

Financial Services and Products ADVISORY

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SEC Adopts New Rules to Curb “Pay to Play” Practices by Investment Advisers

On June 30, 2010, the Securities and Exchange Commission (SEC) voted unanimously to adopt new Rule 206(4)-5 and certain rule amendments under the Investment Advisers Act of 1940 (the “Advisers Act”), which are intended to curtail “pay to play” practices and govern campaign contributions and related payments to elected officials by investment advisers.¹ “Pay to play” by investment advisers refers to practices whereby investment advisers seek to influence government officials’ awards of advisory contracts to manage public pension and retirement funds by making or soliciting political contributions to those officials. The new rules are intended not only to restrict direct political contributions made by investment advisers, but also to limit other means by which advisers may engage in pay to play arrangements. In addition to these new rules, the SEC has recently brought several enforcement actions charging investment advisers with participating in pay to play schemes, including a civil action involving allegations of unlawful kickbacks paid in connection with investments by the New York State Common Retirement Fund.

The newly adopted rules and rule amendments:

- Prohibit an investment adviser from providing advisory services, either directly or through a pooled investment vehicle, for compensation for two years if the adviser (or certain of its executives or employees) makes a political contribution to an elected official who is in a position to influence the selection of the adviser;
- Prohibit an advisory firm (and certain of its executives and employees) from soliciting or coordinating campaign contributions from others (or “bundling”) for an elected official who is in a position to influence the selection of the adviser;
- Prohibit solicitation and coordination of payments to political parties in the state or locality where the adviser is seeking business; and
- Prohibit an adviser from paying a third party, such as a solicitor or placement agent, to solicit a government client on behalf of the investment adviser, unless that third party is an SEC-registered investment adviser or broker-dealer subject to similar pay to play restrictions.

Rule 206(4)-5 applies to all registered investment advisers and advisers exempt from registration pursuant to Section 203(b)(3) of the Advisers Act. The new rule will not be applicable to most small advisers registered with state securities regulators instead of the SEC, or advisers that are exempted from registration in reliance on exemptions other than Section 203(b)(3) of the Advisers Act.

¹ <http://www.sec.gov/rules/final/2010/ia-3043.pdf>

Restrictions on Political Contributions

Two-Year Ban on Contributions

Rule 206(4)-5(a)(1), adopted substantially as proposed, prohibits investment advisers from receiving compensation for providing advice to a government entity² within two years after a contribution to an official³ has been made by the investment adviser or by any of its covered associates. The SEC anticipates that this two-year “time out” will discourage advisers from participating in pay to play practices by providing a “cooling-off period,” during which the effects of any political contributions on the selection of an investment adviser would fade.

The two-year time out is triggered upon the making of the political contribution, which includes a gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing a federal, state or local election, including payments made for debts incurred in the election or transitional or inaugural expenses incurred by a successful candidate for state or local office. After the triggering contribution has been made, an investment adviser may provide only uncompensated advisory services to a government entity.

Covered Associates

The new rule applies not only to the investment adviser firm itself, but also to “covered associates” of the firm, which includes (i) any general partner, managing member or executive officer (or other person with a similar function); (ii) any employee who solicits a government entity for the firm and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee (PAC) controlled by the firm or its covered associates. The definition is intended to capture the fact that contributions made to influence the selection process are typically made by those individuals who have a direct economic stake in the business relationship with the government client or whose position in the investment adviser firm may incentivize them to obtain clients for the firm.

Rule 206(4)-5(a)(1) includes a “look back” provision that attributes adviser contributions made by a person within two years of becoming a covered associate of that adviser in order to prevent advisers from circumventing the rule to influence the selection process by hiring persons who have made political contributions. As an exception to this two-year look back provision, the rule provides that the two-year time out is not triggered by a contribution made by a natural person more than six months prior to becoming a covered associate, if, after becoming a covered associate, that person does not solicit clients for the investment adviser.

² A “government entity” includes all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans.

³ An “official” includes an incumbent, candidate or successful candidate of a government entity, if the office is (or has the authority to appoint any person) directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.

Exceptions for *De Minimis* and Returned Contributions

The *de minimis* exceptions apply only to contributions made by individual covered associates, and not the investment adviser itself. Under Rule 206(4)-5(b), covered associates are permitted to make aggregate contributions without triggering the two-year time out of up to \$350, per election, to an elected official or candidate for whom the individual is entitled to vote, and up to \$150 to an elected official or candidate for whom the individual is not entitled to vote.

The new rule also provides an adviser with a limited ability to cure the consequences of an inadvertent political contribution to an official for whom the covered associate is not entitled to vote. The exception to the two-year time out for contributions is available for contributions that do not exceed \$350 in the aggregate per election to any one official for whom the contributing individual is not entitled to vote. To utilize this exception, the investment adviser must have discovered the contribution within four months of the date of such contribution, and the contributing individual must obtain the return of the contribution within 60 days of such discovery.

Restrictions on Soliciting and Coordinating Contributions and Payments

The SEC adopted the restrictions on soliciting and coordinating contributions substantially as proposed. As adopted, Rule 206(4)-5 of the Advisers Act prohibits advisers and covered associates from coordinating or soliciting⁴ 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 SEC adopted these restrictions in order to prevent advisers from circumventing the rule's prohibition on direct contributions by using some other means to influence an election, such as by "bundling" a large number of small employee contributions to influence an election, or making contributions (or payments) indirectly through a state or local political party.

Direct and Indirect Contributions and Solicitations

Additionally, the SEC adopted Rule 206(4)-5(d), which explicitly prohibits acts done indirectly that, if done directly, would violate the rule. As a result, an adviser and its covered associates could not funnel payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the adviser, as a means to circumvent the rule. However, contributions by these other persons would not otherwise trigger the rule's two-year time out.

⁴ "Solicit," with respect to a contribution or payment, is defined as communicating, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment. Soliciting would include an adviser that consents to the use of its name on fundraising literature for a candidate or sponsors a meeting or conference that features a government official as an attendee or guest speaker and involves fundraising for the government official.

Covered Investment Pools

The new rules also apply to an investment adviser that manages assets of a government entity through a hedge fund or other type of pooled investment vehicle (“covered investment pool”).⁵ Thus, the new rules will also extend to public pension plans that utilize investment advisers through hedge funds and other types of pooled investment vehicles they sponsor or advise.

The SEC anticipates that the new rules will impact two types of arrangements in which a government official is in a position to influence investment of funds in pooled investment vehicles: (1) the investment of public funds in a hedge fund or other type of pooled investment vehicle; and (2) the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a “529 plan.”

Additionally, if an adviser is selected by a government entity to advise a government-sponsored plan (regardless of whether the plan selects one of the pools the adviser offers or manages as an option available under its plan), the prohibitions of the rule directly apply.

Although a number of commenters urged the SEC to exclude from the rule subadvisers to covered investment pools, the SEC chose not to do so. Therefore, subadvisers to covered investment pools will be required to establish procedures with the adviser to monitor contributions and otherwise comply with the rule. However, the SEC did provide some guidance to assist advisers in subadvisory and fund of funds arrangements in complying with the rule.

The SEC noted that under the new rule, if an adviser or subadviser makes a contribution that triggers the two-year time out, the subadviser or adviser, as applicable, that did not make the triggering contribution could continue to receive compensation from the government entity.⁶ Additionally, the SEC noted that 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 such investment were made for the purpose of doing indirectly what the adviser could not do directly under the rule.

Ban on Certain Third Party Solicitations of Contributions

Rule 204(6)-5(a)(2) prohibits an investment adviser or its covered associates to provide or agree to provide, directly or indirectly, payment to any person, such as a solicitor or placement agent, to solicit government clients for investment advisory services on its behalf. Depending on the facts and circumstances, *quid pro quo* arrangements whereby a third party solicits advisory business for the adviser in exchange for being hired to provide unrelated services to the adviser could violate this rule.

⁵ Under the rule, a “covered investment pool” includes (i) any investment company registered under the Investment Company Act of 1940 that is an investment of a plan or program of a government entity; or (ii) any company that would be an investment company under section 3(a) of that Act, but for the exclusion provided from definition by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act. For example, hedge funds, private equity funds, venture capital funds and collective investment trusts would fall under this definition, as would registered pooled investment vehicles, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.

⁶ However, such an arrangement could not be used as a means to do indirectly what the adviser or subadviser could not do directly under the rule.

However, the adopted rule provides an exception whereby investment advisers may make payments to certain “regulated persons,” including registered investment advisers subject to the SEC’s new pay to play rules and registered broker-dealers subject to a registered national securities association’s pay to play restrictions.

The SEC is providing an extended one-year transition period for compliance with the third-party solicitors’ ban to give FINRA an opportunity to propose a rule for broker-dealers and for the SEC to consider the rule. If FINRA has not adopted a rule within the one-year period, advisers would be prohibited from making payments to broker-dealers for distribution or solicitation activities in connection with government entities.

Exemptive Process

Investment advisers will be permitted to apply to the SEC for an order exempting them from the two-year time out when an adviser discovers contributions that trigger the compensation ban only after they have been made. In granting exemptive relief, the SEC will consider various factors in order to cure the consequences of an inadvertent violation by the adviser that does not fall within the scope of the *de minimis* or returned contributions exceptions.

Recordkeeping Requirements

The SEC also adopted amendments to Rule 204-2 of the Advisers Act to require registered investment advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government entity invests, to maintain records of contributions made by the adviser and its covered associates to government officials and of payments to state or local political parties or PACs. An investment adviser that has government clients is further required to keep a list of its covered associates and the government entities to which the adviser has provided advisory services within the past five years. Finally, regardless of whether it currently has government clients or not, an investment adviser must also keep a list of contact information of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity on its behalf.

Compliance Dates

The new rule becomes effective 60 days after its publication in the Federal Register. Compliance with the rule’s provisions generally will be required within six months of the effective date. Compliance with the third-party solicitors’ ban (as discussed above) and those provisions applicable to advisers to registered investment companies that are covered investment pools will be required one year after the effective date of the rule.

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