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SEC Adopts Rule Regarding Political Contributions by Investment Advisers

On June 30, 2010, the SEC adopted a new rule under the Investment Advisers Act of 1940 (the "Advisers Act") to curb "pay to play" practices by certain investment advisers. Pay to play refers to the practice of making campaign contributions to elected officials in an attempt to influence the awarding of contracts for the management of public pension plan assets and similar government investment accounts. Newly adopted Rule 206(4)-5[1] entitled "Political Contributions by Certain Investment Advisers" (the "Rule") prohibits an investment adviser from:

- providing advisory services for compensation to a government entity for two years after the adviser, or certain of its executives or employees, makes a contribution to certain elected officials or candidates who are in a position to influence the selection of the adviser;

- providing or agreeing to provide, directly or indirectly, payment to any third party (*i.e.*, a placement agent) for solicitation of advisory business from any government entity on behalf of such adviser, *unless* the third party is an SEC-registered investment adviser or an SEC-registered broker-dealer, in each case, subject to similar pay to play restrictions; and

- coordinating or soliciting from others (a practice known as "bundling") campaign contributions to certain elected officials who are in a position to influence the selection of the adviser or payments to certain political parties in the state or locality where the adviser is seeking government business.

The Rule becomes effective 60 days after its publication in the Federal Register. Generally, investment advisers will be required to comply with the Rule's provisions within six months of its effective date; however, compliance with the ban on the use of unregulated placement agents will be required within one year of the effective date. The SEC is providing time for the Financial Industry Regulatory Authority ("FINRA") to propose a similar rule covering broker-dealers.

[1] For a copy of the Rule, as well as the SEC's adopting release (the "Adopting Release"), please see http://www.sec.gov/rules/final/2010/ia-3043.pdf

Advisers Subject to Rule 206(4)-5

Importantly, the Rule applies to any investment adviser registered (or required to be registered) with the SEC, or unregistered in reliance on the "private adviser exemption" under Section 203(b)(3) of the Advisers Act for investment advisers who do not hold themselves out to the public as investment advisers and have fewer than 15 clients. The Rule does not apply to investment advisers registered with state securities authorities and unregistered investment advisers relying on any other available exemptions under the Advisers Act. Note that the Private Fund Investment Advisers Registration Act of 2010, recently passed by the U.S. House of Representatives and currently pending in the U.S. Senate, eliminates the "private adviser exemption" and, as a result, the Rule is likely to apply to most investment advisers to private funds.

Two-Year Time Out

The Rule makes it unlawful for an adviser to receive compensation for providing investment advisory services to a "government entity"[2] for a period of two years after the adviser or any of its "covered associates"[3] makes a "contribution"[4] to an official of such government entity that is in a position to influence the award of advisory business. An official includes 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 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 Rule looks specifically at the scope of authority of the particular office of an official, rather than the influence actually exercised by any particular individual, in determining whether the individual has influence over the awarding of an investment advisory contract. Note that a contribution to a candidate for federal office could be a triggering contribution under the Rule, not because of the office such candidate is running for, but, as a result of an office he or she currently holds. So long as an official has influence over the hiring of investment advisers as

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2 ***"Government entity"*** includes all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457 and 529 plans.

3 ***"Covered associates"*** of an investment adviser include such adviser's general partners, managing members, executive officers or other individuals 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 employee; and any political action committee controlled by the investment adviser or by any of the foregoing persons. The term ***"executive officer"*** includes the adviser's president and any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer of the adviser who performs a policy-making function; or any other person who performs similar policy-making functions for the adviser.

4 A ***"contribution"*** includes a gift, subscription, loan, advance or deposit of money or anything of value made for the purpose of influencing any election for federal, state or local office, payment of debt incurred in connection with any such election or transition, or inaugural expenses of a successful candidate for state or local office.

a function of his or her current office, political contributions by an adviser could have the same effect, regardless of the official's campaigns to which the adviser contributes.

Importantly, investment advisers making contributions covered by the Rule are not prohibited from providing advisory services to a governmental client, even after triggering the two-year time out. Instead, such an adviser is prohibited from *receiving compensation* for providing advisory services to the government entity during such time out. Such an investment adviser would, however, be obligated to continue providing uncompensated investment advisory services for a reasonable period of time until the government entity finds a successor adviser to ensure that the adviser's withdrawal or termination does not harm its client.

The two-year time out will continue in effect even after the covered associate who made the triggering contribution has left the advisory firm. In addition, when a person becomes a covered associate (*e.g.*, hired, promoted, transferred to a particular position), an investment adviser must "look back" for the requisite time period to determine if it is subject to any restrictions under the Rule due to such employee's contributions. This two-year time out is not triggered by a contribution made by a natural person more than six months prior to becoming a covered associate, unless such employee, after becoming a covered associate, solicits clients on behalf of the investment adviser. These provisions are intended to prevent advisers from circumventing the Rule by channeling contributions through departing employees or by influencing the selection process by hiring persons who have made political contributions.

The Rule provides the following exceptions: (i) de minimis contributions by an individual covered associate up to $350, per election, to any one official for whom the individual is entitled to vote and up to $150, per election, to any one official for whom the individual is not entitled to vote; and (ii) returned contributions that result in an inadvertent trigger of the ban, where the initial contribution was made by an individual covered associate who was not entitled to vote for the recipient of the contribution and which does not exceed $350 to any one official per election. This second exception is only available when the investment adviser discovers the contribution within four months of the date of the contribution and causes it to be returned within 60 days after learning of the triggering contribution. An investment adviser may rely on this second exception no more than two or three times per 12-month period (depending upon the number of employees of the adviser) and no more than once per covered associate, regardless of the time period.

Ban on Payments to Unregulated Persons

The Rule prohibits an investment adviser or any of its covered associates from providing or agreeing to provide, directly or indirectly, payment[5] to any third party solicitor (*i.e.*, placement

[5] ***"Payments"*** are defined as any gift, subscription, loan, advance or deposit of money or anything of value. Payments may also include *quid pro quo* arrangements.

agents, finders, consultants) to solicit[6] government entities for investment advisory services, unless such third party solicitor is a "regulated person." A regulated person includes:

> (i) an SEC-registered investment adviser; provided, that such person and its covered associates have not, within two years of soliciting a government entity: (a) made a contribution to an official of that government entity (other than a de minimis contribution, as permitted by the Rule); or (b) coordinated, or solicited any person to make, any contribution to an official of a government entity to which the investment adviser that hired 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 hired the solicitor is providing or seeking to provide investment advisory services to a government entity; and
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> (ii) an SEC-registered broker-dealer that is a member of a registered national securities association such as FINRA that has a rule (a) that prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made; and (b) that the SEC finds both to impose substantially equivalent or more stringent restrictions on broker-dealers than the Rule imposes on investment advisers and to be consistent with the objectives of the Rule.

Importantly, an adviser must immediately cease compensating a third party for solicitation of government entity clients upon such third party no longer meeting the definition of a "regulated person." In its Adopting Release[7], the SEC explained that triggering contributions by a third-party solicitor will not trigger the two-year time out for the advisers that hire them stating that this would "lead to unfair consequences." However, investment advisers that use other registered investment advisers as third party solicitors must carefully vet third party solicitors and have policies and procedures in place to appropriately supervise the relationship to determine whether the adviser (and its covered persons) acting as a solicitor has made political contributions or otherwise engaged in conduct that would disqualify it from the definition of a "regulated person" and thereby preclude the hiring adviser from paying it for the solicitation activity.

As noted above, the SEC is delaying compliance with this portion of the Rule for one year after its effective date to give FINRA time to propose a similar rule. Notably, in her remarks, Chairman Schapiro stated "However, if the Commission determines that third party placement agents continue to inappropriately influence the selection of investment advisers for government clients — even under our enhanced rules — I expect that we would consider the imposition of a full ban on the use of these third parties." In addition, this prohibition is limited to third-party solicitors and, therefore, does not apply to payments to any of the investment adviser's employees, general partners, managing members or executive officers.

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6 ***"Solicit"*** is defined as (i) with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and (ii) with respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.

7 See footnote 310 of the Adopting Release.

Restrictions on Bundling

The Rule also prohibits an investment adviser or its covered associates from soliciting others to make, or from coordinating, any contribution to any official of a government entity to which the adviser is providing or seeking to provide investment advisory services. It also prohibits the solicitation or coordination of 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. These provisions ban such activities as "bundling," where a person acting on an adviser's behalf combines smaller contributions or payments from employees of the investment adviser or others to create one large contribution or payment, and "gatekeeping," an arrangement where political contributions are directed by an intermediary who distributes these contributions to elected officials or candidates. In addition, the Rule prohibits acts done indirectly, which, if done directly, would result in a violation of the Rule. The SEC noted that pay to play practices are rarely explicit and often hard to prove, making a prophylactic rule particularly appropriate.

Application of Rule 206(4)-5 to Investment Funds

Under the Rule, each of the pay to play prohibitions is equally applicable to an investment adviser that manages assets of a government entity in a "covered investment pool" (*i.e.*, private equity funds, hedge funds, venture capital funds and mutual funds) managed by that adviser. A "covered investment pool" is defined as: (i) any company that would be an investment company under Section 3(a) of the Investment Company Act of 1940 (the "Investment Company Act"), but for the exclusion provided from that definition by any of Section 3(c)(1), Section 3(c)(7) or Section 3(c)(11) thereof; or (ii) an investment company registered under the Investment Company Act that is an investment option of a plan or program of a government entity, such as a 529 plan. If a government entity is an investor in a covered investment pool at the time the contribution triggering a two-year time out is made, the Rule requires the adviser to forgo any compensation related to the assets invested or committed by that government entity. In the case of a private fund, the adviser typically could waive or rebate the related fees and any performance allocation or carried interest attributable to assets of the government client. The adviser may also seek to cause the pooled investment vehicle to redeem the investment of the government entity.

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. Also, with respect to the use of subadvisers, if an adviser or subadviser makes a contribution that triggers the two-year time out from receiving compensation, the subadviser 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 subadviser could not do directly under the Rule.

Exemptions

The Rule allows advisers to apply to the SEC for an order exempting them from the two-year compensation prohibition. The SEC's considerations in deciding whether or not to grant this exemption will include: (i) whether the exemption is necessary or appropriate and consistent with investor protection; (ii) whether the adviser implemented reasonable compliance measures to prevent violations, had no actual knowledge of the contribution, and after learning of the contribution, took all reasonable steps to obtain a return of the contribution and implement remedial measures; (iii) whether at the time of the contribution the contributor was a covered associate or employee of the adviser; (iv) the timing and amount of the contribution; (v) the nature of the election (*e.g.*, federal, state, or local); and (vi) the apparent intent or motive in making the contribution.

Record keeping

The SEC also adopted amendments to Rule 204-2 of the Advisers Act which requires *registered investment advisers* to keep, at a minimum, certain records enabling the SEC to determine the adviser's compliance with Rule 206(4)-5. These records include: (i) the names, titles, and business and residence addresses of all covered associates of the investment adviser; (ii) details of 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; (iii) 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 locality or to a political action committee; and (iv) 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 the Rule.

With respect to compliance, also note that pursuant to existing Rule 204A-1(a)(2) of the Advisers Act, an adviser's written code of ethics must require compliance with the Rule, and under existing Rule 206(4)-7(a), an adviser must adopt written policies and procedures designed to prevent violations of the Rule.

Relationship between Rule 206(4)-5 and the "Cash Solicitation" Rule

The SEC has also adopted technical amendments to Rule 206(4)-3 under the Advisers Act, namely the "cash solicitation rule." Specifically, a new paragraph has been added to this Section to alert advisers that special prohibitions apply to solicitation activities involving government entity clients pursuant to the Rule. Pursuant to Rule 206(4)-3(a)(1), a registered investment adviser must have a written agreement with all third-party solicitors to whom that investment adviser pays, directly or indirectly, a cash fee for solicitation activities, and any such agreement must provide that the solicitor perform its duties consistent with the instructions of the investment adviser and the provisions of, and the rules promulgated under, the Advisers Act (which would now include the Rule). In addition, pursuant to Rule 206(4)-3(a)(2), it is important to note that the Advisers Act requires the investment adviser to make a

"bona fide" effort to ascertain whether the solicitor has complied with the terms of such a written agreement.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be directed to:

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