

Proposed Rule under Investment Advisers Act Would Limit “Pay to Play” Practices

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On August 3, the Securities and Exchange Commission (SEC) proposed new Rule 206(4)-5 under the Investment Advisers Act of 1940¹ (Advisers Act) aimed at curtailing “pay to play” practices by investment advisers that seek to manage assets of state and local governments. The proposed rule would substantially restrict contribution and solicitation practices of investment advisers and certain of their related persons, and poses possibly draconian consequences for slip-ups. If adopted, the proposed rule will significantly affect investment advisers’ compliance policies and procedures as well as recordkeeping requirements. Below, we discuss key aspects of the proposed rule and some of the many unresolved issues that will have to be sorted out in the comment process.

Background

The proposed rule, if adopted, would seek to protect the beneficiaries of invested state assets, such as state and municipal pension plans and their participants, by curtailing the ability of investment advisers to use political contributions to influence 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 or potentially inferior advisory services provided to government entities because of contribution recoupment by the adviser or because contracts are not negotiated at arm’s length.

Further, according to the SEC, in situations where the most suitable adviser for a mandate is a smaller adviser, pay-to-play practices could effectively block the adviser from consideration if it cannot afford to make pay-to-play contributions. According to the SEC, the proposed rule—which is modeled after Rules G-37 and G-38 of the Municipal Securities Rulemaking Board (MSRB)—aligns the responsibilities imposed on those state persons entrusted by the public to oversee state assets with the fiduciary obligations imposed on investment advisers by the Advisers Act.

The proposed rule would apply 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 proposed rule would not apply to advisers registered with a state securities authority.

¹ See 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.

Proposed Rule Provisions

Two-Year “Time Out” Following Contribution. Under the proposed rule, if an adviser or a “covered associate” (defined below) 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 providing advisory services to that government entity *for compensation* for two years thereafter, otherwise known as a “time out” period.

“Contributions” under the proposed rule are defined as any gift, subscription, loan, advance, or deposit of money or anything of value made for (i) the purpose of influencing any election for federal, state, or local office; (ii) the payment of debt incurred in relation to such election; or (iii) transition into office or inauguration of the successful candidate for state or local office. A “covered associate” of an investment adviser would be defined to include any general partner, managing member, executive officer,³ or other individual with a similar status or function; any employee who solicits a government entity for the investment adviser; and any political action committee (PAC) controlled by the investment adviser or by any person previously described. 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 make a contribution indirectly, as discussed further below.

The SEC noted that the proposed rule does not prohibit contributions, or the provision of advisory services after making a contribution. Instead, the proposed 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 requiring an adviser to abandon a government entity client after the adviser makes a contribution, and that, at a minimum, the adviser would be obligated to “provide (uncompensated) advisory services for a reasonable period of time” until the government entity could find a replacement adviser.

Additionally, under the proposed rule, if a covered associate of an adviser made a contribution prior to his or her employment with another adviser, the time out would apply to the new adviser if the person would be a covered associate of the new adviser. This would require the new adviser to undertake a thorough prehire investigation and to “look back” in time to determine if a person it is hiring or engaging was a covered associate of another adviser, and made a contribution that would make it subject to the restrictions of the proposed rule. However, the prohibition would not last more than two years, and would only apply to the new adviser for the remainder of the two-year period after the contribution. The adviser that the covered associate leaves will still be subject to the two-year time-out period, despite the departure of the covered associate who made the contribution.

Exceptions to the “Time Out” Rule. 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 make up to \$250 in contributions to an official per election, if the covered associate was 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 proposed rule.

³ “Executive Officer” is defined under the proposed rule to include “the adviser’s president and any vice president in charge of a principal business unit, division, or function (such as sales, administration, or finance) or any other executive officer who, in each case, in connection with his or her regular duties: (i) performs investment advisory services (or supervises someone who performs them) for an adviser; (ii) solicits (or supervises someone who solicits) for an adviser, including with respect to investors for a covered investment pool; or (iii) supervises, directly or indirectly, executive officers described in (i) or (ii).” See Proposing Release 1 at 34.

Under the returned contribution exception, if a covered associate of an adviser makes a contribution that triggers the two-year time-out period 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 that will limit the usefulness of the exception. To be eligible for the returned contribution exception, the contribution had to be less than \$250, 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. Further, an adviser can only rely on the returned contribution exception twice in a 12-month period and can never use the returned contribution exception for the same covered associate twice.

Ban on Using Third Parties to Solicit Government Business. The proposed rule also prohibits an adviser or a covered associate of the adviser from providing (or agreeing to provide), directly or indirectly, payment to 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 one of the following:

- A “related person” of the adviser
- An employee of a company that is a related person of the adviser
- An executive officer, general partner, managing member, person with similar status or function, or employee of the adviser

The proposed rule defines “related person” as “any person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser.” According to the SEC, the prohibition would extend to the use of finders, solicitors, placement agents, pension consultants, and others engaged to solicit a government entity for advisory services on behalf of an adviser. “Payment,” according to the proposal, means any gift, subscription, loan, advance, or deposit of money or anything of value.

Ban on Soliciting and Coordinating Contributions and Payments. The proposed rule also prohibits an adviser or a covered associate of the adviser from coordinating or soliciting a person or political action committee to do either of the following:

- 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 also seeks to eliminate “bundling” and “gatekeeping” practices. In “bundling,” a person acting on behalf of the adviser collects small contributions from several employees of the adviser to create one large contribution. In “gatekeeping,” 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.

⁴ According to the SEC Release proposing the rule, “solicit” would be defined as communicating, directly or indirectly, for the purpose obtaining, retaining or referring a client, or obtaining or arranging a contribution or payment. *See id.* at 50.

Application to Pooled Investment Vehicles. The proposed rule’s prohibitions would apply to advisers of certain pooled investment vehicles, or “covered investment pools.” Under the proposed 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. The proposed rule defines covered investment pool as any investment company defined in Section 3(a) of the Investment Company Act of 1940 (Investment Company Act) or any company excluded from the definition of “investment company” under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act. Thus, the prohibited practices under the proposed rule apply not only where advisers seek to be hired to directly manage government assets, but also where advisers seek to obtain government entities as investors in certain collective vehicles managed by the adviser.

Importantly, the two-year time-out period does not apply to a publicly offered, registered investment company unless “it is an investment or an investment option of a plan or program of a government entity.” The proposed rule defines “plan or program of a government entity” as a plan or program sponsored or established by a government entity, 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.

According to the proposal, this definition excludes, for example, situations where a state government invests its pension fund assets in a mutual fund. The SEC stated that it recognized the compliance burdens placed on investment advisers to screen investments from government entities in their investment companies, and noted that the pay-to-play concerns with publicly registered investment companies were not as prevalent as in other situations where the adviser bids for, or solicits, a government entity’s business. The other two provisions of the proposed rule, however, would apply to publicly offered, registered investment companies, with no exception.

Effects of Blanket Prohibition. Although the proposed rule is in some ways narrowly drawn to limit First Amendment and other concerns (for example, by confining certain limits to “covered associates” of an adviser), the proposed rule specifically includes a blanket prohibition restricting all advisers and their covered associates from doing “anything indirectly which, if done directly” would violate the proposed rule, similar to the “directly or indirectly” language in MSRB Rule G-37.

It is significant that the proposed rule not only prohibits in paragraph (a) direct or indirect payments, but also contains a separate prohibition in paragraph (d) on indirect actions that, if done directly, would violate the proposed 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. Additionally, from an adviser’s perspective, there may be a risk that activities that are either carved out of or not covered by the rule could be characterized by the SEC as involving an indirect violation.

Exemptions. The proposed rule includes a provision under which an adviser may apply for an order exempting it from the two-year time-out requirement, under certain conditions based on criteria specified in the proposed rule.

Amendments to Recordkeeping Requirements. Coupled with the proposed rule are proposed amendments to Rule 204-2 under the Advisers Act, outlining recordkeeping requirements of advisers. Under the amendments to Rule 204-2, advisers would have to collect and maintain the following records:

- Contact information of all covered associates

- Information of all government entities to which the adviser provides or seeks to provide services or that are investors of a covered investment pool managed by the adviser
- Information on all such government entities for the last five years
- Chronologically organized information on all direct or indirect contributions and payments made by the investment adviser or any of its covered associates to any official, political party of a state or political subdivision thereof, or a PAC.

A Thicket of Issues

The proposal, as presented, leaves many unanswered questions and unresolved issues, including:

- The costs and burdens of monitoring contributions of covered associates. Unless investment advisers adopt a bright-line prohibition of contributions by their covered associates, the costs and time associated with monitoring contribution practices are likely to be substantial.
- The compliance costs and burdens associated with adopting policies and procedures consistent with the proposed recordkeeping requirements.
- The constitutionality of the proposed rule under the First Amendment. In remarks on the proposed rules, Commissioner Paredes acknowledged the rule may be subject to strict scrutiny and explicitly invited comments on its constitutionality. Rule G-37 of the MSRB, on which the proposed rule is modeled, withstood constitutional challenge in the U.S. Court of Appeals for the District of Columbia Circuit in 1995.⁵ The Supreme Court did not grant review then, but has since decided several significant contribution restriction cases that might affect its posture on the proposed rule.
- The overall ambiguity of the ban on third-party contributions and solicitations, as well as its effect on, *inter alia*, smaller investment advisers. The ban, coupled with the exemption for solicitation by related persons of the adviser or employees of an investment company related to the adviser, could have the effect of favoring larger advisers at the expense of smaller advisers, which typically use third-party solicitors because they often lack in-house institutional sales personnel. This could also effectively shrink the pool of available advisers for government-sponsored savings and retirement plans, such as 529 college savings plans.
- The implementation of any time-out period for advisers to registered investment companies. An adviser's being required to forgo compensation for a government entity's investment in one of its managed investment companies during a time-out period may create difficult legal issues because of restrictions under the Investment Company Act (including Section 18(f)⁶) and the Internal Revenue Code, which may require, for example, forced redemptions.
- The operation of the proposed rule (specifically, the two-year time-out period and ban on solicitors) in connection with mergers, acquisitions, spin-off transactions, joint ventures, and subadvisory arrangements.

⁵ See *Blount v. SEC*, 61 F.3d 938 (D.C. Cir. 1995).

⁶ Section 18(f) generally prohibits a fund from selling any class of senior securities.

- The effect of the ban on third-party solicitors on the use of third-party distributors by registered investment companies. Advisers of registered investment companies may have to revise their standard distribution agreements and related policies and procedures to ensure that third-party distribution arrangements are not viewed as solicitation arrangements that trigger restrictions under the proposed rule.
- The operation of the proposed rule on advisers with individual clients who are government officials, including the potential that ordinary course dealings with them could raise issues under the proposed rule.
- What constitutes contributions and “legitimate expenses” in the ordinary course of business, and how to distinguish them. For example, where an adviser incurs expenses in organizing or sponsoring a conference at which an official is invited to attend, how to identify legitimate conferences from fundraising events.
- For purposes of determining who is a covered associate or related person of an adviser, how to determine who is an “employee” or officer of an investment adviser in a larger organization where the adviser is one of many entities and employment and position lines are determined on an enterprise basis.

Further Questions

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