Alert 10-190

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Investment Management Alert

SEC Adopts Rule to Curtail 'Pay to Play' Practices Involving State and Local Government Entities

The U.S. Securities and Exchange Commission ("SEC") has adopted Rule 206(4)-5 (the "Pay to Play Rule") under the Investment Advisers Act of 1940 ("Advisers Act") to curtail what the SEC believes presents "pay to play" practices and arrangements involving state and local government entities, including public pension plans. The SEC also adopted certain amendments to the recordkeeping requirements under Rule 204-2 (the "Recordkeeping Rule") and the cash solicitation rule under Rule 206(4)-3 (the "Cash Solicitation Rule").

The new Pay to Play Rule was published in the *Federal Register* on July 14, 2010. The new Rule and the amendments to the Recordkeeping Rule and the Cash Solicitation Rule become effective on September 13, 2010. Compliance with the Pay to Play Rule generally is required for covered investment advisers by March 14, 2011, except that covered investment advisers are not required to comply with the Pay to Play Rule's prohibition on paying third parties to solicit business from state and local government entities except in compliance with the Pay to Play Rule until September 13, 2011. September 13, 2011 also is the compliance date for covered investment advisers to registered investment companies that are covered investment pools. Covered investment advisers must comply with the amended Recordkeeping Rule by the same date that their compliance with the Pay to Play Rule is required. Finally, compliance with the amended Cash Solicitation Rule is required by September 13, 2011.

Which Investment Advisers Are Covered by the Pay to Play Rule?

Generally

An investment adviser registered or required to be registered under section 203 of the Advisers Act must comply with the Pay to Play Rule. An investment adviser that is not registered under the Advisers Act in reliance on the current "private adviser" exemption from registration under section 203(b)(3) also needs to comply with the Pay to Play Rule.[1] The Pay to Play Rule applies to this type of investment adviser when it is seeking to provide, or is providing, investment advisory services for compensation to state or local government entities. A "government entity" means any state or political subdivision of a state, including (1), any agency, authority or instrumentality or political subdivision, (2) a plan or program of the government entity, (3) a pool of assets sponsored or established by a state or political subdivision, or any agency, authority or instrumentality thereof (including a defined benefit plan or state general fund), and (4) officers, agents or employees of the state or political subdivision, or any agency, authority or instrumentality thereof, acting in their official capacity.

Investment Advisers to Covered Investment Pools

The Pay to Play Rule also generally applies to an investment adviser that manages "covered investment pools" in which a government entity invests or is solicited to invest. For purposes of the Pay to Play Rule, and the amendments to the Recordkeeping Rule, an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest would be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity.

A "covered investment pool" includes (1) any investment company registered under the Investment Company Act of 1940 ("1940 Act") that is an investment option in a participant-directed plan or program of a government entity (such as a 529 plan, 403(b) plan, 457 plan or similar plan or program), and (2) a company (such as a "private fund," "hedge fund," "private equity fund," "venture capital fund" or "collective investment trust") that would be an investment company under section 3(a) of the 1940 Act but for an exclusion provided from the definition of "investment company" under sections 3(c)(1), 3(c)(7) or section 3(c)(11) of the 1940 Act.

Companies Not Covered

A company that is exempt from registering as an investment adviser under the Advisers Act because of an available exception, or an exemption other than the "private adviser" exemption in section 203(b)(3), is not required to comply with the Pay to Play Rule. For example, banks, broker-dealers and other individuals or entities exempt from the definition of an "investment adviser" are not directly subject to the Pay to Play Rule. A bank, a state registered investment adviser, an intra-state investment adviser,[2] an adviser with only insurance companies as clients, an investment adviser that is a charitable organization, an adviser that is a plan described in section 414(e) of the Internal Revenue Code of 1986, or certain associated persons of such plans, certain commodity trading advisors, and family offices[3] also are not directly subject to the Pay to Play Rule to the extent that they fall within the other exemptions in section 203(b) of the Advisers Act. While banks and the other excluded companies are not directly subject to the Pay to Play Rule, given that the Pay to Play Rule prohibits a covered investment adviser from doing indirectly what it cannot do directly, the activities of banks and the other excluded companies could be indirectly subject to the Pay to Play Rule to the extent a bank or other excluded company acts in concert with a covered investment adviser to allow the covered investment adviser to do indirectly what the covered investment adviser could not do directly under the Pay to Play Rule.

What Does the Pay to Play Rule Prohibit and Require?

Under the Pay to Play Rule, certain "pay to play" practices and arrangements are deemed fraudulent, deceptive and manipulative acts, practices or courses of business under section 206 of the Advisers Act. These practices and arrangements are outlined below.

Two-Year Ban

A covered investment adviser is prohibited from, directly or indirectly, providing investment advisory services for compensation to a government entity within two years after a contribution[4] to an official[5] of the government entity is made by the investment adviser, or any covered associate[6] of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made). This prohibition does not ban political contributions, nor does it limit the amount of any political contribution, but rather imposes a two-year ban or time-out on receiving compensation for advisory services from the government entity. A violation of this prohibition would not result from making a contribution itself, but rather from receiving, or continuing to receive, any compensation (including reimbursement of expenses at cost) for advisory services after the contribution is made. A contribution does not include an individual's donation of time without use of the investment adviser's office space, telephones or other resources, if the investment adviser did not solicit the individual's efforts. A contribution also does not include a charitable donation made by an investment adviser at the request of an official of a government entity. Contributions to political action committees or political parties may or may not be "contributions" under the Pay to Play Rule, depending upon the purposes to which the monies are applied. Contributions by individuals (not an investment adviser) of up to $350 per election to an elected officer or candidate for whom the individual is entitled to vote, and up to $150 per election to an elected official or candidate for whom the individual is not entitled to vote, will not trigger the two-year ban. Primary and general elections are considered two separate elections for purposes of these de minimis exceptions under the Pay to Play Rule.

This prohibition applies on a going-forward basis (for example, the dismissal or demotion of a covered associate who made a triggering contribution will not relieve the investment adviser from complying with the two-year ban). However, the period during which the ban applies also may be determined on a backward-looking basis in certain circumstances. When an individual becomes a "covered associate" (either because of hiring or promotion), an investment adviser must "look back" to determine if the individual made a triggering contribution within six months, or for a covered associate who solicits clients for the investment adviser, two years, of becoming a covered associate. If such an individual did make a prior triggering contribution, the period would be measured from the date of such individual's prior triggering contribution, and the investment adviser would be subject to the ban for a period beginning on the date such individual becomes a covered associate, and ending on the date that is the last day of any remaining portion of the applicable ban period measured from the date of such individual's prior triggering contribution. Given these provisions, an investment adviser will need to require full disclosure of relevant past political contributions from covered associates or potential covered associates to ensure compliance.

After a contribution is made, an investment adviser could prevent a violation of this prohibition by providing uncompensated advisory services (to the extent permitted by applicable state or other laws) for the duration of the two-year ban, or until the government entity can replace the investment adviser (including returning any compensation received between the time when the contribution was made and the time, if different, when the contribution was discovered).

In the case of contributions (in excess of the de minimis contribution exception amounts) that do not, in the aggregate, exceed $350 to any one official per election, an investment adviser may prevent the application of the two-year ban if the investment adviser discovers the contributions within four months of the date of the contributions and, within 60 days after discovering the triggering contribution, the contributor obtains the return of the contribution. If the recipient will not return the contribution, an investment adviser may still seek to obtain an exemption under subsection (e) of the Pay to Play Rule. Larger investment advisers (i.e., those reporting having more than 50 employees in response to Form ADV, Part I, Item 5.A) can avail themselves of this automatic exception to the two-year ban no more than three times in any 12-month period; other investment advisers can avail themselves of this automatic exception to the two-year ban no more than two times in any 12-month period.

Ban on Using Third Parties to Solicit Government Business

The Pay to Play Rule prohibits a covered investment adviser, and its covered associates, from providing or agreeing to provide, directly or indirectly, payment[7] to any third party (e.g., a solicitor or placement agent, but not an investment adviser's employees, general partners, managing members or executive officers) to solicit[8] a government entity for investment advisory services on behalf of such covered investment adviser, unless such third parties are "regulated persons" (regardless of whether the regulated persons are affiliated or non-affiliated with the investment adviser). "Regulated persons" include registered broker-dealers or registered investment advisers, in each case themselves subject to SEC oversight (i.e., registered with the SEC) (and, in the case of broker-dealers, the oversight of a registered national securities association, such as FINRA), and to pay to play restrictions.

In the case of broker-dealers acting as solicitors, the SEC must find, by order, that a registered national security association's pay to play rules impose substantially equivalent or more stringent restrictions on such broker-dealers than the Pay to Play Rule imposes on registered investment advisers, and that such rules are consistent with the objectives of the Pay to Play Rule. The delay of the mandatory date by which compliance with this prohibition is required until September 13, 2011 is intended to provide FINRA time to adopt such pay to play rules for broker dealers. In the case of SEC registered investment advisers acting as solicitors, the registered investment adviser, and its covered associates, cannot, within two years of soliciting a government entity, have (1) made a triggering contribution to an official of that government entity, or (2) coordinated, or solicited any person (including a political action committee) to make, any contribution to an official or a government entity to which the investment adviser that engaged the solicitor is providing or seeking to provide investment advisory services, or payment to a political party of a state or locality where the investment adviser that engaged the solicitor is providing or seeking to provide investment advisory services to a government entity. An investment adviser would violate the Pay to Play Rule if it compensated a third-party for solicitation of government entity clients at any time that third party was not a regulated person even if it was a regulated person at the time the third party was engaged or subsequently becomes a regulated person again in the future. Unlike the proposed rule, the Pay to Play Rule does not contain an exception permitting payments to related persons (e.g., affiliates) and employees of related persons (of course, if such related persons are SEC registered investment advisers or SEC registered broker-dealers, such an exception is not required).

In the adopting release for the Pay to Play Rule, the SEC clarified that distribution fees paid by a mutual fund pursuant to a 12b-1 plan would not constitute payments by the mutual fund's investment adviser and would not be prohibited by the terms of the Pay to Play Rule. The SEC also clarified, however, that "supplemental" or "adviser paid" payments, made out of the "legitimate profits" of a mutual fund's investment adviser, for distribution generally would implicate the Pay to Play Rule. Regarding private funds, the SEC stated that payments to third parties by the private fund's adviser or its affiliated general partner would be subject to the Pay to Play Rule, and structuring such a payment to come from the private fund for purposes of evading the Pay to Play Rule would be a violation.

Restrictions on Soliciting and Coordinating Contributions and Payments

The Pay to Play Rule prohibits a covered investment adviser, and the covered investment adviser's covered associates, from coordinating, or soliciting[9] any person or political action committee to make (1) any contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services, or (2) 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. Whether or not a particular communication is a solicitation is dependent upon the specific facts and circumstances relating to such communication.

In the adopting release for the Pay to Play Rule, the SEC clarified that this restriction prohibits, for example, (1) an investment adviser from soliciting a payment to the political party of a state if the investment adviser is providing or seeking to provide investment advisory services to the state, but would not preclude that investment adviser from soliciting a payment to a local political party (as long as the investment adviser is not also providing or seeking to provide investment advisory services to a government entity in that locality, and as long as soliciting the payment to a local political party is not a means to indirectly make payments to the state party), and (2) an investment adviser or its covered associates from soliciting contributions from professional service organizations.

Restrictions on Indirect Activity

The Pay to Play Rule also makes it unlawful for a covered investment adviser, or its covered associates, to do anything indirectly that, if done directly, would result in a violation of the Pay to Play Rule. A covered investment adviser, and its covered associates, cannot intentionally circumvent the Pay to Play Rule by engaging in "pay to play" conduct indirectly, such as by directing or funding contributions through third parties such as spouses, lawyers, or companies affiliated with the covered investment adviser, if that conduct would violate the Pay to Play Rule if the covered investment adviser, or its covered associates, engaged in such conduct directly. In this regard, the Pay to Play Rule is similar to section 208(d) of the Advisers Act. A "gatekeeper" arrangement, where political contributions or payments are arranged by an intermediary, who then distributes or directs contributions or payments to elected officials or candidates, also would be prohibited.

Application of the Pay to Play Rule to Investment Advisers to 'Covered Investment Pools'

The Pay to Play Rule applies each of the prohibitions and restrictions in the Pay to Play Rule to a covered investment adviser that manages assets of a government entity through a covered investment pool and, thereby, prevents a covered investment adviser from engaging in pay to play practices indirectly through a covered investment pool. For example, the Pay to Play Rule would apply with respect to an official of a government entity that is in a position to influence investments of public funds in a covered investment pool or the selection of a covered investment pool as a funding vehicle, or investment option in a government-sponsored plan, such as a 529 plan. If the covered investment pool is a publicly offered registered investment company, the two-year ban under the Pay to Play Rule applies only when the investment company is included in a participant-directed plan or program of a government entity, such as a 529 plan, a 403(b) plan, 457 plan, or other investment program or plan sponsored or established by a government entity. The two-year ban is not applicable if a government entity invests its pension fund assets in a publicly offered registered investment company outside of a participant-directed plan or program sponsored or established by the government entity.

If the two-year ban is triggered under the Pay to Play Rule by a covered investment adviser to a covered investment pool, the covered investment adviser can prevent the application of the two-year ban by foregoing any compensation related to the assets invested or committed by the relevant government entity. In the case of a registered investment company, this would involve either waiving its advisory fee for the investment company as a whole in an amount approximately equal to the fees attributable to the government entity's assets, or rebating the approximate amount of the advisory fee paid by the government entity with respect to its assets to the investment company as a whole. In the case of a private fund, the covered investment adviser could seek to cause the private fund to redeem the investment of the government entity (if possible), or waive or rebate its advisory fees as discussed above in connection with registered investment companies.

Regarding fund of fund arrangements, in the adopting release for the Pay to Play Rule, the SEC clarified that covered investment advisers to underlying funds in a fund or funds arrangement are not required to look through the investing fund to determine whether a government entity is an investor in the investing fund, so long as the investment was not made in that manner as a means for the covered investment adviser to do indirectly what it could not do directly under the Pay to Play Rule.

Application of the Pay to Play Rule to Subadvisers

The Pay to Play Rule applies to both advisers and subadvisers that are covered investment advisers. In the adopting release for the Pay to Play Rule, the SEC clarified that if an adviser or subadviser makes a contribution that triggers the two-year ban from receiving compensation, the adviser or subadviser (as applicable) that did not make the triggering contribution could continue to receive compensation from the government entity, so long as the arrangement was not a means to do indirectly what the adviser or subadviser could not do directly under the Pay to Play Rule.

Seeking Exemptive Relief Under the Pay to Play Rule

Under the Pay to Play Rule, a covered investment adviser may apply for exemptive relief from the restrictions on political contributions (i.e., the two-year ban). The SEC, upon application, would be able to conditionally or unconditionally exempt an investment adviser from this restriction. The SEC could exempt a covered investment adviser from the two-year ban, where a covered investment adviser discovers improper contributions that trigger the two-year ban only after they have been made, another exception is not available, and the imposition of the restriction is unnecessary to achieve the intended purpose of the Pay to Play Rule.

In considering whether or not to grant an exemption, the SEC would take into consideration the following factors (among others):

- Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Advisers Act
- Whether the covered investment adviser, (1) before the contribution resulting in the restriction was made, adopted and implemented policies and procedures reasonably designed to prevent violations of the Pay to Play Rule; (2) prior to or at the time the contribution that resulted in such restriction was made, had no actual knowledge of the contribution; and (3) after learning of the contribution, (a) has taken all available steps to cause the contributor involved in making the contribution that resulted in such restriction to obtain a return of the contribution; and (b) has taken such other remedial or preventive measures as may be appropriate under the circumstances
- Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the covered investment adviser, or was seeking such employment
- The timing and amount of the contribution that resulted in the restriction
- The nature of the election (e.g., federal, state or local)
- The contributor's apparent intent or motive in making the contribution that resulted in the restriction, as evidenced by the facts and circumstances surrounding such contribution

While an application for an exemption is pending, a covered investment adviser could place into an escrow account any compensation earned between the date of the triggering contribution and the date the exemptive application is granted or denied.

Amendments to the Recordkeeping Rule

In connection with the Pay to Play Rule, the SEC also adopted amendments to the Recordkeeping Rule under the Advisers Act that require an investment adviser registered or required to register under the Advisers Act to maintain certain records relating to political contributions made by the investment adviser or its covered associates. The amended Recordkeeping Rule requires that only records of contributions, not payments, to government officials and candidates are required to be kept under the rule. Specifically, the amendments to the Recordkeeping Rule require an investment adviser to make and keep records of the following:

- The names, titles, and business and residence addresses of all covered associates of the investment adviser;and
- All government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years (but not prior to September 13, 2010);and
- All direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a political party of a state or political subdivision thereof, or to a political action committee. Records related to these contributions and payments would need to be listed in chronological order and indicate (1) the name and title of each contributor, (2) the name and title (including any city/county/state or other political subdivision) of each recipient of a contribution or payment, (3) the amount and date of each contribution or payment, and (4) whether any such contribution was the subject of the exception for certain returned contributions provided for under subsection (b)(2) of the Pay to Play Rule;and
- The name and business address of each regulated person to whom the investment adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf, in accordance with subsection (a)(2) of the Pay to Play Rule

Advisers with no government business are not required to maintain these records; accordingly, an adviser with no government clients would not have to require employees to report their political contributions. However, the "look back" provisions of the Pay to Play Rule would apply, and records developed by the investment adviser in confirming compliance with the Pay to Play Rule upon it accepting compensation from its first government entity client, would be required to be maintained.

A dually registered investment adviser subject to Rules 17a-3 and 17a-4, or the MSRB recordkeeping rules, would be entitled to rely on substantially similar records required to be maintained under those rules for purposes of complying with the above amendments to the Recordkeeping Rule.

Amendment to the Cash Solicitation Rule

Finally, the SEC adopted an amendment to the Cash Solicitation Rule that makes it clear that special prohibitions apply to solicitation activities involving government entity clients under the Pay to Play Rule.

Other Potentially Applicable Regulation

The conduct of an investment adviser relating to obtaining business from government entities and public funds also can be subject to (1) certain other provisions of the Advisers Act and certain other regulations promulgated thereunder, (2) MSRB Rules G-37 and G-38 (for an investment adviser dually registered as a broker-dealer), which are the rules on which the Pay to Play Rule is primarily based, and (3) certain state and local procurement and deceptive practices laws. We can provide additional information regarding existing regulation upon request.

Conclusion

The Pay to Play Rule, and the amendments to the Recordkeeping Rule and the Cash Solicitation Rule, impose new, and in some cases potentially onerous, restrictions and requirements on investment management organizations. As discussed above, the Pay to Play Rule requires an investment management organization to determine, for example, whether it, or an affiliate, is a covered investment adviser and, if so, what modifications to compliance policies and procedures, organizational reporting lines, hiring practices, investment management agreements, solicitation agreements, other business practices, etc., would be necessary to comply with the Pay to Play Rule and the amendments to the Recordkeeping Rule and the Cash Solicitation Rule.

As you seek to digest the Pay to Play Rule, and the amendments to the Recordkeeping Rule and the Cash Solicitation Rule discussed above, and determine how they would apply to and affect your investment management organization, Reed Smith's Investment Management Group can assist you with that analysis.

If we can be of assistance, please contact George Magera (+1 412 288 7268; gmagera@reedsmith.com), Alicia Powell (+1 412 288 8240; apowell@reedsmith.com), Jennifer Dulski (+1 412 288 4592; jdulski@reedsmith.com) or the Reed Smith lawyer with whom you regularly work.

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1. The Private Fund Investment Advisers Registration Act of 2010 (the "PFIAR Act"), a title within the Dodd-Frank Wall Street Reform and Consumer Protection Act, recently eliminated the "private adviser" exemption under the Advisers Act. Therefore, many of the advisers who relied on it for an exemption from Advisers Act registration will be required to registered under the Advisers Act by July 21, 2011.
2. The PFIAR Act recently excluded any "investment adviser who acts as an investment adviser to any private fund" from the intra-state investment adviser exemption under the Advisers Act.
3. The PFIAR Act recently added a "family office" exemption from registration as an investment adviser under the Advisers Act.
4. A "contribution" includes a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such election (such as transition of inaugural expenses incurred by a successful candidate for state or local office).
5. An "official" includes an incumbent, candidate or successful candidate for elective office of a government entity (such as any election committee for such a person) if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser, or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser. The scope of a person's office, not the influence actually exercised by a person, is the relevant inquiry when determining whether the person has influence over the awarding of an investment advisory contract. The SEC would not consider an "official" to include an individual who is also a "covered associate" (defined below) of the investment adviser (thus, such an individual could contribute to his or her own campaign).
6. A "covered associate" includes (1) any general partner (but not a limited partner), managing member (but not a non-managing member) or executive officer (i.e., president, vice president in charge of principal business unit, division or function, other officers that perform policy-making functions, or any other person who performs similar policy-making functions), or other individual with a similar status or function (including sole proprietors, but not persons who are solely shareholders of a corporation), (2) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee, and (3) any political action committee controlled by the investment adviser or by any of its covered associates. Employees who solicit government entities or refer them to investment advisers, and their supervisors, could trigger the two-year ban provisions.
7. A "payment" includes any gift, subscription, loan, advance, or deposit of money or anything of value (including a quid pro quo arrangement).
8. With respect to investment advisory services, "solicit" means to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser.
9. With respect to a contribution or payment, "solicit" means to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.

George F. Magera
Partner
Pittsburgh
+1 412 288 7268

Alicia G. Powell
Partner
Pittsburgh
+1 412 288 8240

Jennifer K. Dulski
Associate
Pittsburgh
+1 412 288 4592

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