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SEC Staff Issues Guidance on "Pay-to-Play" Rule

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On March 22, the staff of the Division of Investment Management (Staff) of the Securities and Exchange Commission (SEC) provided guidance on Rule 206(4)-5 (Rule) under the Investment Advisers Act (Advisers Act)—the so-called "Pay-to-Play" Rule.[1] The Rule was adopted on July 1, 2010[2] and the compliance date was March 14, 2011.[3] The Staff's guidance may assist advisers in fine-tuning their compliance programs, although we note that the guidance does not account for recently proposed amendments to the Rule.

Compliance Dates—Records of Government Entity Clients

- As of March 14, 2011, advisers subject to the Rule (with one exception) were required to begin keeping records of all "government entities" to which they provide or have provided advisory services. The one exception is for advisers to registered investment companies that are "covered investment pools" under the Rule. Those advisers must begin keeping records on September 13, 2011 of all "government entities" that are or were investors in their funds.

- Rule 204-2(a)(18), as adopted (the pay-to-play component of the recordkeeping rule), requires advisers to keep records of government entity clients for a rolling five-year period, but not prior to September 13, 2010. According to the Staff's guidance, the rolling five-year period either began on March 14, 2011 or, for advisers to registered investment companies that are covered investment pools, will begin on September 13, 2011. The Staff clarified that, in its view, there is no backward extension of recordkeeping requirements to September 13, 2010, notwithstanding that Rule 204-2(a)(18)(i)(B), as written, still would require records dating back five years, "but not prior to September 13, 2010."

Covered Associates

The majority of the Staff's guidance focused on who *must* be treated as a "covered associate" and not whether certain employees *should* otherwise be included in an adviser's compliance policy and procedures. Advisers should consider whether certain employees that may not be "covered associates" under the Rule, and the Staff's interpretations of the Rule, should otherwise be included in the adviser's compliance program so as to prevent indirect violations of the Rule and to include those employees who may later become covered associates as a result of a change in work responsibilities.

- The Staff noted that, in its view, only certain natural persons described in the Rule (or political action committees (PACs) controlled by an adviser or its covered associates) can be "covered associates" under

1. *See* Staff Reponses to Questions About the Pay to Play Rule (Mar. 22, 2011), *available at* http://www.sec.gov/divisions/investment/pay-to-play-faq.htm. Morgan Lewis's prior summary on the adoption of the Pay-to-Play Rule is available at http://www.morganlewis.com/pubs/IM-PIF_PaytoPlay_LF_09jul10.pdf.

2. *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.

3. Advisers still have until September 13, 2011 to comply with the Rule and its related recordkeeping requirements with respect to registered investment companies that are investment options in plans or programs of government entities.

the Rule. Thus, a parent company of an adviser or employees of the parent company could not be a "covered associate." However, the prohibition on indirect violations of the Rule would still apply if contributions were channeled through a parent company or its employees with the intent of circumventing the Rule.

- The Staff noted that under the Rule, the PAC of an adviser's managing member would not be a "covered associate" unless the adviser or its covered associates had the ability to direct or cause the direction of governance or operations of the PAC. On November 19, 2010, the SEC proposed an amendment to the Rule that would clarify that a legal entity (and not just a natural person) that is a general partner or a managing member of an adviser could be a "covered associate" under the Rule (Amending Release).[4] If adopted, this amendment could cause PACs controlled by such a legal entity to also be "covered associates." As a result, this portion of the Staff's guidance should be carefully considered before relying on it, as it may reflect only a transient application of the Rule.

- An adviser's affiliated companies and personnel of those affiliated companies cannot be "covered associates" of the adviser. The Staff noted, however, that if an affiliate or its employees are paid by an adviser to solicit government business, then the affiliate must be a "regulated person" under the Rule, which is defined as a registered investment adviser, broker, or dealer that is subject to pay-to-play rules. In the Amending Release, the SEC proposed that "regulated person" be replaced with "regulated municipal adviser" in the Rule, which would effectively require any paid solicitors to be registered with both the SEC and the Municipal Securities Rulemaking Board (MSRB). Further, because of an exclusion from the definition of "solicitation of a municipal entity or obligated person" in the Securities Exchange Act of 1934, as amended (Exchange Act),[5] an adviser could be prohibited from paying any affiliated third party for soliciting government clients if the Rule is amended as proposed in the Amending Release and the Exchange Act is not otherwise amended.

- Contributions by advisers or covered associates to a PAC that, in turn, contributes to "officials" under the Rule would not trigger the two-year time-out unless the adviser or the adviser's covered associates directs the PAC's governance or operations. The Staff noted, however, that a "chain of contributions" made to an "official" through a PAC could violate the prohibition on indirect violations of the Rule.

- Contributions by a covered associate's family members generally would not be covered by the Rule, according to the Staff, but could implicate the prohibition on indirect violations of the Rule.

- The Staff stated that independent contractors acting on behalf of an adviser should be treated as "employees" of the adviser. Although not spelled out, by citing prior guidance, the Staff seemed to limit this treatment of independent contractors as employees to those independent contractors who perform "investment advisory functions for the adviser [and] whose activities are controlled by the adviser."[6] This clarification could have the following effects on the Rule:

    - An adviser's independent contractors who solicit government clients for the adviser would be "covered associates."

    - Supervisors of an adviser's independent contractors who solicit government clients for the adviser would be "covered associates."

    - An adviser or its covered associates may pay independent contractors of the adviser to solicit government entities, subject to the other requirements of the Rule.

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4. *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3110 at 73 (Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3110.pdf.

5. Section 975(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 15B of the Exchange Act to add, among other things, subsection 15B(e)(9), which would define "solicitation of a municipal entity or obligated person" to exclude communications with a municipal entity or obligated person made on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser by a person who controls, is controlled by, or is under common control with the person undertaking the solicitation.

6. *See* Investment Advisers; Uniform Registration, Disclosure, and Reporting Requirements; Staff Interpretation, Advisers Act Release No. 1000 (Dec. 3, 1985).

- An adviser may have to count its independent contractors when determining whether the exception for returned contributions under the Rule is available to the adviser. As further discussed below, an adviser can rely on the exception only three times per year if the adviser has more than 50 "employees" and twice per year if the adviser has less than 50 "employees."

- When determining whether to grant exemptive relief under the Rule, the SEC may consider whether a contribution was made by an independent contractor, among other factors.

- The Staff stated that, in its view, a firm's broker-dealer employees who solicit government clients on behalf of the firm could be "covered associates."

- The "returned contribution exception" under the Rule is limited to, among other things, a single use per covered associate for the life of that covered associate's employment with the adviser. According to the Staff, a covered associate who no longer has the one-and-done returned contribution exception obtains a fresh start at his or her subsequent firm and the new firm would be able to use the returned contribution exception on the covered associate one time. Notably, this approach is unlike a triggering contribution under the Rule, which follows a covered associate to each of his or her subsequent firms for the applicable look-back period (and also stays with each firm for the same period).

Government Entities and Officials

- In the Staff's view, the management of assets of non-U.S. governments is not covered under the Rule. Political contributions in connection with the award of advisory services with non-U.S. governments would still be subject to other applicable laws and regulations, such as the Foreign Corrupt Practices Act of 1977.

- The Staff interprets the Rule to include within the definition of "official" any member of a public pension plan board that is elected by plan participants. The Staff noted that the Rule "does not differentiate between popularly elected officials and participant-elected officials." Although a technical reading of the Rule supports this interpretation, it is not contemplated in the Adopting Release or the Proposing Release. It also seems to be inconsistent with most discussion of "contributions" set forth in the Rule, such as payment for debt incurred in connection with an election (i.e., campaign expenses) or transitional or inaugural expenses, which would seem to not apply to most participant-elected positions in a plan's governance structure. In any event, regardless of the application of the Rule, a "contribution" by an adviser to such a participant-elected person—which may not otherwise be subject to campaign reporting laws and regulations—may have the connotation of a bribe, which would be otherwise regulated under the Advisers Act and the rules thereunder, as well as other laws. For that reason, it is unlikely that this interpretation by the Staff will have much effect on advisers' compliance programs.

Third-Party Solicitors and Interpretation of the Rule Through MSRB Rules

- According to the Staff, trailing payments made to a third-party solicitor that is not a "registered person" under the Rule in connection with the prior solicitation of a client for the adviser (i.e., for the period during which the client remains with the adviser) would be permitted so long as the solicitor does not solicit the government client "after the compliance date." The Rule does not prohibit an adviser from paying a third-party solicitor that is not a "regulated person" for soliciting government clients until September 13, 2011. As such, advisers could enter into third-party solicitation arrangements with entities that are not "regulated persons" under the Rule prior to September 13, 2011 and continue paying them after September 13, 2011, provided the solicitation of government clients does not occur after September 13, 2011. Further, the Staff's interpretation would seem to permit increased payments to a solicitor that result from an additional capital contribution of a solicited government client, even if the additional capital was contributed after September 13, 2011, so long as the solicitor does not engage in further solicitation of the client. This result would differ from interpretations of comparable rules by the MSRB.[7] The Staff noted, however, that "solicitation" is broadly defined under the Rule and that compensation arrangements

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7. *See e.g.*, MSRB Rule G-38(c)(i)(B); Prohibited Payments to Non-Affiliated Persons for Solicitation of Municipal Securities Business Under Rule G-38 and Form G-38t Submissions Requirements, MSRB Interpretive Notice (June 12, 2007).

structured to avoid the Rule would violate the Rule's prohibition on indirect violations of the Rule. Given these warnings from the Staff, solicitation arrangements with entities other than registered investment advisers, broker-dealers, or municipal securities brokers entered into before September 13, 2011 should be carefully considered.

- The Staff noted that advisers cannot rely on guidance from the MSRB on Rule G-37 (Political Contributions and Prohibitions on Municipal Securities Business) to interpret the Rule and Rule G-37 does not provide an "authoritative interpretation" of the Rule. However, according to the Staff, where the MSRB has interpreted Rule G-37 to address an issue not addressed by the SEC in connection with the Rule, the MSRB's guidance "may be useful to consider." Because of the longer history of the MSRB rules (compared to the Rule) and the availability of interpretive guidance, many advisers may have considered the MSRB rules and related interpretations in creating their compliance policies and procedures. Given the Staff's comments, advisers should be careful to not place undue reliance on MSRB interpretations.

- If an adviser's employee is also employed by an affiliated broker-dealer (i.e., a dual employee) to solicit government clients on behalf of the adviser, and the adviser pays the broker-dealer for the employee's solicitation services, then the broker-dealer would have to be a "regulated person" under the Rule. Further, according to the Staff, the dual employee would be a covered associate of the adviser because of his or her solicitation activities, even if these activities were performed in his or her capacity as an employee of the broker-dealer.

Effect on State and Local Laws

- The Staff, without providing any analysis, noted that the Rule does not preempt state and local laws regarding campaign contributions and pay-to-play activities. Analysis of preemption of state and local laws is often a difficult and detailed legal exercise. Advisers' compliance policies and procedures should be designed to comply with the laws, rules, and regulations regarding campaign contributions, lobbying, and placement agent activity and registration and other pay-to-play requirements in each jurisdiction in which the adviser is registered with a securities regulatory authority or conducts or is seeking to conduct business. Although many jurisdictions have an exception from lobbying and placement agent requirements for participation in a competitive bidding process, some jurisdictions do not. Others are unclear. Further, although the Rule is equivalent to or more restrictive than many state or local pay-to-play requirements, certain jurisdictions impose restrictions greater than those in the Rule. Advisers should also note that preemption analysis for other state and local laws, such as privacy laws, laws limiting employer restrictions on political activity, antidiscrimination laws, and at-will employment laws (and exceptions thereto) should also be considered. In those cases, the Rule may preempt state and local laws, rules, and regulations according to any of an express/field, conflict, or implied preemption analysis.

Further Questions

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