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SEC Update

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SEC Adopts Pay-to-Play Rules Under Investment Advisers Act

The U.S. Securities and Exchange Commission (the "SEC") has adopted new rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Advisers Act") to address the growing number of actions involving investment adviser pay-to-play activity (such as the practice of making campaign contributions to elected officials in an effort to secure management contracts for public pension plan assets and similar government investment accounts[1]). This new rule seeks to curtail investment adviser participation in pay-to-play practices by restraining political contributions, prohibiting the solicitation of political contributions, and prohibiting the use of particular third party solicitors. The SEC suggests that this new rule not only reflects the high ethical standards of investment advisers, but will also help to ensure that the most qualified investment advisers are selected to manage public pension plans.

Pay-to-Play Prohibitions

New rule 206(4)-5 contains three main prohibitions that apply to registered investment advisers, unregistered investment advisers relying on the exemption under section 203(b)-(3) of the Advisers Act[2], and their respective covered associates (including general partners, managing members, executive officers, and employees who solicit government entities for the investment adviser). The new rule also applies to investment advisers that manage the assets of a government entity through a registered investment company that is an investment option of a plan or program of a government entity, a hedge fund, a private equity fund, or other covered investment pools.

If an elected official or candidate of a government entity is in a position to influence whether an investment adviser is awarded business, and the adviser (or any of its covered associates) makes a political contribution to the elected official or candidate, it is unlawful for the adviser to receive compensation for services to that government entity within two years of making a contribution. The SEC defines a “contribution” as any gift, subscription, loan advance, or deposit of money or anything of value. The SEC does not consider an individual’s donation of time to be a contribution so long as the investment adviser did not solicit the individual’s effort or use its own resources to aid the individual. The SEC also does not consider charitable donations made by an investment adviser at the request of an elected official to be a contribution.

Additionally, an investment adviser and its covered associates are prohibited from coordinating or soliciting: 1) contributions for any elected official or candidate who can influence whether the investment advisor is awarded business; and 2) payments to a political party of a state or locality where the investment advisor is providing or seeking to provide services to a government entity. This prohibition is aimed at preventing investment advisors from getting around the prohibition on direct contributions by bundling a large number of small contributions or by making indirect contributions through political parties.

Further, an investment adviser and its covered associates are prohibited from providing payments, directly or indirectly, to a third party engaged to solicit business from a government entity on the investment adviser’s behalf, unless such third party is a SEC-registered investment adviser or broker-dealer subject to similar pay-to-play bans. This prohibition applies to third party solicitors and placement agents, but does not apply to any of the investment adviser’s employees, general partners, managing members or executive officers.

Exceptions and Exemptions

In recognition of the potentially harsh consequences of unrestrained prohibitions, new rule 206(4)-5 contains certain exceptions, including a *de minimus* exception to the prohibition on providing advisory services for compensation within two years of a contribution. Particularly, an individual is permitted to make contributions of up to $350 to any one official, per election, if he is entitled to vote for the official at the time of the contribution. He can also contribute up to $150 to any one official, per election, who he was not entitled to vote for at the time of the contribution. Furthermore, under the new rule, the SEC is given the discretionary authority to exempt an investment adviser from the prohibition on providing advisory services for compensation within two years of a contribution after consideration of factors such as the public interest.

Record Keeping

To ensure compliance with new rule 206(4)-5, the SEC has amended rule 204-2 of the Advisors Act to require registered investment advisers that have government clients, or provide advisory services to a covered investment pool in which a government entity investor invests, to make and maintain certain records of political contributions.

Effective Date

Rule 206(4)-5 and the amendment to record-keeping rule 204-2 are effective on September 13, 2010. However, in an effort to provide investment advisers with an adequate transition period, the prohibition on providing advisory services for compensation within two years of a contribution will not apply to, and the prohibition on soliciting or coordinating contributions will not be triggered by contributions made before March 14, 2011. Additionally, the prohibition on the use of certain third parties to solicit government entities for business will not be enforced before September 13, 2011. Investment advisors to registered investment companies that are covered investment pools must comply with rule 205(4)-5 by September 13, 2011. Investment advisors subject to rule 204-2 must comply with the amended record-keeping rule on March 14, 2011, while investment advisers to registered investment companies that are covered investment pools have until September 13, 2011 to comply with the amended record-keeping rule.

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(1) Examples of other government investment accounts include “qualified tuition plans” authorized by section 529 of the Internal Revenue Code and retirement plans authorized by section 403(b) or 457 of the Internal Revenue Code.

(2) Section 203(b)-(3) of the Advisers Act exempts from registration any investment adviser that is not holding itself out to the public as an investment adviser and had fewer than 15 clients during the last 12 months.
