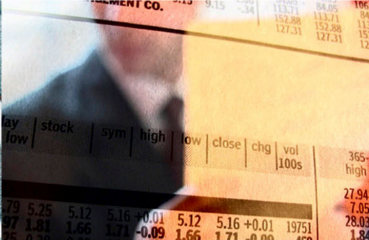
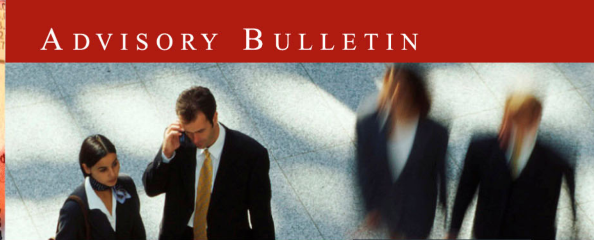

THOMPSON HINE

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INVESTMENT MANAGEMENT UPDATE

SEC Adopts "Pay-to-Play" Rules for Investment Advisers

On July 1, the Securities and Exchange Commission (SEC) voted unanimously to adopt a rule designed to curb "pay-to-play" practices by investment advisers who seek to manage money for state and local governments.[1] Rule 206(4)-5 under the Investment Advisers Act of 1940 ("Advisers Act") provides that an investment adviser who makes political contributions to an elected official who is in a position to influence the selection of the adviser to provide advisory services to a government entity will be barred for two years from providing advisory services for compensation to that government entity. The rule applies to the investment adviser as well as certain executives and employees of the adviser.

Rule 206(4)-5 also prohibits 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 the solicitor or placement agent is a "regulated person" subject to prohibitions against engaging in pay-to-play practices. Further, the rule prevents an adviser from coordinating or asking another person or political action committee (PAC) to make contributions to an elected official, candidate or political party for purposes of influencing the selection of the adviser. Finally, the rule prohibits an adviser and certain of its executive officers and employees from 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 adviser, if that conduct would violate the rule if the adviser engaged in it directly.

The rule is effective on September 13, 2010.

Advisers Subject to Rule 206(4)-5

Rule 206(4)-5 applies to any investment adviser registered or required to register with the SEC, as well as any investment adviser not registered in reliance on Section 203(b)(3) of the Advisers Act. Thus, advisers to hedge funds and private equity funds, in addition to SEC-registered advisers, are subject to the rule. Only state-registered investment advisers and other advisers who are exempt from registration with the SEC are not be subject to the rule.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), signed into law by President Obama on July 21, increases the threshold for SEC registration of investment advisers from $25 million in assets under management to $100 million. This change will increase the number and size of investment advisers registered with the states and, thus, reduce the number of advisers subject to Rule 206(4)-5.

In addition, the Dodd-Frank Act eliminates the current "private adviser" exemption in Section 203(b)(3) and requires advisers to private funds with assets in excess of $150 million to register

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with the SEC. Only foreign private advisers, advisers to small business investment companies and advisers registered with the Commodity Futures Trading Commission as commodity trading advisers may now rely on Section 203(b)(3). Advisers to venture capital funds and private funds with assets under $150 million are now exempt from registration with the SEC under new Sections 203(l) and 203(m), respectively. Presumably, they will now not be subject to Rule 206(4)-5.

Pay-to-Play Restrictions

The pay-to-play restrictions are designed to capture not only direct political contributions by advisers, but also pay-to-play practices that are less explicit, such as payments to third-party solicitors or the bundling of campaign contributions for elected officials. Rule 206(4)-5 attempts to accomplish this with the following measures.

Restrictions on Political Contributions. The rule makes it unlawful for an investment adviser to receive compensation for providing advisory services to a government entity for a two-year period after the adviser or any of its covered associates makes a political contribution to an official of a government entity that is in a position to influence the award of advisory business to the adviser.

- *Prohibition on compensation*. Investment advisers making contributions covered by the rule would not be prohibited from providing advisory services after triggering the two-year "time-out," but would be prohibited from receiving compensation for providing advisory services during that time. The two-year time-out begins to run once the contribution is made and not when the contribution is discovered by the adviser or the SEC examination staff. An adviser's fiduciary duties may obligate it to continue to provide advisory services without compensation for a reasonable period of time after the two-year time-out is triggered.
- *Official of a government entity*. An "official" is defined in the rule to mean any person (including the campaign committee for that person) who, at the time of the contribution, was an incumbent, candidate or successful candidate for elective office of a government entity, if the office is directly or indirectly responsible for or can influence the hiring of an investment adviser by a governmental entity or has the authority to appoint any person who is directly or indirectly responsible for or can influence the hiring of an investment adviser by a governmental entity. An incumbent state or local official running for a federal office would continue to be an "official" under the rule not because of the office he or she is running for, but because of the office he or she currently holds.
- *Contributions*. The term "contribution" includes a gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing an election for federal, state or local office, including any payment of debt incurred in connection with an election. A contribution also includes transition or inaugural expenses of the successful candidate for state or local office. Transition or inaugural expenses of a successful candidate for federal office are not included in the definition. The SEC would not consider donations of time by an individual to be a contribution, provided the donation of time is not made at the adviser's request and the adviser's resources, such as office space and telephone are not used.

- *Covered associates*. Under the rule, "covered associates" include the adviser's general partners, managing members, executive officers or other individuals with similar status or function. The term also includes any employee who solicits a government entity for the investment adviser and any person who directly or indirectly supervises that employee.[2] Finally, the term also includes any PAC controlled by the adviser or any of its covered associates. An adviser and its covered employees are considered to control a PAC if each has the ability to direct or cause the direction of the governance or operation of the PAC.

  The term "executive officers" includes the adviser's president; any vice president in charge of a principal business unit, division or function; any other officer of the adviser who performs a policy-making function; and a person who performs similar policy-making functions for the investment adviser. Whether an individual is an executive officer depends on his or her function, not title. Contributions by non-executive employees (other than those who solicit government entities) would not trigger the rule, unless the adviser or any of its covered associates used the person to indirectly make a contribution.

- *Look back*. Under the rule, the two-year time-out continues to apply to an advisory firm after the covered associate who made the triggering contribution has left the firm. In addition, the two-year time-out applies to any new advisory firm that, within two years after the contribution was made, employs a person who made the contribution. However, the two-year time-out will not be applicable to a covered associate's new advisory firm if the contribution that would normally trigger the time-out is made more than six months prior to the individual becoming a covered associate of the new firm, unless the person, after becoming a covered associate, solicits clients.

  Advisers should consider requiring full disclosure of any relevant political contributions from covered associates or potential covered associates to ensure compliance with Rule 206(4)-5. Statements by prospective employees regarding whether they have made relevant contributions are insufficient to protect the adviser.

- *Exceptions*. Rule 206(4)-5(b)(1) contemplates two exceptions to the two-year time-out applicable to contributions made by covered associates. First, a de minimis exception permits each covered associate, if a natural person, to make an aggregate contribution without triggering the two-year time-out of up to $350 to an elected official or candidate for whom the covered associate is entitled to vote and up to $150 per election to an elected official for whom the individual is not entitled to vote.[3] The $350 limit applies per covered employee and is not an aggregate limit for all of an adviser's covered associates.[4]

  The second exception is intended to address situations in which the contributions are returned. This exception is available to contributions by a covered associate, if a natural person, that in the aggregate do not exceed $350 per official, per election. In order to avail itself of this exception, the adviser must have discovered the contribution within four months of the date the contribution was made and, within 60 calendar days of learning of the contribution, must cause the contribution to be returned to the contributor. An adviser with more than 50 employees may rely on this exception three times in any calendar year, while

advisers with 50 or fewer employees may rely on this exception no more than twice in a calendar year. No adviser may rely on the exception more than once with respect to the same covered associate, regardless of the time period.

Both of the exceptions in Rule 206(4)-5(b)(1) are applicable only to contributions made by natural persons, not to contributions made by the advisory firm.

Prohibition on the Use of Third-Party Solicitors. Rule 206(4)-5(a)(2)(i) makes it unlawful for investment advisers subject to the rule and their covered associates to make or agree to make payments to any third-party solicitor or placement agent, directly or indirectly, to solicit a government entity for advisory business, unless the solicitor or placement agent is a "regulated person" subject to prohibitions against engaging in pay-to-play practices.

- *Regulated person***.** A "regulated person" is a registered investment adviser and broker-dealer who is in compliance with applicable pay-to-play regulations.[5] An adviser must immediately cease compensating a solicitor who no longer meets the definition of a "regulated person." Advisers compensating other advisers who qualify as regulated persons for soliciting government entities must adopt policies and procedures reasonably designed to prevent a violation of the rule.[6]
- *Covered associates***.** The rule applies only to third-party solicitors who solicit government entities for advisory services. The prohibition does not apply to the solicitation activities of the adviser's employees, general partners, managing members, executive officers or other individuals with similar status or functions.
- *Payments*. The rule defines "payment" to mean any gift, subscription, loan, advance, deposit of money or anything of value, and would include payments to pension consultants for performing various services, such as sponsoring conferences, if those services are intended to obtain government clients. Unlike the definition of "contribution," the definition of "payment" does not include the limiting language relating to the purposes for which the money is given.

A violation of this section of the rule does not trigger the two-year ban on compensation, but would be a violation of the rule.

Ban on Solicitation or Coordination of Contributions. Rule 206(4)-5(a)(2)(ii) makes it unlawful for an adviser subject to the rule and its covered associates to coordinate or solicit any person or PAC to make contributions to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services, or to make payments 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.

- *Coordination and solicitation*. The SEC declined to draw a bright line on what activities involve coordination or solicitation of a contribution, stating that whether a particular activity involves a coordination or solicitation of a contribution or payment for purposes of the rule will

depend on the facts and circumstances. However, the SEC did note in the adopting release that an adviser who consents to the use of its name on fundraising literature for a candidate would be soliciting contributions for that candidate. Similarly, an adviser who sponsors a meeting or conference that features a government official as an attendee or guest speaker and that involves fundraising for the government official would be soliciting contributions for that official.

- *Contributions***.** Any expenses incurred by an adviser in hosting a fundraising meeting or conference for a candidate or official would be a contribution by the adviser, thereby triggering the two-year time-out on the adviser receiving compensation for providing advisory services to the government entity over which that official has influence. Such expenses may include, but are not limited to, the cost of the facility, the cost of refreshments, any expenses paid for administrative staff or the payment or reimbursement of any of the government official's expenses for the event. The de minimis exception under Rule 206(4)-5(b)(1) would not be available with respect to these expenses because they would have been incurred by the firm, not by a natural person.
- *Seeking to provide advisory services***.** An adviser is deemed to be "seeking to provide" advisory services to a government entity when it responds to a request for proposal, communicates with a government entity regarding that entity's formal selection process for investment advisers or engages in some other solicitation of investment advisory business of the government entity.[7]

A violation of this section of the rule would not trigger the two-year ban on compensation, but would be a violation of the rule.

Prohibition on Certain Indirect Activities. To ensure that advisers and government officials do not structure pay-to-play arrangements in a way that attempts to evade the prohibitions of the rule, the rule includes a provision that makes it unlawful for an adviser or any of its covered associates to do anything indirectly that, if done directly, would result in a violation of the rule. As a result, an adviser and its covered associates may 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.

Application to Covered Investment Pools. An investment adviser to certain pooled investment vehicles in which a government entity invests or is solicited to invest, is treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity.[8] Thus, a political contribution to a government official that would, under the rule, trigger the two-year time-out from providing advice for compensation to the government entity would also trigger a two-year time-out from the receipt of compensation for the management of those assets through a covered investment pool. Covered investment pools include registered investment companies, hedge funds, private equity funds and collective investment trusts.[9]

- *Registered investment companies***.** The rule defines "covered investment pool" to include any investment company registered under the Investment Company Act of 1940 ("1940 Act") that is an investment option of a plan or program of a government entity. A "plan or

program of a government entity" is defined to mean a participant directed plan established by a state or political subdivision, including 529 plans, 403(b) plans, 457 plans or any similar plan or program.

- *Unregistered funds***.** The term "covered investment pool" also includes any company that would be an investment company under Section 3(a) of the 1940 Act but for the exclusions provided by Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the 1940 Act.
- *Two-year time-out***.** If a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year time-out is made, the adviser must forgo any compensation related to the assets invested or committed by that government entity. Advisers can comply with the rule in a variety of ways. Advisers to private pools can seek to cause the pool to redeem the investment of the government entity, or if that is not possible, waive or rebate the portion of its fees or any performance allocation or carried interest attributable to assets of the government client. An adviser to a registered investment company can waive its advisory fee for the fund as a whole in an amount approximately equal to fees attributable to the government entity. Alternatively, the government entity can continue to pay its portion of the advisory fee, but require the adviser to rebate that portion of the fee to the fund as a whole.
- *Sub-advisers***.** By the terms of the rule, if an adviser or sub-adviser makes a contribution that triggers the two-year time-out, the sub-adviser or adviser, as applicable, that did not make the triggering contribution could continue to receive compensation from the government entity, unless the arrangement were a means to do indirectly what the adviser or sub-adviser could not do directly under the rule. 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 the investment was made in that manner as a means for the adviser to do indirectly what it could not do directly under the rule.

EXEMPTIONS

The rule contains a provision authorizing the SEC to exempt advisers from the time-out requirements where the adviser discovers the contributions that trigger the compensation ban only after they have been made or when the imposition of the prohibitions is unnecessary to achieve the rule's intended purpose. Rule 206(4)-5(e) lists the factors to be considered by the SEC in determining whether to grant an exemption.

An adviser seeking an exemption could place into an escrow account any advisory fees earned between the date of the contribution triggering the prohibition and the date on which the SEC determines whether to grant an exemption. The escrow account would be payable to the adviser if the SEC grants the exemption. If the SEC does not grant the exemption, the fees contained in the account would be returned to the government entity client.

Recordkeeping Requirements

Rule 204-2 under the Advisers Act has been amended to require an investment adviser who is registered or required to be registered with the SEC to make and keep records of contributions made by the adviser and covered associates to government officials and candidates, payments to state or local political parties and PACs and the names of regulated persons the adviser pays for solicitation services. The amendments require advisers to make and keep records of their covered associates, and their own and their covered associates' contributions, only if they provide advisory services to a government client. However, an adviser who does not maintain these records because it currently does not have any government entity clients risks violating Rule 206(4)-5 and subjecting itself to the two-year time-out if it ultimately obtains a government entity client.

The records of contributions and payments are required to be in chronological order and indicate the name and title of the contributor, the name and title of the recipient, the amount and date of each contribution or payment and whether the contribution or payment was subject to an exception provided by the rule. The records would need to be maintained for five years, the first two in the office of the investment adviser. Unlike Rule 206(4)-5, the amendments to Rule 204-2 do not affect unregistered advisers.

Amendments to Cash Solicitation Rules

The SEC amended Rule 206(4)-3 to alert advisers that special prohibitions apply to solicitation activities involving government entity clients.

Transition Period

Rule 206(4)-5 is effective on September 13, 2010; however, the SEC permits different transition periods for separate parts of the rule, as follows:

- Investment advisers subject to Rule 206(4)-5 must be in compliance with the rule on March 14, 2011.
- Investment advisers may no longer use third parties to solicit government business except in compliance with the rule on September 13, 2011.
- Advisers to registered investment companies that are covered investment pools must comply with the rule by September 13, 2011.
- Advisers subject to Rule 204-2 must comply with amended Rule 204-2 on March 14, 2011. However, if they advise registered investment companies that are covered investment pools, they have until September 13, 2011 to comply with the amended recordkeeping rule with respect to those registered investment companies.

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[1] *Political Contributions by Certain Advisers*, Investment Advisers Act Release No. 3043 (July 1, 2010), available at http://www.sec.gov/rules/final/2010/ia-3043.pdf.

[2] The proposed rule would only have applied to senior officers who supervise employee solicitors. The revised definition includes all supervisors of those solicitors who solicit government entities because the SEC believes the incentives to engage in pay-to-play exist for all such supervisors, not just those at a certain level of seniority.

[3] For purposes of the exception, a person is entitled to vote for an official if the person's principal residence is in the locality in which the official seeks election.

[4] The rule permits a contribution of up to $350 in both the primary and general election campaigns of each official for whom the covered associate is entitled to vote, i.e., up to $700.

[5] For a broker-dealer to be a "regulated person" under Rule 206(4)-5, the broker-dealer must be registered with the SEC and be a member of a registered national securities association that has a rule that prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made, and that the SEC finds both to impose substantially equivalent or more stringent restrictions on broker-dealers than Rule 206(4)-5 imposes on investment advisers and to be consistent with the objectives of Rule 206(4)-5.

[6] A person who is registered under the Exchange Act as a broker-dealer and under the Advisers Act as an investment adviser could potentially be a "regulated person" under the rule if he or she met the conditions for either prong of the definition. Such a regulated person should follow the rules that apply to the services he or she is performing, rather than complying with both investment adviser and broker-dealer pay-to-play requirements.

[7] Investment Advisers Act Release No. 3043 at Note 330.

[8] Rule 206(4)-5(c).

[9] A bank maintaining a collective trust fund would not be subject to the proposed rule if the bank falls within the exclusion from the definition of "investment adviser" in Section 202(a)(11)(A) of the Advisers Act.