

Expert Advice

New Pay-To-Play Rules To Impact Advisors

Following several high-profile scandals involving payments made to government officials designed to influence the awarding of investment advisory business, the U.S. Securities and Exchange Commission recently adopted a new rule designed to curb pay-to-play practices.

Political Contributions

Among other things, the new rule will prohibit an investment adviser from receiving compensation from a government entity (which generally includes not only states and localities, but also plans or programs sponsored by states and localities) for two years after an adviser or its covered employees makes a contribution to a government candidate or official that can influence the awarding of advisory business by that government entity.

To clarify, the rule does not prohibit an adviser or its covered employees from making political contributions to government candidates or officials. It simply restricts an adviser's ability to collect fees from a government entity for two years if the adviser or its covered employees makes a triggering contribution. The rule, however, provides an exception whereby covered employees may make small contributions of up to \$350 per candidate per election in which the covered employee is entitled to vote and up to \$150 per candidate per election in which the covered employee is not entitled to vote without triggering the two-year cooling-off period. Covered employees include, among others, an adviser's principals, executive officers, and employees soliciting government entities on behalf of the adviser as well as those supervising such

Using Third Party Marketers

The rule also prohibits an adviser from using unaffiliated third party marketers, including placement agents, to solicit government entities on the adviser's behalf unless such third party marketers satisfy certain requirements, including, among other things, being subject to registration, regulation and supervision by either the SEC or another national securities association such as the Financial Industry Regulatory Authority. These provisions supplement existing rules applicable to solicitation by third party marketers on behalf of investment advisers and do not apply to third party marketers soliciting advisory business from non-government entities.

Compliance Policies and Procedures

It is imperative that advisers soliciting business from government entities adopt policies and procedures reasonably designed to prevent violations of such rules. Adopting such compliance measures also goes a long way towards demonstrating to investors that an adviser understands such rules and takes its compliance obligations seriously.

An adviser must evaluate its policies and procedures in several important areas to address the new rule's requirements. First, advisers must determine if they will impose any restrictions or prohibitions on the making of political contributions by their covered employees. Advisers that have government entity clients or seek to solicit such business should be particularly cautious of contributions made by them or their employees not only because of the dire con-

sequences of making such contributions, but also because it is difficult to discern what government candidates or officials are in a position to influence a government entity's awarding of advisory business.

At one end of the spectrum, advisers could completely prohibit their employees from making political contributions to government candidates or officials which establishes a bright-line rule that is not subject to misinterpretation by employees. At the other end of the spectrum, advisers could decide not to impose any restrictions on the making of political contributions by their covered employees; however, if the adviser seeks to solicit business from government entities, triggering political contributions that have already been made could hinder its ability to collect fees from such clients.

Alternatively, an adviser could impose restrictions on its employees based on the amount of the contribution to be made, the type of employee involved, or the type of government candidate or official involved. To minimize the likelihood of inadvertent contributions, an adviser could require its covered employees to pre-clear any political contributions. In addition, an adviser should consider requiring its covered employees to report any political contributions that have been made to ensure that inadvertent political contributions have not been made.

Also, advisers must evaluate their hiring and promotion practices as political contributions already made by prospective covered employees can also trigger the two-year cooling-off period. As a result, advisers should inform themselves as to the political contributions made by a prospective covered employee prior to the hiring or promotion decision to avoid triggering the two-year cooling-off period.

Additionally, investment advisers should conduct due diligence on any third party marketers they use to solicit government entities to ensure they are eligible to solicit government entities on behalf of the adviser. Furthermore, advisers should consider requiring third party marketers to represent in third party marketing agreements that they are eligible to (and will remain eligible to) solicit government entities on behalf of the adviser and will comply with all pay-to-play laws applicable to their services.

Conclusion

An adviser that solicits advisory business from government entities will also likely be subject to state or local pay-to-play rules that may impact its business and compliance obligations. For instance, California recently adopted a new law that will require third party marketers and certain employees of an adviser to register as and become subject to regulation as lobbyists in California if such persons solicit advisory business from state or local public retirement systems. As a result, it is important for an adviser to consult legal counsel to ensure that it understands the pay-to-play rules applicable to its business and to obtain assistance in implementing effective compliance policies and procedures designed to ensure compliance with such rules.

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