

SEC Adopts Pay-to-Play Rule Under Investment Advisers Act

July 9, 2010

On July 1, the U.S. Securities and Exchange Commission (SEC) adopted new Rule 206(4)-5 (the Rule) under the Investment Advisers Act (Advisers Act)¹ aimed at curtailing pay-to-play practices by investment advisers that seek to manage assets of state and local governments. The Rule, which was adopted substantially as proposed, restricts the contribution and solicitation practices of investment advisers and certain of their related persons, and poses significant consequences for slip-ups. Below, we discuss key aspects of the Rule and its potential effects on investment advisers and their compliance policies and procedures, and recordkeeping obligations.

Background

The Rule seeks to protect the beneficiaries of invested state and municipal assets, such as state and municipal pension plans and their participants, by curtailing the ability of investment advisers to use political contributions to influence those governmental officials responsible for the hiring of investment advisers, otherwise known as pay-to-play practices.

According to the SEC, pay-to-play practices potentially result in higher fees paid to advisers for potentially inferior advisory services, provided to government entities because of an attempt to recoup political contributions by the adviser, or because contracts are not negotiated at arms-length. Further, the SEC reasoned that pay-to-play practices could effectively block the most suitable adviser for a mandate from consideration if the most suitable adviser is a smaller adviser that either cannot afford to make or refuses to make pay-to-play contributions. Accordingly, the Rule—which is modeled after Rules G-37 and G-38 of the Municipal Securities Rulemaking Board (MSRB)—addresses not only direct political contributions by advisers, but also other indirect methods calculated to influence government officials.

The Rule applies to investment advisers registered (or required to be registered) under the Advisers Act and unregistered advisers relying on the Advisers Act's *de minimis* exemption under Section 203(b)(3).² The Rule will typically not apply to small advisers registered with a state securities authority, advisers that are unregistered in reliance on an exemption other than Section 203(b)(3), or advisers excepted from the definition of "investment adviser" under Section 202(a)(11) of the Advisers Act.

¹ See Political Contributions by Certain Investment Advisers, Advisers Act Release No. 3043 (July 1, 2010) (Adopting Release), available at <http://www.sec.gov/rules/final/2010/ia-3043.pdf>; see also Political Contributions by Certain Investment Advisers, Advisers Act Release No. 2910 (Aug. 3, 2009) (Proposing Release), available at <http://sec.gov/rules/proposed/2009/ia-2910.pdf>.

² Section 203(b)(3) of the Advisers Act exempts from registration under the Advisers Act investment advisers that are not holding themselves out to the public as investment advisers and have had fewer than 15 clients during the last 12 months. We note, however, that the Dodd-Frank Wall Street Reform and Consumer Protection Act proposes to eliminate the small adviser exemption under Section 203(b)(3) of the Advisers Act.

Rule Provisions

Two-year “Time-Out” following contributions. Under the Rule, if an adviser or a “covered associate” of the adviser makes a contribution to an official of a government entity who is in a position to influence the award of the government entity’s business, then the adviser is *prohibited from receiving compensation* for providing advisory services to that government entity for two years thereafter, otherwise known as a “time-out” period.

“Contribution” under the Rule is defined as any gift, subscription, loan, advance, or deposit of money, or anything of value made for:

- The purpose of influencing any election for federal, state, or local office
- The payment of debt incurred in connection with any such election
- Transition or inaugural expenses incurred by a successful candidate for state or local office

The SEC clarified that charitable donations and contributions to a political action committee (PAC) or local political party would not trigger the time out, although they may violate the provision of the Rule that prohibits an adviser and its covered associates from doing anything indirectly which, if done directly, would violate the Rule.

The definition of a “covered associate” of an investment adviser includes any:

- General partner, managing member, executive officer³ or other individual with a similar status or function
- Employee who solicits a government entity for the investment adviser (and any person who supervises, directly or indirectly, such an employee)
- PAC controlled by the investment adviser or by any of its covered associates

Contributions by nonexecutive employees of an adviser (unless they are soliciting government entity clients) would not trigger the time-out provision, unless the adviser or any of its covered associates used the employee to indirectly make a contribution.

The SEC noted that the Rule does not prohibit contributions or the provision of advisory services after making a contribution. Instead, the Rule prohibits the *receipt of compensation* for advisory services within two years after making a proscribed contribution. The SEC stated that it took this approach to prevent an adviser from having to abandon a government entity client after the adviser makes a contribution. After making a prohibited contribution, an adviser would, at a minimum, be obligated to “provide uncompensated advisory services for a reasonable period of time” until its government entity client could find a replacement adviser. According to the SEC, what constitutes a reasonable period of time will depend primarily on the amount of time a client may need in good faith to find and engage a successor to the adviser.

Additionally, the SEC refined its “look-back” period, which, as proposed, would have prohibited an adviser from earning compensation if any covered associate made a contribution at any time within the prior two years, even if the covered associate did not solicit government entity clients or if the contribution was made prior to the person becoming a covered associate of the adviser.

As adopted, the Rule requires a two-year look-back for all covered associates who solicit clients, but only a six month look-back for “new” covered associates who do not solicit clients. The “look-back” period will follow covered associates that change investment advisers such that a prohibited contribution by a covered associate will result in a “time out” for the covered associate’s new firm for the remainder of the two-year or six-month period, depending on whether the covered associate solicits clients for the new firm.

³ “Executive officer” is defined under the Rule to include the adviser’s president; any vice president in charge of a principal business unit, division, or function (such as sales, administration, or finance); and any other officer of the adviser or other person who performs a policy-making function for the adviser. According to the SEC, whether a person is an executive officer depends on his or her function, not title.

To prevent advisers from channeling contributions through departing covered persons, if a covered person makes a prohibited contribution and then leaves the employ of that investment adviser, the adviser will still be subject to the two-year time-out period, despite the departure of the covered associate who made the contribution. (The SEC adopted this provision despite receiving comments that a departing or terminated employee could make a contribution in an effort to seek retribution against an adviser.)

Exceptions to the “time-out” provision. In addition to the six-month look-back provision for “new” covered persons who do not solicit clients, there are two narrow exceptions to the two-year time-out: a *de minimis* exception and a returned contributions exception.

The ***de minimis* exception** allows a covered associate of an adviser that is a natural person to contribute: (i) up to \$350 to an official per election (with primary and general elections counting separately) if the covered associate was entitled to vote for the official at the time of the contribution, and (ii) up to \$150 to an official per election (with primary and general elections counting separately) if the covered associate was *not* entitled to vote for the official at the time of the contribution. Such *de minimis* contributions would not trigger the two-year time-out under the Rule.

Under the **returned contribution exception**, if a covered associate of an adviser makes a contribution that triggers the two-year time-out period solely because he or she was *not* entitled to vote for the official at the time of the contribution, the adviser can effectively undo the contribution under very narrow circumstances. To be eligible for the returned contribution exception, the contribution had to be less than \$350, the adviser must have discovered the contribution within four months of the date of such contribution, and the adviser must cause the contributor to re-collect the contribution within 60 days after the adviser discovers the contribution. The specificity of the requirements significantly limits the availability of the exception. Further, an adviser with less than 50 employees can only rely on the returned contribution exception twice in a 12-month period (three times for advisers with more than 50 employees) and an adviser can never use the returned contribution exception for the same covered associate twice.

In addition, the Rule allows an adviser to apply for an order exempting it from the two-year time-out requirement in the event of an inadvertent violation that falls outside of the exceptions set forth above when, according to the SEC, the imposition of the time-out provision is unnecessary to achieve the Rule’s intended purpose.

Ban on using third parties to solicit government business. The Rule prohibits an adviser or a covered associate from paying (or agreeing to pay), directly or indirectly, any person to solicit a government entity for advisory services on behalf of the adviser.⁴ However, such solicitation is *not* prohibited if the person is:

- A “regulated person”
- An executive officer, general partner, managing member (or person with similar status or function), or employee of the adviser

The Rule defines “regulated person” as a:

- Registered investment adviser that has not (and whose covered persons have not) made, coordinated, or solicited a contribution within the last two years that would violate the Rule.
- Registered broker or dealer that is a member of a registered national securities association, so long as such association’s rules prohibit members from engaging in distribution or solicitation activities after making political contributions and the SEC finds, by order, that such rules are at least substantially equivalent to the restrictions imposed on advisers under the Rule.

As proposed, the Rule would have banned the use of third-party solicitors entirely. However, the adopting release permits advisers to make payments to registered investment advisers and broker-dealers under the theory that

⁴ The Rule defines “solicit” as communicating, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an adviser, or obtaining or arranging a contribution or payment. See Advisers Act Rule 204(6)-5(f)(10).

such regulated persons are (or will be) prohibited from engaging in pay-to-play practices. According to the SEC, the Financial Industry Regulatory Authority (FINRA) is in the process of preparing pay-to-play rules that would apply generally to all member firms that solicit advisory business from a government entity. The compliance date for this prohibition has been extended to one year from the effective date of the Rule in order to give FINRA time to propose rules governing pay-to-play.

Ban on soliciting and coordinating contributions and payments. The Rule also prohibits an adviser or a covered associate from coordinating or soliciting a person or PAC to:

- Contribute to an official of a government entity to which the adviser provides or seeks to provide advisory services.
- Make a payment to a political party of a state or locality in which the adviser provides or seeks to provide advisory services to a government entity.

According to the SEC, this provision seeks to eliminate “bundling” practices, whereby a person acting on behalf of the adviser collects small contributions from several employees of the adviser to create one large contribution, and “gatekeeper” practices, whereby an intermediary, such as a pension consultant, collects and distributes political contributions in such a way that advisers not meeting a minimum aggregate contribution are eliminated from consideration for advisory contracts and the contributions are obscured so as to minimize public disclosure.

Application to pooled investment vehicles. The Rule’s prohibitions will apply to advisers (and subadvisers) of certain pooled investment vehicles, or “covered investment pools.” Under the Rule, advisers to covered investment pools in which a government entity invests or is solicited to invest are treated as though they provided or solicited services directly to that government entity. Thus, the prohibited practices under the Rule apply not only when advisers seek to be hired to manage government assets directly, but also when advisers seek to obtain government entities as investors in certain investment vehicles managed by the adviser. The Rule defines covered investment pool as:

- A registered investment company that is an investment option of a plan or program of a government entity.
- Any company that would be an investment company as defined in Section 3(a) of the Investment Company Act of 1940 (Investment Company Act) but for the exclusion from the definition of “investment company” under Section 3(c)(1), 3(c)(7), or 3(c)(11) of the Investment Company Act.

Importantly, the definition of a covered investment pool was narrowed so that all three of the prohibitions in the Rule apply to advisers to registered investment companies, but only if the registered investment company is “an investment option of a plan or program of a government entity.” The Rule defines “plan or program of a government entity” as a *participant-directed* plan or program sponsored or established by a state or political subdivision, agency, authority, or instrumentality, including, but not limited to, a 529 savings plan, a retirement plan authorized by Section 403(b) or 457 of the Internal Revenue Code, or any similar plan or program.

This definition is intended to cover situations in which a government official has directly or indirectly selected a registered investment company as an investment choice for plan participants. The investment option qualification is intended to strike a balance between the compliance burdens placed on investment advisers to identify investments from government entities in registered investment companies and the fact that the risks associated with pay-to-play concerns are not as prevalent when the adviser is not bidding for or soliciting a government entity’s business. The investment option qualification does not apply to private funds that are considered covered investment pools.

Blanket prohibition. The Rule specifically includes a blanket prohibition restricting all advisers and their covered associates from doing “anything indirectly which, if done directly,” would violate the Rule. This signals the SEC’s heightened concern about indirect payments and puts advisers on notice that the SEC will not tolerate attempts to “game” the Rule.

Amendments to recordkeeping requirements. Coupled with the Rule are amendments to Rule 204-2 under the Advisers Act, which impose additional recordkeeping obligations on advisers that provide investment advisory services to a government entity or a covered investment pool in which a government entity is an investor. Such advisers must collect and maintain:

- The names, titles, and business and residence addresses of all covered associates of the adviser.
- All government entities to which the adviser provides or has provided investment advisory services (directly or indirectly through a covered investment pool) in the last five years.
- All direct and indirect contributions made by the adviser or its covered associates to an official of a government entity or direct or indirect payments made to a political party or PAC.
- The name and business address of each regulated person to which the adviser agrees to provide direct or indirect payment to solicit a government entity.

Effectiveness and Compliance Dates

The Rule will become effective 60 days after publication in the *Federal Register*. Advisers subject to the Rule generally will have to comply with its provisions within six months after the effective date. However, advisers will have up to one year to comply with the prohibition on the use of third parties (other than regulated entities) to solicit government business and the related recordkeeping requirements. Similarly, advisers to registered investment companies that are “covered investment pools” have up to one year to comply with the provisions of the Rule that relate to covered investment pools and the related recordkeeping requirements.

Implications and Effects on Advisers and Covered Investment Pools

- In prohibiting an adviser from doing anything indirectly that it would not be allowed to do directly, the Rule references Section 206(4) of the Advisers Act, which gives the SEC the authority to “prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.” As such, a violation of the Rule arguably should not be a violation of the general anti-fraud provisions of Sections 206(1) and 206(2) of the Advisers Act.
- The Rule, its definitions, schemes, and exceptions are complicated and provide significant opportunities for missteps with possibly draconian results. Because of the significant limits to the Rule’s exceptions, we expect that many advisers will either bar all political contributions by their employees or will need to seek special exemptive relief under the Rule and potentially defer or hold in escrow advisory fees from government entity clients, pending receipt of such relief.
- Advisers should be aware that pay-to-play practices may violate federal and state laws that carry criminal sanctions, as well as state and local laws that may disqualify advisers from providing services to government entities or otherwise subject advisers and their employees to actions that are separate from, and independent of, any violation of the Rule.
- Because the Rule takes effect in a relatively short time, advisers will need to act quickly to prepare. The following are steps advisers may wish to consider or take:
 - Impose preclearance requirements on all political contributions by covered associates, including employees, so that the adviser is able to assess whether they would trigger requirements under the Rule. In this regard, it would also be advisable to identify covered associates and make sure such persons are aware of their status.
 - Amend solicitation and placement agent agreements (including existing agreements) to reflect the Rule’s requirements and bar the solicitor from engaging in proscribed political contribution activity under the Rule.

- Engage intermediaries to assist the adviser in identifying government entities invested in covered investment pools.
 - Adopt new pre-hire and termination procedures designed to ensure that political contribution activities by new or departing employees do not trigger a time-out under the Rule.
 - Adopt new policies and procedures to govern compliance with the Rule and roll out employee training programs to educate employees about the new requirements.
 - Develop a surveillance process for political contribution activities by employees, possibly including checking names of associated persons, including employees that the adviser has identified as “covered associates” against public databases of political contributions.
 - Consider how the adviser would approach a time-out, including possible escrow arrangements for fees (assuming an adviser seeks SEC exemptive relief) and contractual provisions obligating government entity clients to hire a successor adviser on a prompt basis.

The SEC’s adopting release is available at: <http://www.sec.gov/rules/final/2010/ia-3043.pdf>.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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