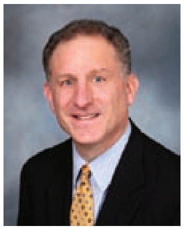
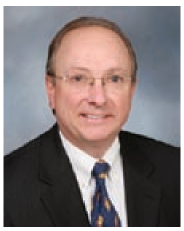
# SEC Adopts Pay-To-Play Rule for Investment Advisers

*August 2010*





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After almost a year of deliberations, on June 30 the SEC approved a "pay-to-play" rule that restricts political contributions by investment advisers that seek business from public pension funds and similar government investment accounts. These pension plans control over $2.6 trillion in assets and account for one-third of all U.S. pension assets.

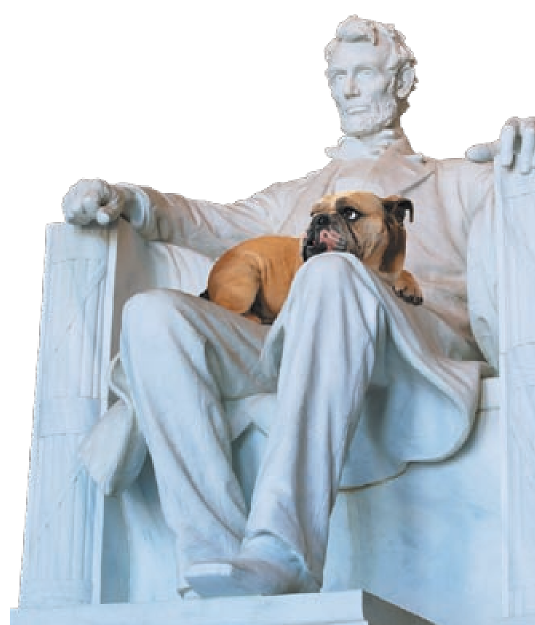
This client alert summarizes key provisions and compliance considerations, as well as record-keeping obligations.

## Restrictions on Political Contributions

New Rule 206(4)-5 under the Investment Advisers Act of 1940 prohibits an investment adviser from providing compensated services to a state or local government entity if the adviser makes contributions to a public official in a position to influence the award of that advisory business. If this time-out is triggered, the adviser may provide uncompensated advice for a reasonable time to allow the government client to replace the adviser. The Rule also prohibits investment advisers from "bundling" contributions for covered officials, and from funneling contributions through others, such as spouses, lawyers or affiliated companies.

This two-year ban also applies to political contributions by a "covered associate" of the investment adviser, which includes any general partner, managing member, executive officer, or other person with a similar status or function; any employee who solicits a government entity for the investment adviser (and any person who supervises, directly or indirectly, such an employee); and a PAC controlled by the investment adviser or any of its covered associates.

The Rule defines a "contribution" as any gift, payment of money, loan, or anything of value made for the purpose of influencing an election. The term includes the payment of debt in connection with an election and donations for inaugural expenses incurred by a successful candidate for state or local office. The SEC has clarified that merely volunteering time to a candidate is not a contribution, provided that the adviser has not solicited the individual's efforts and the adviser's resources (office space, phones, etc.) are not used. Also, charitable donations made by an investment adviser are not contributions for purposes of the Rule.



## Look-Back and Look-Forward Provisions

The two-year ban on providing compensated services to state or local government clients may be triggered by the Rule's "look-back" and "look-forward" provisions. When an adviser hires a covered employee, the Rule requires the adviser to "look back" at the employee's contributions for a two-year period. A prohibited contribution by the new employee will disqualify the adviser from receiving compensation for providing advisory services to the relevant governmental entity for two years from the date of the contribution. The "look-back" period is only six months for covered associates who are not engaged in soliciting business for the adviser. Prohibited contributions by these employees disqualify the adviser for six months from the date of the contribution.

The "look forward" provision applies to contributions by a covered employee who subsequently leaves the adviser or ceases to work in a covered status. If such a person makes a prohibited contribution, the adviser is still subject to the two-year time-out period. The SEC rejected concerns that a disgruntled employee might make a contribution before being terminated or accepting other employment for the very purpose of triggering the two-year time-out.

The "look back" and "look forward" provisions can be particularly harsh given that the adviser is subject to the time-out regardless of whether it is aware of the political contributions. Advisers considering work for government entities should require full disclosure from existing and potential covered associates.

## *De Minimis* Exceptions

The SEC also included *de minimis* exceptions for contributions by covered associates up to $350 per election, if the contributor was entitled to vote for the candidate at the time of the contribution, and up to $150 if the contributor was <u>not</u> entitled to vote for the candidate, such as an out-of-state candidate. Such *de minimis* exceptions would not trigger the two-year time-out. Under limited circumstances, an investment adviser may avoid the two-year time-out if a covered associate obtains a refund of a contribution for less than $350 that was given to a candidate for whom the covered associate was not entitled to vote.

## Use of Third-Parties to Solicit Government Business

One of the thorniest issues during the rulemaking process concerned investment advisers' use of third-party placement agents to solicit government business. The August 2009 proposal completely banned investment advisers from retaining such agents – an unpopular proposal with many in the advisory community. In a nod to smaller funds that are more dependent on placement agents, the final Rule allows advisers to hire third-party agents if the agent is an SEC-registered investment adviser or a registered broker-dealer subject to the pay-to-play restrictions of a national securities association such as the Financial Industry Regulatory Authority (FINRA).

## Compliance and Record-Keeping

It is essential that investment advisers implement an effective compliance program. Under the Rule, an adviser's code of ethics must require compliance with the pay-to-play provisions, and the adviser must adopt policies and procedures designed to prevent violation of the Rule. Also, advisers must maintain detailed records regarding payments and political contributions to placement agents and solicitors, and all direct and indirect contributions made by the investment adviser and all covered associates. Moreover, while the SEC says that it "designed the rule to reduce its impact, investment advisers are best positioned to protect [their] clients by developing and enforcing robust compliance programs designed to prevent contributions from triggering the two-year time out."

## Effective Date

The SEC Rule becomes effective on September 12, 2010, which is 60 days after the Rule was published in the Federal Register (July 14, 2010). The placement agent ban will not take effect for one year, which will allow time for FINRA to draft pay-to-play rules of its own. Similarly, the Rule will not apply for one year after the effective date to advisers who manage "covered investment pools," such as mutual funds, in which government entities have invested or are solicited to invest.

## Other Federal and State Pay-to-Play Laws Still Apply

The SEC Rule does not preempt state and local "pay-to-play" laws that may disqualify advisers from providing services to governmental entities, and that impose civil and criminal sanctions. Approximately 20 states and numerous localities have pay-to-play laws that prohibit or limit contributions by bidders and contractors, key employees, and even the family members of such individuals. Some of these laws also require companies that seek or have government contracts to register and file periodic disclosure reports regarding political contributions.

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