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SEC RULE PROPOSAL: REGULATING "PAY TO PLAY" PRACTICES

The Securities & Exchange Commission ("SEC") has taken note of "pay to play" practices of investment advisers, in which advisers make political contributions to elected officials responsible for managing public pension plan assets in order to influence the official's selection of investment advisers to manage the funds they oversee. Such practices create a significant risk of corruption and tend to compromise an adviser's fiduciary obligations in violation of the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940 ("Advisers Act").

Recently, the SEC proposed a new rule under the Advisers Act designed to eliminate adviser participation in pay to play practices.[1] The proposed rule regulates political contributions from investment advisers to local and state government clients and similarly related public programs. These programs primarily include "public pension plans that pay retirement benefits to government employees, retirement plans in which teachers and other government employees can invest money for their retirement, and 529 plans that allow families to invest money for college."[2]

The SEC attempted a similar proposal in 1999, but received strong opposition throughout the industry for not having enough evidence that such activities were occurring at the time. However, more recent allegations of various "pay to play" conduct throughout many states indicate that investment advisers are playing a larger role in pay to play practices, thus establishing the SEC's need to revisit such a proposed rule. As models in the drafting of the proposal, the SEC used Rules G-37 and G-38 of the Municipal Securities Rulemaking Board ("MSRB"), which addresses "pay to play" practices in the municipal securities markets.

Proposed Rule 206(4)-5 is designed to prohibit advisers from participating in "pay to play" activities, either directly or indirectly. This proposed rule would apply to SEC registered firms, firms required to be SEC registered and unregistered firms relying upon the exemption available under Section 203(b)(3) of the Advisers Act. According to SEC Chairman Mary Schapiro, these often difficult to prove yet frequently occurring arrangements could "result in public plans and their beneficiaries receiving sub-par advisory services at inflated prices."[3] The purpose is to prevent contributing investment advisers from unduly influencing government officials in the selection of investment advisers or obtaining more benefits than those available to advisers who had not made political contributions. The new proposal specifically addresses a "time out" period, third party consultants, and amendments to rules covering recordkeeping and cash solicitation.

Recordkeeping and Cash Solicitation Rules

Accompanying the proposed new rule, the SEC is proposing an amendment to Rule 204-2 of the Advisers Act, which covers recordkeeping requirements. The amendment would require advisers registered or required to be registered with the SEC to make and keep certain books and records of any political contributions made by the adviser or its covered associates. Such records must

consist of at least: covered associate information (names, titles, business and residential addresses); all former, current and prospective governmental entities who have received, are receiving or are soliciting to receive advisory services; and all direct and indirect contributions or payments made to a governmental entity, political party or political action committee. Records would be required to be kept for a minimum of five (5) years. In addition, the SEC proposes to amend Rule 206(4)-3 of the Advisers Act, the Cash Solicitation Rule, to include soliciting restrictions on governmental entities in "pay to play" activities.

"Time out" Period

The new proposal focuses significantly on a "time out" period. Under the proposal, investment advisers would be prohibited from providing advice for compensation within two years after any contribution[4] by the adviser or any of its covered associates to an official of a government entity.[5] To trigger the rule, the government official must have the ability to influence the selection process of investment advisory services or have authority to appoint another person to perform such responsibilities. Such official may be an incumbent, a candidate, or a successful candidate for elective office. Regulated contributions would include those made by the adviser as well as the adviser's general partners, managing members, executive officers, employees, or other individual in a similar role. This provision would not prohibit the providing of advisory services to a government client, even after triggering the time out period, but rather the receiving of compensation for advisory services during the time out. Importantly, this proposed rule also would apply to advisers that manage a covered investment pool or government sponsored plan, such as a 529 plan.

In an effort to keep advisers from abandoning service of government programs, the SEC applied a two year restriction to those advisers *receiving* compensation for their services. Therefore, an adviser or its covered associates could conceivably contribute to an influential official of government plans and simultaneously provide advisory services to such plans, as long as they receive no compensation for those services. Should the covered associate responsible for initiating the "time out" period change advisory firms, then the "time out" period would carry over to the new firm employing such covered associate. If this proposed rule passes, advisers may want to add political contribution history to firm hiring processes.

Exceptions: The SEC offers two exceptions under the proposal.

(1) If the total amount contributed by a covered associate is $250 or less, per official, per election, then the adviser qualifies for the de minimis exception and is exempt from the two year restriction on advisory services.[6]

(2) If a contribution is made by a covered associate to an official that such covered associate is not eligible to vote for and the amount does not exceed $250, then the adviser may qualify for the Certain Returned Contributions Exception. However, there are several actions and deadlines the adviser must take in order to claim this exemption successfully. The adviser must discover such contribution was made within four (4) months of the contribution date and the contribution must be returned to the contributor within 60 days of such discovery. This exception also carries limits. The adviser may use this exception twice per 12-month period, however, only once per covered associate irrespective of a time period.[7]

Additional Bans

Due to several third party consultants being involved in recent investment schemes, the SEC has decided to extend the "time out" period to include the use of third party consultants, solicitors, finders, or placement agents. The "time out" period would take effect should a direct or indirect payment be made to a person who solicits government clients for investment advisory services on behalf of the adviser. The SEC considers a payment to include any gift, subscription, loan, advance, deposit of money, or anything of value. The proposed rule also prohibits an adviser, either directly or through an intermediary from soliciting or coordinating payments and contributions to a government entity or state or local political party that is seeking advisory services. The implementation of "direct or indirect" actions of an adviser or its covered associates was designed to prevent an adviser from circumventing the proposed two year compensation restriction through outside persons, including family members, friends, professional acquaintances and the like.

Exception: If such payment is made to a related person (as defined by the SEC), an employee of the adviser or the adviser's general partners, managing members, executive officers or other similar functioning person, the two year restriction would not apply.

The SEC is currently accepting comments regarding the proposed "pay to play" rule and amendments. Please visit www.sec.gov to review the full proposal and submit comments on or before October 6, 2009. For more questions regarding this update, please contact us at (619) 278-0020.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

Author: Michelle L. Jacko, Esq., CEO, Core Compliance & Legal Services ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.

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[1] Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 2910, 74 Fed. Reg. 39840 (proposed Aug. 3, 2009), *available at* http://www.sec.gov/rules/proposed/2009/ia-2910.pdf [hereinafter IA Act Release No. 2910].

[2] Press Release 2009-168, Securities & Exchange Commission, SEC Proposes Measures to Curtail "Pay to Play" Practices (July 22, 2009) *available at* http://www.sec.gov/news/press/2009/2009-168.htm.

[3] Chairman Mary Schapiro, Speech by SEC Chairman:,Statement at SEC Open Meeting (July 22, 2009), *available at* http://www.sec.gov/news/speech/2009/spch072209mls.htm.

[4] In this context, "contribution" is defined as a gift, subscription, loan, advance, deposit of money or anything of value, including expenses. IA Act Release No. 2910, s*upra* note 1, at 30-31.

[5] "Covered associate" is defined within the proposal as the adviser's general partners, managing members, executive officers, or other individual with a similar status or function; any employee of the adviser who solicits government entity clients for the investment adviser; and any political action committee controlled by the investment adviser or any of the adviser's covered associates. *Id*. at 33.

[6] *Id*. at 39.
[7] *Id*. at 40-42.