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SEC "PAY TO PLAY" RULES RESTRICT POLITICAL CONTRIBUTIONS BY INVESTMENT ADVISERS

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On June 30, 2010, the SEC adopted new Rule 206(4)-5 and amendments to related rules, which disqualify investment advisers, their key personnel, and placement agents acting on their behalf from seeking to be engaged by a governmental client if they have made political contributions. Under the new rule, even a single prohibited contribution *in any amount* may result in an effective two-year disqualification of the investment adviser from providing services to or accepting investments from a government client or plan. The new rules become effective on September 13, 2010.[1]

A Brief Review of "Pay to Play" Laws Applicable to Investment Advisers

The term "pay to play" refers to the unspoken, but well understood,[2] practice whereby investment advisers (or persons acting on their behalf) make political contributions or other payments in exchange for investment commitments from pension plans and other government clients or accounts. In other words, the investment adviser must "pay" (i.e., make political contributions) in order to "play" (i.e., be considered for a government engagement).

Neither the practice nor the concern is particularly new. In 1999, the SEC proposed a similar set of rules that were never adopted. Then and now, the SEC's rules were modeled on pay to play restrictions applicable to the municipal securities industry promulgated by the Municipal Securities Regulatory Board ("MSRB") in 1994.[3] In recent years, a number of states, including New Jersey, California, and New York,[4] followed the MSRB's lead by enacting their own pay to play regulations applicable to investment advisers seeking to do business with their public pension and retirement funds. The SEC followed suit in 2009 by proposing the new rules.[5]

In all likelihood, recent scandals in New York and New Mexico have served as a catalyst for the SEC's new rulemaking. In these instances, investment advisers or placement agents acting on their behalf have allegedly attempted to funnel political contributions to government officials responsible for the oversight and supervision of public pension funds. The activities of third-party placement agents have come under particular scrutiny, with some critics arguing that they are valued and compensated more for their political influence and relationships than any substantive expertise.

The SEC's new rules, which apply nationwide, are intended to fill gaps left by patchwork local regulation involving pay to play and conflicts of interest generally. In addition to the ban on political contributions, the new rules also regulate the use of placement agents and establish new recordkeeping requirements.

Restrictions on Making or Soliciting Political Contributions

As noted above, the primary purpose of the new rules is to restrict and impose penalties on persons who directly or indirectly make or solicit political contributions and seek governmental clients. The key questions addressed in this summary are: (1) Whose contributions matter? (2) Which contributions matter? and (3) What are the penalties?

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Whose Contributions Matter?

The new rules apply to registered investment advisers and advisers exempt from registration pursuant to the "fewer than fifteen clients" provision of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(b)(3) (the "Advisers Act").[6] Investment advisers that manage assets of a government entity through a hedge fund or other type of pooled investment vehicle are within the scope of the new rules as well.

Under the new rules, the ban on contributions extends to certain employees and managers of investment advisers known as "covered associates." Contributions by covered associates are treated as if they were made by the investment adviser itself. As a general matter, covered associates include those employees whose job function involves the solicitation of government clients.[7] Also covered by the ban are supervisors of these employees, most members of senior management and any political action committees controlled by the investment adviser or a covered associate.[8]

In addition, an investment adviser can be disqualified by a prohibited contribution made by a covered associate *prior* to employment with the investment advisor. As described in more detail in the Safe Harbors section below, pre-hire contributions may "follow" the covered associate for a period of up to two years. Investment advisers are, therefore, strongly cautioned to perform appropriate due diligence with regard to the prior contribution activity of prospective new hires.

Investment Adviser	• Investment advisers required to register with the SEC • Investment advisers exempt from registration pursuant to the "fewer than fifteen clients" provision of the Advisers Act of 1940[12]
Covered Associate of an Investment Adviser	• General partner (including others with similar status or function) • Managing member (including others with similar status or function) • Executive officer (including president, vice president responsible for a principal business unit, or other high-level managers who perform a policy-making function) • Employee who solicits a government entity for the investment adviser (including any person who supervises, directly or indirectly, such employee) • Political action committee controlled by the investment adviser or by any of its covered associates

Investment advisers and covered associates subject to the new rules are summarized in the table above.

Which Contributions Matter?

Prohibited contributions are defined as "any gift, subscription, loan, advance, or deposit of money or anything of value,"[9] and the ban extends to the solicitation of such contributions (such as hosting fundraising events). The investment adviser is prohibited from making contributions ***in any amount***. Pursuant to a "de minimis" exception (discussed below), covered associates who are natural persons may annually contribute $350 per candidate in elections in which the covered associate is entitled to vote, and $150 per candidate in elections in which the covered associate is not so entitled.

Contributions are disqualifying if made to a candidate for, or holder of, a government office that has the power to "directly or indirectly" hire an investment adviser, influence the hiring decision, or appoint other officials who can hire the adviser or influence such decision.[10]

Neither the rules nor the SEC's accompanying statements present a clear picture as to precisely when a government official will be deemed to "indirectly influence" the selection of an investment advisor. However, the SEC's primary area of inquiry appears to be on whether the official sits on the governing body (such as an advisory board or pension fund board of directors) that makes such hiring decisions or has the power to appoint members of the governing body.[11] Based on the lack of clarity on this point, prudence suggests that when contemplating a political contribution of any kind, investment advisers and their

covered associates undertake a jurisdiction-specific facts and circumstances review to determine whether the candidate or officeholder has the power to influence the hiring or investment decisions of any public pension plan or collective government fund (including 403(b), 457, and 529 plans).

What Are The Penalties?

If an investment adviser or covered associate makes a prohibited contribution to a government official, the investment adviser will be subject to a two-year "time out" from entering into new advisory service engagements or accepting placements from the government entity or entities over which that official has authority or influence.[13] As a technical matter, the new rules do not "bar" such new engagements or placements, but rather prohibit the investment adviser from earning any compensation in connection with such engagements.[14] The result for existing engagements and investments is even worse — the investment adviser will be required to provide its services to the government entity ***free of charge*** for an undefined "reasonable period of time" until the investment adviser can be replaced.[15]

Indirect Violations

The new rules also prohibit investment advisers and their covered associates from doing indirectly that which they could not do directly.[16] For example, it is improper and unlawful for an adviser to provide funds to a third party (such as a consultant or attorney) with the understanding that the third party will use such funds to make an otherwise prohibited contribution. Additionally, investment advisers and covered associates must refrain from soliciting or "bundling" contributions from others to be directed to state and local political organizations in areas where the adviser's government clients are located.[17] Such indirect violations may trigger disqualification and result in other sanctions, including possible criminal penalties.[18]

Safe Harbors

There are four possible safe harbors to the applicability of the new rules:

(1) Under the "de minimis" exception noted above, a covered associate, if a natural person, may contribute up to $350 per election to each official for whom the covered associate is entitled to vote.[19] For officials for whom the covered associate is not entitled to vote, the limit is $150 per official, per election.[20]

(2) The "new covered associate" exception may shorten the time period that pre-employment contributions follow a covered associate. For covered associates who will solicit government clients in their new job, this "look back" period is two years. If the covered associate is not involved in soliciting government clients for their new employer, the look back period is only six months.

(3) Under the "returned contribution" exception, an investment adviser may avoid the penalties imposed by the new rules if the following elements are satisfied: (i) the investment adviser discovers the prohibited contribution within four months of the contribution date; (ii) the contribution does not exceed $350; and (iii) the contribution is returned by the official within 60 calendar days after the date it is discovered by the investment adviser.[21]

(4) Under the "facts-and-circumstances" exemption, it may be possible for an investment adviser to cure a violation that cannot be remedied by the "returned contribution" exception described above. Pursuant to this exemption, the SEC will consider: (i) 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;" (ii) the nature of the election (e.g., federal, state or local); and (iii) the timing and amount of the contribution.[22]

Restrictions on Third-Party Placement Agents

The new rules also regulate the use of third-party placement agents in connection with the solicitation of government clients. Rather than institute a complete moratorium (as the SEC originally proposed in 2009), the new rules require that all such placement agents be registered as either (1) broker-dealers with FINRA (which is in the process of enacting similar pay to play restrictions), or (2) investment advisers under the Advisers Act. In this way, the SEC seeks to ensure that third-party placement agents will also be subject to pay to play rules.[23]

Enhanced Recordkeeping Requirements

The new rules also contain additional recordkeeping requirements applicable to investment advisers that provide

services to government entities. Among the records required to be maintained are the following:

- a list of government entities to which the adviser has provided advisory services;
- the name, title, and residential address of all covered associates; and
- all direct or indirect contributions by the investment adviser and its covered associates to an official of a government entity, political party of a state or local jurisdiction, or a political action committee.

These records must be maintained for five years. However, the enhanced recordkeeping requirements do not mandate the preservation of records reflecting activities before the compliance dates set forth below.

What's Next?

The new rules become effective on September 13, 2010, but are subject to rolling compliance dates. Investment advisers must comply with the political contribution restrictions by March 14, 2011, and the rules regarding third-party placement agents by September 13, 2011.

Given the potential consequences of a violation of the new rules, investment advisers should adopt and implement policies and procedures designed to monitor political contributions that may run afoul of the new rules, and ensure that prospective placement agents are appropriately registered. In the design of such policies and procedures, investment advisers should be mindful that many states may have adopted regulations in this area (which may go beyond the scope of the SEC rules).

Lowenstein Sandler's Investment Management Group will continue to monitor and report on developments relating to the SEC's new rules on pay to play, as well as other legislative, regulatory, and industry developments that may be of importance to our clients.

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[1] The complete text of new Rule 206(4)-5 and amendments to Rules 204-2 and 206(4)-3 can be found at Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41,018 (July 14, 2010) (to be codified at 17 C.F.R. pt. 275), available at http://edocket.access.gpo.gov/2010/pdf/2010-16559.pdf.

[2] Mary L. Schapiro, *Opening Statement at the SEC Open Meeting* (June 30, 2010), available at http://www.sec.gov/news/speech/2010/spch063010mls.htm.

[3] *See* MSRB Rules G–37 and G–38, available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx and http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-38.aspx respectively.

[4] *See* Michael T.G. Long, Esq., and Kerstin M. Sundstrom, Esq., Lowenstein Sandler PC Client Alert, *Effective November 7, 2009: New York Investment Advisers Subject to New "Pay-to-Play" Rules* (Nov. 2009), available at http://www.lowenstein.com/files/Publication

[5] *See* Scott H. Moss, Esq., Cole Beaubouef, Esq. and Gary J. Cocco, Esq., Lowenstein Sandler PC Client Alert, SEC Releases Proposed Rules Addressing Political Contributions By Certain Investment Advisers (Aug. 2009), available at http://www.lowenstein.com/files/Publication

[6] The "private adviser exemption" under Section 203(b)(3) of the Advisers Act will be phased out in 2011 in connection with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 403 (2010).

7 The rules define "solicit" to mean "to communicate, directly or indirectly for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser." 75 Fed. Reg. at 41,031. According to the SEC, what constitutes solicitation is "dependent upon the specific facts and circumstance relating to such communication." *Id*. at 41,032. The few examples provided by the SEC suggest that "limited communication" with a government client — such as responding to an initial inquiry as to whether the investment adviser provides some form of service and referring the client to the appropriate personnel — does not amount to solicitation. *Id*. at 41,032 n.187. However, there is no bright-line test.

8 The investment adviser's senior-most management personnel — including the general partner, managing member, president, and vice president of a principal business unit — are expressly included among covered associates. *Id*. at 41031. The delineation is less clear with regard to what might be described as "middle management," and the new rules contemplate that investment advisers may have a substantial number of employees holding "vice president" or similar titles. Again, no bright-line test is provided, but for more junior officer designations, the scope of "covered associate" is limited to only those who perform a "policy-making function" for the investment adviser or who are involved in the solicitation of government clients. *Id*. Similarly, limited partners, non-managing members, and shareholders are not subject to the new rules unless they independently fall into the category of "covered associate" by soliciting government clients or supervising those that do. *Id*.

9 Rule 206(4)-5(f)(7). This definition also encompasses payments toward debts incurred by a campaign in an election and any post-election transition or inaugural expenses. 75 Fed. Reg. at 41030. However, covered associates are permitted to voluntarily donate their own time, so long as it does not involve the use of the investment adviser's resources (e.g., office space, telephones, and the like). *Id*.

10 Rule 206(4)-5(f)(6)(i) defines a government "official" to include:

> any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (i) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) 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 by a government entity.

11 75 Fed. Reg. at 41029–30.

12 *See* note 6 *infra*.

13 *See id*. at 41026.

14 For obvious reasons, this prohibition on compensation will be viewed by most investment advisers as essentially complete disqualification from providing services to the affected government entity. On the other hand, if an investment adviser does not have or seek government clients, this prohibition is of little significance.

15 *Id*. at 41028 n.122.

16 *Id*. at 41044.

17 *Id*. at 41042

18 *Id.* at 41033 n.193.

19 *Id*. at 41034.

20 *Id*.

21 *Id.* at 41035. An investment adviser may rely on this exception only 2 or 3 times per twelve month period (depending on the size of the investment adviser) and only once for each covered associate. *Id*. at 41035–36.

22 As an example, the SEC notes that a disgruntled employee who makes a prohibited contribution as he or she exits the firm is a situation that could merit this exemption. *Id*. at 41049.

23 Chairman Schapiro indicated, however, that the SEC would not shy away from more draconian measures should the new rules fall short of stemming investment advisers' influence: "[I]f the [SEC] 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." Mary L. Schapiro, *Opening Statement at the SEC Open Meeting* (June 30, 2010), available at http://www.sec.gov/news/speech/2010/spch063010mls.htm.

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