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SEC Finalizes Investment Adviser Pay-to-Play Rules

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On June 30, 2010, the Securities and Exchange Commission (the "SEC") voted unanimously to adopt new Rule 206(4)-5 and to amend Rule 204-2 (collectively referred to herein as the "Final Rules") under the Investment Advisers Act of 1940 (the "Advisers Act") in an effort to curtail pay-to-play practices by Covered Investment Advisers (as defined below) with respect to public pension plans and certain other Government Entities (as defined below), and to impose similar pay-to-play restrictions on third-party placement agents and solicitors who are retained by Covered Investment Advisers to solicit business for them from Government Entities.

Although similar in many respects to the Proposed Rules that the SEC issued in July 2009 (the "Proposed Rules"),¹ the Final Rules contain many significant changes in response to the approximately 250 comment letters that the SEC received, most of which objected to various provisions in the Proposed Rules. Most significantly, the SEC has deleted its previously proposed absolute ban on the use of placement agents by Covered Investment Advisers seeking business from Government Entities and replaced it with a more lenient provision that allows Covered Investment Advisers to continue to use third-party placement agents and solicitors as long as such third-party placements agents and solicitors are either registered with the SEC as investment advisers or are registered broker-dealers and are subject to similar pay-to-play regulations that are expected to be adopted by the Financial Industry Regulatory Authority ("FINRA").

Restrictions on Political Contributions

The Final Rules, when they go into effect (see below), will prohibit both registered investment advisers and investment advisers that are exempt from registration because they have fewer than 15 clients² (collectively, "Covered Investment Advisers") from providing investment advisory services for compensation to a Government Entity within two years after the Covered Investment Adviser or any of its Covered Associates (defined below) made a contribution to an elected official of the Government Entity who has the legal authority to retain (or has the authority to appoint the person authorized to retain), or is otherwise in a position to influence the retention of, an investment adviser by the Government Entity.

For purposes of this restriction, the following definitions and interpretations apply:

- A "**Governmental Entity**" is defined to include: (i) any agency, authority, or instrumentality of a state or political subdivision; (ii) a pool of assets sponsored or established by a state or political subdivision or any agency, authority or instrumentality thereof, such as a defined benefit plan; (iii) a plan or program of a government entity, which includes participant-directed investment programs, such as a qualified tuition plan; and (iv) officers, agents, or

employees of a state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

- A “**Covered Associate**” of a Covered Investment Adviser means: (i) a general partner, managing member, president, vice president in charge of a significant business unit, or any other officer of a Covered Investment Adviser who performs a policy-making function, or any other individual (including persons employed by, e.g., a parent company) with similar status or functions; (ii) any employee who solicits a Government Entity for the Covered Investment Adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by a Covered Investment Adviser or a Covered Associate. A Covered Investment Adviser or its Covered Associate is deemed to have “control” over a political action committee if they have the ability to direct or cause the direction of the governance or operations of the political action committee.
- The term “**contributions**” is defined broadly to include gifts, loans, repayments of debts, payments for transition or inaugural expenses, or, generally, anything of value (but not the provision of volunteer services). The restriction on contributions applies both to contributions to incumbent officials who currently hold the position of authority or influence and to contributions to candidates for those offices.

In response to comments objecting to the two-year ban (the SEC refers to it as the two-year “time out”), the SEC noted that the two-year time out does not require investment advisers to abandon their Government Entity clients; rather, it only precludes Covered Investment Advisers from receiving compensation for services rendered during the two-year time out period. In this regard, the SEC has indicated that for this purpose, “*compensation*” for providing investment advisory or investment management services that will be prohibited during a two-year time out includes not only investment advisory or investment management fees, but also reimbursements for costs and expenses incurred by the Covered Investment Adviser. Also, in response to comments by representatives of several states that their Government Entities are precluded from accepting services without the payment of compensation, the SEC suggested that these Government Entities should “work out arrangements” that are consistent with their state and local laws and with the SEC rules.

The two-year ban will generally apply to a Covered Investment Adviser as a result of hiring a new officer or employee who (i) qualifies as a Covered Associate, (ii) has made a prohibited contribution before the commencement of his or her employment, and (iii) solicits clients for the Covered Investment Adviser. The ban will apply for a “look-back” period up to two years starting with the date of the contribution. However, for new Covered Associates who do not solicit clients, the two-year ban period is reduced to a maximum of six months. Further, the two-year or six-month ban, as the case may be, will continue to apply to a Covered Investment Adviser for the duration of the ban period even if the Covered Investment Adviser no longer employs the Covered Associate who made the relevant contribution. The SEC reasoned that this “look forward” provision will prevent Covered Investment Advisers from channeling contributions through departing employees.

The SEC intentionally omitted contributions by Covered Investment Advisers and Covered Associates to political action committees from automatically triggering the two-year ban on the basis that certain political action committees may fund general political party activities or campaigns for candidates other than officials of a Government Entity. The SEC noted, however, that contributions to political action committees will still trigger the two-year ban if a Covered Investment Adviser or Covered Associate has made a contribution to a political action committee knowing or with the expectation that the political action committee will make a political contribution to an official of a Government Entity,

because the contribution to the political action committee will be deemed to constitute an indirect contribution on behalf of the Covered Investment Adviser. Further, as discussed below, registered investment advisers will be required to maintain records of all direct or indirect payments made by the registered investment adviser or their Covered Associates to a political action committee. While payments to political action committees will not automatically trigger a two-year time out, the SEC reasoned that such payments may serve as a means for investment advisers and their Covered Associates to funnel contributions to an official of a Government Entity. Therefore, the SEC requires records of such payments so that it may identify situations intended to circumvent the Final Rules.

The Final Rules include a *de minimis* exception which will allow Covered Associates to make contributions of up to (i) \$350 per election per candidate if such Covered Associates can vote for the candidate, and (ii) \$150 per election per candidate if such Covered Associates cannot vote for the candidate. For this purpose, primaries and general elections are considered separate elections.

Application to Investment Advisers of Pooled Investment Funds

The Final Rules apply not only to investment advisers who manage Government Entity assets directly, but also to Covered Investment Advisers who manage Covered Investment Pools in which Government Entities have invested or are solicited to invest. The Final Rules define "**Covered Investment Pools**" as (i) registered investment companies (e.g., mutual funds), provided that such funds are an investment option of a plan or program of a Government Entity, and (ii) entities that are exempt from registering under the Investment Company Act because they either (A) have less than 100 shareholders ("3(c)(1) funds"), (B) have only qualified purchasers ("3(c)(7) funds") or (C) are collective investment funds maintained by a bank ("3(c)(11) funds"). In response to comment letters stating that the two-year ban could have significant adverse consequences for private investment funds because it might be interpreted to require these funds to redeem the interests of a Government Entity, the SEC stated that the two-year ban would not mandate redemption from a fund if the Covered Investment Adviser would instead waive or rebate a portion of the fees that are applicable to the Government Entity.

The SEC received several comment letters indicating that Covered Investment Advisers of registered investment companies would likely have difficulty identifying whether Government Entities have invested in the registered investment company, and, thus, would struggle to comply with the Proposed Rules. The SEC acknowledged this difficulty but determined that Covered Investment Advisers of registered investment companies should remain subject to the Final Rules because of the significant growth in government-sponsored savings plans in recent years and the increased competition among investment advisers for their funds to be selected as an investment option. Based on these findings, the SEC expressed concern that investment advisers of registered investment companies might begin making political contributions in an attempt to influence government officials to include their funds as options in such plans. In an attempt to strike a balance with the concerns voiced in various comment letters, the SEC modified the Final Rules to apply to investment advisers for registered investment companies only if a registered investment company is an investment option of a plan or program of a Government Entity that is participant-directed (e.g., a qualified tuition plan or a tax deferred employee benefit retirement plan). The SEC reasoned that an investment adviser will know (or can reasonably acquire) the identity of each participant-directed government plan or program that chooses the registered investment company as an investment option. As a result, a Government Entity investing in a mutual fund that is not an option in a government plan or program will not subject the Covered Investment Adviser to the Final Rule. The same is not true with respect to 3(c)(1), 3(c)(7) or 3(c)(11) funds as investments by Government Entities in such funds will subject

such Covered Investment Advisers to the restrictions of the rule regardless of whether the funds are an investment option in a government plan or program.

Restrictions on Soliciting and Coordinating Contributions and Indirect Pay-to-Play Practices

In an effort to prevent investment advisers from circumventing the intent of the Final Rules, the Final Rules prohibit a Covered Investment Adviser and its Covered Associates from coordinating or soliciting another person or political action committee to contribute (i) to an official of the Government Entity to which the Covered Investment Adviser provides or seeks to provide investment advisory services, or (ii) to a political party of the state or locality where the investment adviser provides or seeks to provide investment advisory services to the Government Entity. Further, the Final Rules also prohibit a Covered Investment Adviser and its Covered Associates from indirectly engaging in prohibited pay-to-play conduct by making contributions through third parties such as spouses, lawyers or companies affiliated with the Covered Investment Adviser.

Third-Party Placement Agents and Solicitors

Under the Final Rules, a Covered Investment Adviser and its Covered Associates will be prohibited from paying a third-party solicitor or placement agent to solicit business for the Covered Investment Adviser from any Government Entity unless such third-party solicitor or placement agent is an SEC-registered investment adviser or a registered broker-dealer subject to pay-to-play restrictions that are imposed by a national securities association, such as FINRA.

Notably, if a Covered Investment Adviser retains a placement agent or solicitor that is properly registered and regulated, then the Covered Investment Adviser will not be subject to the two-year time out because the placement agent or solicitor violates the political contribution restrictions to which it is subject. Instead, it is expected that such placement agent or solicitor will be subject to its own two-year time out on soliciting business for clients from the Government Entity in question. The SEC further indicated that FINRA is currently drafting pay-to-play rules for placement agents and solicitors that are registered broker-dealers. If FINRA and the other national securities associations fail to adopt rules by the effective date (discussed below), then Covered Investment Advisers would be prohibited from making payments to placement agents and solicitors that are registered broker-dealers for solicitation to Government Entities.

Maintenance of Books and Records

Under the Final Rules, investment advisers registered with the SEC (but not Covered Investment Advisers who are exempt from registration) will be required to maintain records regarding political contributions and payments to placement agents and solicitors, including (i) a list of all Government Entities to which the investment adviser provides or has provided investment advisory services (this includes any Government Entity that is an investor in a Covered Investment Pool that received investment advisory services from the investment adviser) in the past five years, and (ii) the name and business address of each placement agent and solicitor retained by the investment adviser to solicit a Government Entity. In addition, registered investment advisers that currently provide investment advisory services to a Government Entity must maintain records of (i) the names, titles and business and residence addresses of all Covered Associates, and (ii) all direct and indirect contributions made by the investment adviser or any of its Covered Associates to an official of a Government Entity and all direct or indirect payments to a political party of a state or political subdivision thereof or to a political action committee. The records regarding direct and indirect contributions must be in chronological order and include, among other things, the amount of each contribution and its recipient.

Effective Date

The Final Rules will become effective 60 days after their publication in the *Federal Register*. Compliance with the Final Rules' provisions generally will be required within six months after the effective date. However, in order to ensure that new regulations are in place to cover placement agents and solicitors that are registered broker-dealers, compliance with the Final Rules' provisions regarding third-party solicitors and placement agents will not be required until one year after the effective date. Additionally, in response to concerns expressed in comment letters that registered investment companies may require additional time to identify Government Entities that have selected them as an investment option, the Final Rules will not apply to Covered Investment Advisers of registered investment companies until one year after the effective date.

Further, the Final Rules do not preempt or override state laws. Thus, each state (and each political subdivision of a state) may maintain its existing laws and rules, or enact its own laws and rules, on pay-to-play and the use of placement agents.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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- 1 For more information regarding the Proposed Rules, please see the Paul Hastings client alert dated August 17, 2009 entitled "SEC Proposed Pay-to-Play Rules That Would Significantly Restrict Political Contributions by Investment Advisers and Prohibit Payments to Placement Agents for Marketing to Public Pension Plans".
- 2 We note that the financial reform legislation, entitled the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (H.R. 4173), which has been passed by the House and is pending in the Senate, will, if enacted, essentially repeal the exemption from registration for investment advisers with fewer than 15 clients.