SEC PROPOSES RULES TO CURTAIL PAY TO PLAY PRACTICES

On August 3, 2009, the US Securities and Exchange Commission (SEC) issued a release (Release) in which it proposed rules to curb the making of political contributions and other payments by investment advisers for the purpose of influencing the award of advisory contracts by government entities. The rule proposal, originally introduced in 1999, was reintroduced 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.[1]

The SEC stated that the proposed measures are designed to safeguard the interests of participants in government pension plans or funds by ensuring that the award of advisory contracts is based on arms-length negotiations and not "distorted" by the making of political contributions and other payments to government officials and candidates who have influence over the selection of such investment advisers. The SEC has recently heightened its scrutiny of pay to play practices. As recently as August 5, 2009, SEC Director of Enforcement Robert Khuzami noted that pay to play schemes are "ripe for scrutiny."[2]

In the past few years, the SEC and other government authorities have instituted a number of enforcement actions premised on participation in pay to play schemes. For instance, in April 2009, the SEC settled an administrative action against an investment adviser who agreed to a statutory bar from association with investment advisers and broker-dealers for paying kickbacks in exchange for investment advisory business to be directed to the investment adviser by the New Mexico State Treasury office.[3] The Release notes that these and other enforcement actions, as well as calls for regulation of pay to play practices from officials overseeing public pension funds, were instrumental in the SEC's decision to introduce the rule proposals.

I. RULE 206(4)-5 UNDER THE ADVISERS ACT: POLITICAL CONTRIBUTIONS BY CERTAIN INVESTMENT ADVISERS

A. Introduction

Proposed Rule 206(4)-5 under the Investment Advisers Act of 1940, as amended (the Advisers Act), would generally make it unlawful, both for investment advisers

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

2 *See* http://www.sec.gov/news/speech/2009/spch080509rk.htm.

3 *See In the Matter of Kent D. Nelson, Investment Advisers Act*, Release No. 2765 (Aug. 1, 2008); Initial Decision Release No. 371 (Feb. 24, 2009); *Investment Advisers Act Release* No. 2868 (Apr. 17, 2009).

that are registered under the Advisers Act and for most unregistered investment advisers (collectively, covered advisers), and their "covered associates" to:

(a) receive compensation for advisory services rendered to a government entity for two years after a covered adviser or any of its covered associates makes a contribution to certain elected officials or candidates;

(b) directly or indirectly provide payment to any unaffiliated third party for soliciting advisory business from any government entity on behalf of such covered adviser;

(c) coordinate or solicit persons to make contributions to government officials or payments to political parties in a state or locality where a covered adviser is providing advisory services to or seeking advisory business from a government entity; and

(d) do indirectly what the proposed rule prohibits a covered adviser from doing directly.

The proposed rule is modeled on similar rules adopted by the Municipal Securities Rulemaking Board (MSRB)[4] governing pay to play practices in the municipal securities markets.

Proposed Rule 206(4)-5 would cover a broad range of executives and employees of an investment adviser as well as a wide range of government entities. Under the proposed rule, "covered associates" of an investment adviser would include the general partners, managing members, executive officers (i.e., the president, vice presidents in charge of business units, and others responsible for investment advisory or client solicitation activities or supervision of such activities), others with similar status or serving similar functions, any person soliciting government entities on behalf of the adviser, or any political action committee (PAC) controlled by the investment adviser or its covered associates. The proposed rule would cover "government entities" which include "all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds."

The proposed rule would apply whether a government entity sought advisory services directly from a covered adviser or whether it invested in a "covered investment pool" managed by the covered adviser. "Covered investment pools" would include registered investment companies and private investment funds that rely on an exclusion from registration as an investment company pursuant to Section 3(c)(1) or 3(c)(7) of the US Investment Company Act of 1940, as amended.

B. Making of Political Contributions by Covered Advisers and Their Covered Associates

Proposed Rule 206(4)-5(a)(1) would prohibit a covered adviser from providing advisory services for compensation to a government entity for two years after the covered adviser or any of its covered associates makes a "contribution" (which covers anything of value provided to influence a federal, state, or local election) to a government "official." The proposed rule would not prohibit covered advisers or their covered associates from making political contributions to government officials. It would 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. The Release makes it clear that a covered adviser would be able to continue to provide uncompensated advisory services to government entities during the two-year cooling-off period. The SEC noted that rendering of uncompensated advisory services would be permitted in order to avoid requiring a covered adviser to abruptly discontinue providing advisory services to a government entity upon discovering that a triggering contribution has been made. The SEC even suggested that, at a minimum, the investment adviser would likely be required to continue to provide uncompensated investment advisory services to the government entity for a reasonable period of time after the making of a triggering contribution in order to give the government entity time to find another investment adviser to provide advisory services.

Under the proposed rule, a government "official" is broadly defined to cover any "incumbent, candidate, or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the selection of an investment

4 *See* MSRB Rules G-37 and G-38.

adviser or has authority to appoint any person who is directly or indirectly responsible for or can influence the outcome of the selection of an investment adviser." The broad definition of an "official" raises questions as to whether an investment adviser would be necessarily in a position to determine whether a person to whom it or any of its covered associates was making a contribution is an "official" covered by the proposed rule.

The proposed rule would also continue to apply with respect to contributions made by departing covered associates prior to their departure. Therefore, the fact that a covered associate terminated employment with a covered adviser would not terminate the cooling-off period for the covered adviser from which the covered associate departed. Additionally, the rule would also apply with respect to any person that is hired or otherwise becomes a covered associate of a covered adviser within two years of making a triggered contribution.

The proposed rule would provide several exceptions from its coverage. First, proposed Rule 206(4)-5(b) contains a *de minimis* exception whereby the cooling-off period would not even be triggered as long as a covered associate does not make aggregate contributions of more than US$250 per election to an elected official or candidate if the covered associate is entitled to vote for the official or candidate. Second, Rule 206(4)-5(b) would also provide an exception for an inadvertent contribution where a covered associate makes an aggregate contribution of no more than US$250 in an election in which he/she is not entitled to vote, as long as the covered adviser discovers the inadvertent contribution within four months of such contribution and within 60 days of the inadvertent contribution, causes the contribution to be returned to the contributor. Nonetheless, no covered adviser would be permitted to rely on this inadvertent contribution exception more than twice per any twelve-month period. Additionally, Rule 206(4)-5(e) also permits a covered adviser to apply for an exemption from application of proposed Rule 206(4)-5(a)(1) if a covered adviser discovers a triggering contribution after it has been made or when the application of the rule is unnecessary in a given circumstance to achieve the proposed rule's intended purpose. The SEC will consider a variety of factors in determining whether to grant an exemption, including, among other things, the covered adviser's policies and procedures designed to prevent violations of the rule, whether the adviser had knowledge of the contribution before it was made, any remedial actions taken by the covered adviser, whether the covered associate was employed by the covered adviser when the contribution was made, the nature of the election, and the intent of the covered associate in making the contribution.

C. Prohibition on Using Third Parties to Solicit Government Entities as Clients

Proposed Rule 206(4)-5(a)(2)(i) would make it unlawful for covered advisers and their covered associates "to provide or agree to provide, directly or indirectly, any payment to any person to solicit a government entity for investment advisory services unless such person is (i) a 'related person' of the investment adviser or, if the related person is a company, an employee of that related person; or (ii) any of the adviser's employees, general partners, managing members, executive officers or other persons with a similar status or function." This prohibition would cover payments to third parties commonly known as "finders," "solicitors," "placement agents," and "pension consultants." The term "payment" would be broadly defined to include anything of value. The term "solicit" is broadly defined to include any act "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 any given communication constitutes a "solicitation" requires a facts-and-circumstances analysis. This broad prohibition may prove especially difficult and disadvantageous for private investment fund sponsors (particularly smaller fund sponsors) that employ SEC-registered securities broker-dealer firms as private placement agents for sales to state and local government pension plans, and seems oddly at cross-purposes with the SEC's and the Financial

Industry Regulatory Authority's comprehensive program of regulation of securities broker-dealers.

D. Restrictions on Soliciting and Coordinating Contributions and Payments

Proposed Rule 206(4)-5(a)(2)(ii) would 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 adviser is providing or seeking to provide investment advisory services, or any payment 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. The proposed rule is designed to prevent the coordination or solicitation of others to make contributions or payments to political parties instead of directly to government officials for the purpose of influencing an official's selection of investment advisers. Additionally, the proposed rule is designed to prohibit arrangements whereby "gatekeepers" (such as pension consultants) bundle contributions or payments from a number of investment advisers and distribute such contributions or payments to elected officials or candidates. Gatekeepers ensure that investment advisers that do not make sufficient contributions or payments are not awarded advisory contracts. Therefore, if a "gatekeeper" is a covered adviser, it would be subject to this prohibition.

E. Direct or Indirect Contributions or Solicitations

Proposed Rule 206(4)-5(d) would also make it unlawful for a covered adviser to do indirectly what the proposed rule prohibits a covered adviser from doing directly. The proposed rule 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 proposed rule.

II. AMENDMENTS TO RULE 204-2: RECORD-KEEPING REQUIREMENTS

In connection with the proposed rule, the SEC is also proposing amendment of Rule 204-2 under the Advisers Act which would require registered advisers (or advisers required to register pursuant to the Advisers Act) that either seek government entities as clients or that provide investment advice to government entities through investments in covered investment pools to keep records of contributions made by the covered adviser or its covered associates to an official of a government entity, a political party of a state or political subdivision thereof, or a PAC, and such contributions must be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment, and whether such contribution or payment was subject to the exception for certain returned contributions pursuant to proposed Rule 206(4)-5(b)(2).

III. PRACTICAL GUIDANCE FOR COVERED ADVISERS

If the rule proposals are adopted, covered advisers should carefully consider what measures they want to take to ensure that their businesses are in compliance with the requirements of the rules and are not unnecessarily restricted because of the activities of their covered associates. To begin with, pursuant to Rule 206(4)-7 under the Advisers Act, a covered adviser should consider adopting and implementing written policies and procedures reasonably designed to prevent violations of Rule 206(4)-5 and monitoring the adequacy of those policies and procedures and their effectiveness on at least an annual basis. For instance, to comply with the requirements of Rule 206(4)-5(a)(1), a covered adviser should consider periodically evaluating its personnel to determine which persons are "covered associates" for purposes of Rule 206(4)-5 and to define the parameters for the making of political contributions by such covered associates to avoid the inadvertent triggering of the prohibition contained in Rule 206(4)-5(a)(1). In addition, a covered adviser should consider conducting pre-employment checks of employees to be hired to determine whether any employee to be hired had made a triggering contribution to a government official within the past two years which would trigger application of Rule 206(4)-5(a)(1) with respect to his or her new employer. In defining to whom political contributions can be made, it may be difficult for a covered adviser and its covered associates to determine whether an elected official or candidate is an "official" for purposes of Rule 206(4)-5(a)(1), which may suggest the need to consider all government officials and candidates to be "officials" for purposes of Rule 206(4)-5(a)(1). To facilitate risk monitoring, covered advisers may want to consider requiring covered associates to obtain approval prior to making some or all political contributions.

Second, to prevent violation of Section 206(4)-5(a)(2), a covered adviser should consider requiring its service providers (particularly its unaffiliated placement agents, solicitors, and pension fund consultants) to do one of the following: (i) represent that they will not solicit government entities as clients on behalf of the covered adviser; or (ii) comply with the adviser's policies and procedures designed to prevent violation of Rule 206(4)-5(a)(2).

IV. CONCLUSION

Investment advisers should note that, in addition to proposed Rule 206(4)-5, 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.

Comments with respect to the rule proposals should be received by the SEC no later than October 6, 2009.

Arnold & Porter LLP will be closely monitoring any developments in this area, including public comments, and will prepare additional advisories as necessary. 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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