).

1 *See* Political Contributions by Certain Investment Advisers, Release No. IA-3043 (July 1, 2010), *available at* http://www.sec.gov/rules/final/2010/ia-3043.pdf (Adopting Release). *See also* Press Release, US Securities and Exchange Commission, SEC Adopts New Measures to Curtail Pay to Play Practices by Investment Advisers (June 30, 2010), *available at* http://www.sec.gov/news/press/2010/2010-116.htm.

2 *See SEC* v. *Henry Morris, et al.,* Litigation Release No. 21036 (May 12, 2009).

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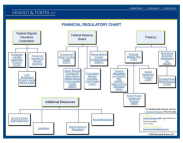

Financial Regulatory Chart

- **Solicitors and Placement Agents.** A covered adviser will not be permitted to directly or indirectly pay or agree to pay a person for "soliciting" advisory business on its behalf from any government entity unless the soliciting person is (i) a "regulated person"; or (ii) an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of such investment adviser.
- **Coordination or Solicitation of Political Contributions.** A covered adviser and its covered associates will be prohibited from coordinating or soliciting any person or political action committee (PAC) to make (i) a contribution to any official; or (ii) a payment to any political party in a state or locality where such investment adviser is providing advisory services to or seeking advisory business from a government entity.
- **Indirect Pay to Play Practices.** A covered adviser and its covered associates will not be permitted to do indirectly what they are prohibited them from doing directly.

In addition, the Rule Amendments will require a covered adviser that has a client that is a government entity (including through covered investment pools) or that solicits government business on behalf of other investment advisers to maintain certain books and records. The new recordkeeping requirements will provide the SEC with a roadmap to determine an investment adviser's level of compliance with the requirements of Rule 206(4)-5 during examinations of such investment adviser.

Except with respect to the use of third party solicitors and placement agents, the Rule Amendments are substantially similar to the rule proposals introduced by the SEC on August 3, 2009 (Proposed Rules).[3] Unlike the Proposed Rules, the Rule Amendments do not contain an outright ban on a covered adviser's use of third party solicitors and placement agents to solicit advisory business from government entities. Rather, the Rule Amendments provide for limited use of placement agents and solicitors that are broker-dealers or investment advisers that are subject to registration, regulation and supervision either by the SEC or a national securities association such as the Financial Industry Regulatory Authority (FINRA).

The Rule Amendments will become effective on September 13, 2010. The SEC has provided for a six-month transition period before investment advisers will be required to comply with most of the Rule Amendments to enable such investment advisers to identify their covered associates and government entity clients as well as to modify their compliance programs. Generally, investment advisers will be required to comply with the Rule Amendments from and after March 14, 2011, except as follows:

- **Solicitors and Placement Agents.** Investment advisers will not be required to comply with the requirements for using third-party solicitors or placement agents until September 13, 2011.
- **Registered Investment Companies.** An investment adviser that advises a registered investment company that is a "covered investment pool" will not be required to comply with the Rule Amendments in respect of such registered investment company until September 13, 2011.

II. Application to Investment Advisers

Rule 206(4)-5 applies to investment advisers that are registered (or required to be registered) with the SEC (collectively, SEC-registered investment advisers) and unregistered investment advisers that rely on the exemption from registration found in Section 203(b)(3) of the Advisers Act. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted on July 21, 2010, repealed the exemption under Section 203(b)(3) of the Advisers Act. Therefore, only SEC-registered investment advisers will be subject to the provisions of Rule 206(4)-5. In addition, only SEC-registered investment advisers are required to comply with the new recordkeeping provisions. As a result, in this advisory, we refer to these registered investment advisers as "covered advisers."

Furthermore, Rule 206(4)-5 will apply to a covered adviser that manages assets of a government entity directly in a

3 The Proposed Rules were introduced in response to certain pay to play scandals that resulted in actions by the SEC and various state government entities. For a more in-depth description of the Proposed Rules, please click here http://sec.gov/rules/proposed/2009/ia-2910.pdf.

managed account or through a hedge fund or other "covered investment pool." A "covered investment pool" means (i) any investment company registered pursuant to the Investment Company Act of 1940, as amended (Company Act), that is an investment option of a plan or program (such as a 529 plan, a 403(b) plan, or a 457 plan) of a government entity that is participant-directed (i.e., a pooled investment vehicle 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 choose from); and (ii) any entity excluded from the definition of an "investment company" under Section 3(c)(1), 3(c)(7), or 3(c)(11) of the Company Act (including many hedge funds, private equity funds, venture capital funds, and collective investment trusts).[4]

In addition, most of the provisions of Rule 206(4)-5 apply to the "covered associates" of a covered adviser. "Covered associates" of a covered adviser include (i) the general partners, managing members, executive officers, or other individuals with a similar status or function; (ii) any person soliciting government entities on behalf of the covered adviser or any person that directly or indirectly supervises such persons; or (iii) any political action committee (PAC) controlled by the covered adviser or any of its covered associates. "Executive officers" of a covered adviser include the president, vice presidents in charge of a principal business unit, division, or function, other officers or persons that perform policy-making functions on behalf of the covered adviser, and any other person that performs policy-making functions on behalf of the covered adviser.

III. Application to State and Local Government Entities

The Rule Amendments define "government entity" broadly to mean any state or political subdivision of a state and includes: (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" as defined in section 414(j) of the Internal Revenue Code of 1986, as amended (Code); (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. A "plan or program of a government entity" is defined as 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 Code, a retirement plan authorized by section 403(b) or 457 of the Code), or any similar program or plan.

As a result, the term "government entity" does not cover the federal government, foreign government, Native American tribes, or multi-lateral entities such as the World Bank or any plans sponsored by such entities. Nonetheless, the Rule Amendments may still apply to contributions made to a candidate for federal office if such candidate currently holds an office that is covered by the term "government entity."

IV. Political Contributions by Covered Advisers and Their Covered Associates

A. Two-Year Cooling-Off Period

Rule 206(4)-5(a)(1) prohibits a covered adviser from receiving compensation for providing advisory services to a government entity for two years after the covered adviser or any of its covered associates makes a "contribution" to an "official" of the government entity.

A "contribution" that will trigger a two-year cooling-off period includes any gift, subscription, loan, advance, or deposit of money, anything of value made to an "official" for (i) the purpose of influencing any election for federal, state, or local office; (ii) payment of debt incurred in connection with any such election; or (iii) transition or inaugural expenses of the successful candidate for state or local office. Other forms

4 The Proposed Rules originally proposed including all registered investment companies as covered investment pools. However, in the Adopting Release, the SEC noted that a covered adviser of a registered investment company would likely find it difficult to determine if or when a government entity was a shareholder for purposes of complying with Rule 206(4)-5. As a result, the SEC ultimately elected to narrow the definition of "covered investment pools" to cover only those registered investment companies that are investments or investment options in a plan or program of a government entity.

of support for a government official, such as volunteering time or making speeches, will not trigger the two-year cooling-off period.

An "official" means 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.

This rule will not prohibit covered advisers or their covered associates from making political contributions to government officials. It will simply impose a two-year cooling-off period during which a covered adviser may not receive compensation from government entities for providing investment advisory services to such government entities. In fact, the Adopting Release notes that a covered adviser may provide *uncompensated* advisory services to government entities during the two-year cooling-off period, and the SEC even suggested that it would be consistent with a covered adviser's fiduciary obligations to provide uncompensated advisory services to a government entity for a reasonable period of time following a triggering contribution in order to give the government entity time to retain another investment adviser to provide advisory services.

The SEC recognized the difficulty of structuring an arrangement whereby the covered adviser to a registered investment company could avoid receiving compensation from a government entity in the event that the covered adviser or its covered associates made a triggering contribution due to Company Act provisions and tax consequences. Nonetheless, the SEC suggested that a covered adviser to a registered investment company subject to the two-year cooling-off period could either (i) waive an amount approximately equal to the amount in fees that would otherwise be paid by the government entity; or (ii) rebate the amount in fees that are paid by the government entity to the fund as a whole.

The SEC also provided informative guidance with respect to the application of the two-year cooling-off period to sub-advisory arrangements and investments made through funds of funds. The SEC noted that as long as an arrangement between an adviser and a sub-adviser was not structured to do indirectly what this rule prohibits directly, if either the adviser or the sub-adviser makes a triggering contribution, the two-year cooling-off period would not apply to the sub-adviser or adviser that did not make a triggering contribution. The SEC also noted that where a government entity has a contract only with an adviser that triggers the two-year cooling-off period and not with an underlying sub-adviser that did not trigger the two-year cooling-off period, it is entirely appropriate for the adviser that triggers the two-year cooling-off period to pass along to the sub-adviser the portion of its fees attributable to the services rendered by the sub-adviser. In addition, the SEC noted that an adviser to an underlying fund in which a fund of funds invests would not be required to look through the investing fund of funds to determine whether a government entity was an investor in the fund of funds unless the investment was structured in such a manner as to permit the adviser to do indirectly what it would be prohibited from doing directly.

B. Contributions Made Prior to Becoming a Covered Associate

For purposes of determining whether a contribution triggering the two-year cooling-off period has been made, a covered adviser will be required to include contributions made by a covered associate within two years (or in some cases six months) of becoming a covered associate, including by transfer or promotion. Therefore, a covered adviser that seeks to hire a person as a covered associate or to transfer or promote a person to a position as a covered associate must inform itself as to the contributions made by a prospective covered associate during the relevant time period prior to such employment, transfer or promotion.

Although the Proposed Rules would have considered all contributions made by a prospective covered associate within the two years prior to his or her hiring, transfer, or promotion as a triggering contribution, in the Adopting Release, the SEC recognized this would impose a significant burden on the

hiring and promotion practices of many investment advisers. As a result, the Rule Amendments provide that the relevant "look back" period for prospective covered associates who will solicit government business will be two years, and the relevant "look back" period for all other covered associates will be six months.

C. Exceptions to the Two-Year Cooling-Off Period

Rule 206(4)-5 contains several exceptions that would not require application of the two-year cooling-off period:

- ***De Minimis* Exceptions for Individual Covered Associates.** An individual covered associate may make a *de minimis* contribution to a government official without triggering the two-year cooling-off period.
  - — An individual covered associate may contribute up to US$350 per election to an elected official or candidate in an election in which he or she is entitled to vote without triggering the two-year cooling-off period.[5]
  - — In addition, an individual covered associate may contribute up to US$150 per election to an elected official or candidate in an election in which he or she is **not** entitled to vote without triggering the two-year cooling-off period.[6]
- **Exception for Certain Returned Contributions.** Inadvertent contributions made by a covered associate that do not exceed US$350 in the aggregate to any one official per election will not trigger the two-year cooling-off period as long as: (i) the covered adviser discovers the potentially triggering contribution within four months of such contribution; and (ii) within 60 days after learning of the triggering contribution, the contributor must obtain the return of the contribution. Although the Proposed Rules would have restricted any covered adviser's reliance on this exception to twice per year, the Rule Amendments will permit covered advisers that state in their Forms ADV that they have more than 50 employees that perform advisory functions to rely on this exception three times per year and will permit all other covered advisers to rely on this exception twice per year. In addition, this exception is only available once for each covered associate regardless of time period.
- **Discretionary Exemption.** The SEC may exempt a covered adviser from application of the two-year cooling-off period where such covered adviser discovers the triggering contributions only after they have been made and when imposition of the two-year cooling-off period is unnecessary to achieve the purpose of Rule 206(4)-5. Although in the Adopting Release the SEC recognized that applications for this exemption will be time-sensitive and stated that it will consider such applications expeditiously, the SEC did not establish any required time period to review such applications.

V. Use of Third Party Solicitors and Placement Agents to Solicit Government Business

Rule 206(4)-5(a)(2)(i) restricts a covered adviser from using unaffiliated third parties to "solicit" advisory business from government entities on behalf of the covered adviser unless the third party is a "regulated person."

The Proposed Rules would have imposed an outright prohibition on the use of third party solicitors or placement agents to solicit government business on behalf of a covered adviser unless such third party was such covered adviser's "related person" or an employee of such a related person that is an entity. In relaxing the restrictions on the use of third party solicitors and placement agents in the Rule Amendments, the SEC reasoned that broker-dealers and investment advisers that qualify as "regulated persons" would be adequately deterred from engaging in pay to play

5 The Proposed Rules originally included an exception for a *de minimis* contribution by an individual covered associate of up to US$250 (not US$350) per election to an elected official or candidate in an election in which such covered associate was entitled to vote. The SEC raised this *de minimis* threshold from US$250 to US$350 to reflect an inflation adjustment since the adoption of a similar rule by the Municipal Securities Rulemaking Board in 1996.

6 The Proposed Rules did not propose any *de minimis* exception with respect to elections in which an individual covered associate was not entitled to vote. In adopting this additional *de minimis* exception, the SEC recognized that individual covered associates may have an interest in such elections.

practices because such broker-dealers and investment advisers are registered with the SEC, are subject to similarly stringent pay to play rules directly applicable to them, and are subject to regulatory oversight. In addition, the SEC noted in the Adopting Release that it eliminated the exception provided in the Proposed Rules for a covered adviser's related persons and the employees of related persons that are entities to perform solicitation activities on behalf of a covered adviser, and, as such, a covered adviser's related person must be a "regulated person" to solicit advisory business from government entities on behalf of the covered adviser.

"Solicit" means (i) with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and (ii) with respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment. Whether a particular communication constitutes a "solicitation" will depend on the particular facts and circumstances; however, the SEC has provided some guidance in the Adopting Release. For example, the SEC noted that a covered adviser's employee does not engage in a solicitation if, in response to a government official's inquiry as to whether the covered adviser has pension fund advisory capabilities, the employee simply provides a limited affirmative response and either provides the contact information for a covered associate of the adviser or indicates to the government official that a representative of the adviser that handles government advisory business will contact the government official.

A broker or dealer will qualify as a "regulated person" if it is registered with the SEC and is a member of a national securities association (such as FINRA) that has rules that prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made and such rules are determined by the SEC to be equally or more stringent than the restrictions imposed on covered advisers by Rule 206(4)-5. An investment adviser will be a "regulated person" if it is registered with the SEC as an investment adviser and it and its covered associates have not, within two years of soliciting a government entity: (i) made a contribution to an official of that government entity other than *de minimis* contributions[7]; and (ii) coordinated or solicited a person (including a PAC) to make a contribution to an official of a government entity to which the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services, or payment to a political party of a state or locality where the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services to a government entity.

Covered advisers that compensate other investment advisers to solicit advisory business from government entities on their behalf must maintain policies and procedures reasonably designed to prevent violations of Rule 206(4)-5(a)(2)(i) with respect to such solicitation activities, including, without limitation, policies with respect to the vetting of prospective and current investment advisers that act on behalf of the covered adviser as "regulated persons." Most notably, the covered adviser's due diligence should determine whether any investment adviser acting as solicitor or placement agent has engaged in any of the conduct that would prohibit such solicitor or placement agent from soliciting government entities on the covered adviser's behalf.

Rule 206(4)-5(a)(2)(i), as adopted, could present issues for investment advisers or sub-advisers (that are not themselves banks or trust companies) to some bank-sponsored collective investment trusts and insurance company separate accounts which invest, reinvest and trade in securities and would fall within the definition of "investment company" under Section 3(a) of the Company Act but for their reliance on the exclusion from the definition of "investment company" contained in Section 3(c)(11) of the Company Act and are sold by the bank or other non-SEC regulated marketing firms to state and local pension plans, and to investment advisers and sub-advisers to registered investment companies that are offered by banks to state and local governments or their pension plans.

7 *See* discussion above under Section IV.C.

VI. Coordinating or Soliciting Contributions

Rule 206(4)-5(a)(2)(ii), which was adopted as proposed, will prohibit a covered adviser from coordinating or soliciting any person or PAC to make any contribution to an official of a government entity to which the covered adviser is providing or seeking to provide investment advisory services, or any "payment"[8] to a political party of a state or locality where the covered adviser is providing or seeking to provide investment advisory services to a government entity. This rule will prohibit, among other things, a covered adviser from "bundling" a large number of *de minimis* employee contributions for the purpose of influencing an election.[9]

VII. Indirect Engagement in Prohibited Pay to Play Practices

Rule 206(4)-5(d), which was adopted as proposed, will make it unlawful for a covered adviser to do indirectly what Rule 206(4)-5 prohibits a covered adviser from doing directly. Rule 206(4)-5(d) is designed, among other things, to prevent a covered adviser or its covered associates from directing or funding contributions through third parties, including, for example, family members, friends, consultants, attorneys, or companies affiliated with the adviser to avoid application of the rule.

VIII. Recordkeeping Requirements

The SEC amended Rule 204-2 under the Advisers Act to require each covered adviser that has government clients, that provides investment advice to government entities through investments in covered investment pools or that solicits government business on behalf of other investment advisers to maintain certain books and records, including:

- The contributions and payments made on or after March 14, 2011 by such covered adviser or any of its covered associates to an official of a government entity (including candidates), a state or local political party, or a PAC, in chronological order and identifying, among other things, each contributor and recipient and the amounts and dates of each contribution or payment; however, such covered adviser will not be required to maintain this record if it does not have any government client;[10]
- The names, titles, and business and residential addresses of the covered associates on March 14, 2011 and thereafter; however, such covered adviser will not be required to maintain this record if it does not have any government client;
- The names of government entities to which such covered adviser currently provides advisory services (including through any covered investment pool other than a registered investment company) on and after March 14, 2011 or to which such covered adviser has provided such advisory services during the past five years, but such covered adviser will not be required to maintain records for the five years prior to September 13, 2010;[11]
- The names of government entities to which such covered adviser currently provides advisory services through a registered investment company that is a covered investment pool on and after September 13, 2011 or to which such covered adviser has provided such advisory services during the past five years, but such covered adviser will not be required to maintain books and records for the five years prior to September 13, 2011; and
- The names and business addresses of the regulated persons that solicit government business on such covered adviser's behalf on or after September 13, 2011, regardless of whether such covered adviser actually has any government clients.

8 A "payment" means any gift, subscription, loan, advance, or deposit of money or anything of value.

9 *See* discussion above under Section IV.C.

10 The Proposed Rules would have required covered advisers to keep books and records of all "payments" (including contributions) made by a covered adviser and its covered associates to government officials and candidates, but in the Adopting Release, the SEC limited this recordkeeping requirement to "contributions" which the SEC notes are the only kind of "payment" that can trigger the two-year cooling-off period. Nonetheless, covered advisers will be required to keep books and records with respect to "payments" to state and local political parties and PACs.

11 In contrast to the Proposed Rules, the SEC will only require a covered adviser to keep books and records with respect to government entities to whom it provides advisory services or has provided advisory services during the past five years. The Proposed Rules would have required a covered adviser to keep books and records with respect to any government entity solicited by the covered adviser for advisory business, including those government entities that do not become the covered adviser's clients.

IX. Practical Guidance for Covered Advisers

Covered advisers should consider whether there are any changes that are necessary or appropriate to their operations and compliance programs to facilitate their compliance with the Rule Amendments. For starters, covered advisers will need to consider whether they must modify their hiring practices to ascertain whether prospective employees have made political contributions to government officials that could inadvertently trigger the two-year cooling-off period. Covered advisers will also need to consider whether to ban or restrict some or all of their employees from making contributions to government officials. For covered advisers that opt to permit some or all employees to make contributions to government officials, such covered advisers should consider whether to require employees to pre-clear any contributions to be made to government officials (which will prevent the making of inadvertent contributions that trigger application of the two-year cooling-off period), to limit the aggregate amount of contributions that may be made to any government official by any employee to a certain dollar amount (e.g., $150), and/or to require employees to report any contributions on a periodic (perhaps quarterly) basis (which will permit an adviser to discover any inadvertent contributions made with sufficient time to take remedial measures to prevent application of the two-year cooling-off period).

In addition, to prevent violations of Rule 206(4)-5's restrictions on the use of third party solicitors and placement agents, a covered adviser should consider adopting policies and procedures reasonably designed to ensure that third party solicitors and placement agents are "regulated persons." Covered advisers may want to consider whether it is necessary to, among other things, conduct due diligence on their third party solicitors and placement agents and/or to require such third party solicitors and placement agents to make representations regarding their "regulated person" status in any service agreements signed between the solicitor and the covered adviser.

X. Conclusion

Investment advisers should note that, in addition to the Rule Amendments, a host of other federal, state, and local laws, rules, and regulations govern the making of contributions and payments to government officials from persons that do business with an official's agency or jurisdiction. Relevant federal and criminal laws apply where the circumstances of contributions suggest a *quid pro quo* to influence the award of business from a government entity. Therefore, it is necessary for each investment adviser to become familiar with the laws, rules, and regulations applicable to its specific business to ensure that there are no inadvertent violations of such laws, rules, and regulations.

We hope that you have found this advisory useful. If you have any questions, please contact your Arnold & Porter attorney or:

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