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A legal update from Dechert's Financial Services Group

Pay-to-Play: SEC Staff Provides New Guidance on Advisers Act Rule 206(4)-5

The staff of the Securities and Exchange Commission's ("SEC") Division of Investment Management ("Staff") recently posted to the SEC's website responses to a series of questions (the "FAQs") raised by new Rule 206(4)-5 ("Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[1] The Rule, which had a compliance date of March 14, 2011, for most advisers, is designed to limit pay-to-play practices involving public pension plans and other government entities. The Staff's FAQs offer clarity concerning some issues that have been raised by advisers, but may also create confusion on certain other issues.

Overview

FAQs are provided occasionally in response to new rulemaking when the answers to questions regarding compliance may not be clear from the rule or related SEC guidance. FAQs represent the Staff's views, and not necessarily those of the SEC, but provide a source of guidance that is often followed for compliance purposes, similar to no-action or interpretive letters that are issued by the Staff.

The FAQs for the Rule fall into several major categories, as outlined below. Among other things, the FAQs provide the Staff's view on: the definition of the term "covered associate;" recordkeeping requirements under the Rule; and the extent to which persons may rely on prior interpretations of the Municipal Securities Rulemaking Board ("MSRB") regarding MSRB Rules G-37 and G-38 (the "MSRB Rules"), which address pay-to-play practices in the municipal securities arena.

Summary of FAQs

Reliance on Interpretations by the MSRB

The MSRB Rules provided a template for the Rule. In many cases, the language of the Rule is either similar to, or the same as, the language of the MSRB Rules. The SEC referenced the MSRB Rules over two hundred times in the adopting release for the Rule ("Adopting Release").[2] Moreover, all of the MSRB's rules and related interpretations are subject to public comment and must be formally approved by the SEC.

The FAQs state that MSRB guidance "directly address[ing] an issue that the [SEC] has not addressed ... might be useful to consider" with respect to similar questions regarding the Rule, but are not "authoritative interpretations" of the Rule. However, in light of the limited guidance currently available regarding the Rule, the MSRB's interpretations may, as a practical matter, be the best source of reference in many instances. With respect to political activity, for example, the MSRB's interpretations regarding the definition of a contribution, and what activity involves soliciting contributions, may be relevant, since

[1] *See* Staff Responses to Questions About the Pay-to-Play Rule (updated as of April 28, 2011), Securities and Exchange Commission, *available at* http://www.sec.gov/divisions/investment/pay-to-play-faq.htm.

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

these concepts have not been clearly addressed at this time by the SEC or the Staff.

Importantly, however, the FAQs signal that the Staff is prepared to depart from the MSRB's interpretations to more appropriately reflect the nature of the money management industry. For example, mere attendance at a presentation to government officials would be considered to be a "solicitation" for purposes of the MSRB Rules. If such an interpretation were extended to the Rule, operational and legal staff of certain advisers could become "covered associates" under the Rule as a result of participating in the due diligence process. The FAQs suggest that the SEC or the Staff may determine that the MSRB's guidance is too broad or otherwise inappropriate. Therefore, the activities described above may not be considered a "solicitation" that would cause an adviser's employee to be considered a "covered associate" under the Rule.[3]

Determining Who Is an "Official of a Government Entity"

The boards of public pension plans often are comprised of one or more members who either are themselves elected officials, or are appointed by elected officials, of a state or local government. For example, many boards have members appointed by an executive, such as a mayor or governor. However, boards also frequently include persons elected by the plan participants themselves.

Contributions to officials who run for public office and their appointees are clearly covered by the Rule. In addition, FAQ III.2 indicates that a person seeking to be a participant-elected member of a public pension plan's board also will be considered an "official of a government entity" under the Rule. Thus, an adviser's efforts to assist in the election of participant-elected board members, whether or not such persons serve in any other elected positions, would be subject to the Rule.

Determining Who Is a "Covered Associate"

One of the most vexing questions facing many advisers in complying with the Rule has been determining who is a "covered associate," and therefore who is subject to limits on both political contributions and solicitation activities as well as recordkeeping requirements.

Parent Entities

FAQ II.1 indicates that apart from the adviser itself, and its controlled political action committees ("PACs"), only "natural persons" may be considered covered associates. Thus, a parent company that controls its subsidiary adviser, or that acts as its managing member, is not considered a covered associate according to the Staff. However, although not specifically noted in the FAQs, the SEC has proposed amendments to the Rule that, if adopted, would amend the definition of a covered associate to include business entities that are general partners or managing members of an adviser.[4] It is unclear whether those proposed amendments will be adopted. However, if these proposed amendments are adopted, FAQ II.1 will no longer apply.

Employees of Affiliates

The original FAQ II.3 indicated that neither the adviser's affiliates, nor the affiliates' employees, could be considered covered associates of the adviser. However, the Rule's definition of covered associate is not limited to personnel of the adviser. Instead, the definition includes (i) supervisors of personnel who solicit government entities, and (ii) persons who have a policy-making function with respect to the adviser. Moreover, the SEC itself noted in the Adopting Release for the Rule that "whether a person is a covered associate ultimately depends on the activities of the individual and not his or her title" and acknowledged, *by way of example*, that a person who "resides at a parent company" may for this reason be a covered associate of the adviser.[5] In its April 28, 2011 update to this FAQ, the Staff cites to the Adopting Release in likewise acknowledging the possibility that an employee of a *parent entity* may be a covered associate. The response, however, appears to ignore the possibility that an employee residing at another affiliate may have similar responsibilities despite the fact that FAQ II.3 asks

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3 The Staff's position is likely to create some confusion with respect to certain issues that were covered in the Adopting Release, in which the SEC stated that its view was the "same as" or "consistent with" the MSRB's positions.

4 *See* Investment Advisers Act Release No. 3110 (November 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3110.pdf. The SEC noted in the release that "[w]e are proposing to replace the word 'individual' with the word 'person.'" This proposed amendment "is meant to clarify the rule and the [SEC]'s original intent that 'covered associate' include legal entities as well as natural persons, and to respond to interpretive questions our staff has received."

5 *See* Adopting Release, at footnote 179.

about affiliates more generally than parents.[6] In light of the terms of the Rule, advisers should take a comprehensive approach in determining whether affiliate personnel with relevant supervisory or policy making responsibility should be classified as covered associates under the Rule.

Status of Independent Contractors and Dual Registrants

FAQ II.7 states that persons who are "independent contractors" of an adviser for tax or other reasons will be considered to be employees (and thus may be covered associates) for purposes of the Rule. In addition, FAQ II.8 states that employees of a "dual registrant" (i.e., a firm that is registered as both a broker-dealer and an investment adviser) who solicit government entities to engage the firm's investment advisory services are covered associates under the Rule. This suggests that employees of a dual registrant soliciting only for the firm's brokerage services would be excluded from the definition of "covered associate."

Payments to Brokers and Others

The FAQs also address payments of commissions or other compensation for soliciting advisory business on behalf of the adviser. Among other things, FAQ IV.2 states that after September 13, 2011, any payments by an adviser to an affiliate or dual-hatted employee for soliciting advisory business may be made only if the affiliate is, or the dual-hatted employee is employed by, a "regulated person." The SEC has proposed a rule allowing such an affiliate to register as a "municipal advisor" under Section 15B of the Securities Exchange Act of 1934.[7] Currently, however, the definition of a "regulated person" includes only investment advisers subject to the Rule and registered broker-dealers.[8]

FAQ IV.1 indicates that after September 14, 2011, the Rule would not limit the ability of an adviser to make previously earned trailing payments to a person, such as a solicitor who would no longer be permitted to perform solicitation activities after that date, provided the person no longer solicits the government entity client. However, because efforts to retain a client are a solicitation, an adviser could only make payments if the solicitor becomes a "regulated person" (or, if the rule proposal noted above is adopted, a "municipal advisor") or has no ongoing contact with the government client.

PACs and Indirect Contributions

The FAQs seek to clarify certain aspects of the Rule's application to PACs. First, by not including corporate parents within the definition of a "covered associate," FAQ II.2 eliminates concerns that contributions made by a corporate parent's affiliated PAC would be attributed to the adviser, so long as such contributions are not structured to evade the Rule. However, the proposed amendment that would extend the definition of "covered associate" to entities that are general partners or managing members of an adviser would, if adopted, necessitate further guidance. Second, FAQ II.5 clarifies that contributions made to a trade association PAC, provided the PAC is not controlled by a covered associate of the adviser or used as an indirect means of making contributions, would not be attributed to the adviser.[9] Similarly, consistent with other statements in the FAQs, FAQ II.4 states that while the recent MSRB guidance concerning PACs is useful, it is not authoritative.[10] Finally, FAQ II.5 affirms that PAC contributions may not be used as an indirect means of making contributions to a particular candidate, and that covered associates may not solicit contributions to PACs.

Recordkeeping Compliance

Although there was some ambiguity based on the different "effective dates" and "compliance dates" under the related recordkeeping rules, FAQ I.2 indicates that the related requirement in Advisers Act Rule 204-2 to make and keep a record of all government entities to which the adviser provides or has provided advisory services (or which are or were investors in any covered investment pool to which the adviser provides or has

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6 The Staff stated that, "[d]epending on facts and circumstances ... there may be instances in which a person who formally resides at an adviser's parent company, but who supervises an adviser's covered associate, could ... be considered a covered associate." *See* Updated FAQ II.3.

7 *See* Exchange Act Release No. 63576 (December 20, 2010), *available at* http://www.sec.gov/rules/proposed/2010/34-63576.pdf.

8 *See* Rule 206(4)-5(f)(9).

9 This interpretation also would seem to apply to PACs maintained by public interest groups.

10 *See* MSRB Guidance on Dealer-Affiliated Political Action Committees Under Rule G-37 (December 12, 2010), *available at* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx?tab=2. *See also DechertOnPoint* "Pay-to-Play: Proposed MSRB Guidance Regarding PACs Under Rule G-37," *available at* http://www.dechert.com/library/FS_24-09-10-Pay-to-Play_Proposed_MSRB_Guidance.pdf.

provided investment advisory services) will begin on March 14, 2011. However, an adviser to a registered investment company does not have to keep records of government entities that were investors in the fund prior to September 13, 2011.[11]

Conclusion

The Staff's FAQs in most cases announce cautious positions and do not address the more difficult issues that advisers may face on a day-to-day basis. However, the Staff's responses to some questions also may cause confusion because they fail to reflect conflicting statements made by the SEC, and because some are contrary to pending proposals of the SEC, which may cause the answers to change. One positive aspect of the FAQs is the signal that in some areas, such as determining whether a particular activity involves a "solicitation" of a government entity, the Staff may determine in the future that particular standards used by the MSRB are not authoritative guidance. Although advisers may currently rely on statements made in the FAQs, it will be important to keep abreast of any changes.

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This update was authored by Edward L. Pittman (+1 202 261 3387; edward.pittman@dechert.com), Christopher P. Harvey (+1 617 728 7167; christopher.harvey@dechert.com), Michael L. Sherman (+1 202 261 3449; michael.sherman@dechert.com) and Brenden P. Carroll (+1 202 261 3458; brenden.carroll@dechert.com).

[11] The Rule only requires records to be maintained by advisers who manage an investment company that is preselected as an investment option of a plan or program sponsored by a government entity, such as a 529 plan, 403(b) plan or 457 plan. Advisers to funds that are offered by third-party brokers, which hold shares on behalf of their customers in omnibus accounts, have complained to the SEC that it may be difficult, if not impossible, to know whether their funds are part of such government sponsored plans, and to comply with this requirement.

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

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Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

David L. Ansell
Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Thomas C. Bogle
Washington, D.C.
+1 202 261 3360
thomas.bogle@dechert.com

Julien Bourgeois
Washington, D.C.
+1 202 261 3451
julien.bourgeois@dechert.com

Kevin F. Cahill
Orange County
+1 949 442 6051
kevin.cahill@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Robert M. Friedman
New York
+1 212 649 8735
robert.friedman@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Christopher P. Harvey
Boston
+1 617 728 7167
christopher.harvey@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Richard M. Hervey
New York
+1 212 698 3568
richard.hervey@dechert.com

Richard Horowitz
New York
+1 212 698 3525
richard.horowitz@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon
Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

Matthew Kerfoot
New York
+1 212 641 5694
matthew.kerfoot@dechert.com

Robert H. Ledig
Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Gordon L. Miller
Washington, D.C.
+1 202 261 3467
gordon.miller@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Reza Pishva
Washington, D.C.
+1 202 261 3459
reza.pishva@dechert.com

Edward L. Pittman
Washington, D.C.
+1 202 261 3387
edward.pittman@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Orange County
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Jeremy I. Senderowicz
New York
+1 212 641 5669
jeremy.senderowicz@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Michael L. Sherman
Washington, D.C.
+1 202 261 3449
michael.sherman@dechert.com

Stuart Strauss
New York
+1 212 698 3529
stuart.strauss@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

M. Holland West
New York
+1 212 698 3527
holland.west@dechert.com

Jennifer Wood
London
+44 20 7184 7403
jennifer.wood@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

www.dechert.com

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