

Investment Funds Alert

SEC Adopts "Pay to Play" Rule, but Drops Proposed Complete Ban on Placement Agents

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The Securities and Exchange Commission (SEC) unanimously adopted a new rule, Rule 206(4)-5 (the "Pay to Play Rule") under the Investment Advisers Act of 1940 ("Advisers Act") that will prohibit most investment advisers to public pension plans, regardless of whether they are registered with the SEC, from—

- receiving compensation for providing advice to a Government Entity within two years after the adviser or any of its Covered Associates makes a contribution to an Applicable Official of the entity (terms defined below)
- hiring a third-party solicitor or "placement agent" to solicit a Government Entity to retain the investment adviser unless the third party is registered with the SEC as an investment adviser or broker-dealer
- coordinating or soliciting any person or political action committee (PAC) to contribute to an Applicable Official or to make a payment to a political party of the state or locality where the Government Entity receiving investment advice or being solicited to receive investment advice is located.

In addition to adopting the Pay to Play Rule, the SEC amended its record-keeping rule, Rule 204-2 under the Advisers Act (the "Record Keeping Rule"), to require the maintenance of records related to political contributions. The Pay to Play Rule and the amendments to the Record Keeping Rule will become effective 60 days after publication in the *Federal Register*. Investment advisers will be required to comply with the new provisions (except the prohibition on the use of unregistered third-party solicitors) within six months after the effective date and with all portions of the amended rules within one year.

Advisers Subject to the Rule

The Pay to Play Rule will apply to any investment adviser registered (or required to be registered) with the SEC or unregistered in reliance upon Section 203(b)(3) of the Advisers Act (together, "Subject Advisers").¹ Note, however, that the Pay to Play Rule will not apply to advisers that are registered with state securities authorities rather than the SEC or advisers that are unregistered in reliance upon other exemptions (such as banks and intrastate advisers).

Political Contributions

The Pay to Play Rule will prohibit Subject Advisers from directly or indirectly through any covered pooled investment vehicle² providing investment advisory services for compensation to any (a) agency of a state or subdivision of a state, (b)

¹ Section 203(b)(3) exempts from registration any investment adviser that does not hold itself out to the public as an investment adviser and had fewer than 15 clients during the last 12 months. In the adopting release, the SEC makes clear that it included this category of exempt advisers within the scope of the Pay to Play Rule in order to extend the scope of the rule's restrictions to many advisers to private funds that are not required to be registered under the Advisers Act.

² A covered investment pool means an issuer that would be an investment company under the Investment Company Act of 1940 (the "Company Act"), if it were not for the exclusions in 3(c)(1), 3(c)(7) or 3(c)(11) of the Company Act (i.e., most hedge and private equity funds) or an investment company registered under the Company Act that is an investment option of a plan or program of a government entity.



plan or pool sponsored or established by a state or political subdivision thereof or (c) an official of any of the above, acting in his or her official capacity (a “Government Entity”) if that investment adviser or any of its Covered Associates made a contribution of value³ to an official of a Government Entity from which investment advisory services have been solicited (an “Applicable Official”) within the past two years. “Covered Associates” will include a Subject Advisers’ general partners, managing members, executive officers, any employee that solicits from a Government Entity for the Subject Adviser and any persons who supervise such persons or any PAC controlled by the Subject Adviser or other Covered Associates. The Pay to Play Rule includes a “look back” requirement that will require advisers to make inquiries regarding an employee’s contributions made prior to becoming a Covered Associate to determine whether the time-out restriction will apply to the Subject Adviser. The “look back” period is two years for persons who solicit clients on behalf of the Subject Adviser and six months for all other Covered Associates.

The Pay to Play Rule will, however, provide for a de minimis carve-out from the two-year prohibition for contributions of \$350 or less to officials for whom the investment adviser or its Covered Associates were entitled to vote and \$150 or less if the investment adviser or its Covered Associates were not entitled to vote for such official or candidate. For purposes of measuring the \$350 de minimis carve-out, the Pay to Play Rule includes an exception for certain inadvertent contributions, including scenarios wherein the Subject Adviser discovered the contribution that resulting in the prohibition within four months of the contribution, and the contribution is returned within 60 days.

The Pay to Play Rule will also prohibit Subject Advisers from coordinating or soliciting (1) contributions to an official of a Government Entity to which an adviser is providing or seeking to provide investment advisory services or (2) payments to a political party of a state or locality in which the Subject Adviser is providing or seeking to provide investment advisory services to a Government Entity. The above exceptions for de minimis and returned contributions do not apply to coordinated or solicited contributions or payments.

Placement Agents

The Pay to Play Rule prohibits the use of third parties in connection with any solicitation unless the third party is either (1) an SEC-registered investment adviser that has not made a contribution to an Applicable Official nor solicited or coordinated any person or PAC to make any contribution or payment that will be prohibited under the Pay to Play Rule or (2) a broker-dealer registered with the SEC and subject to the rules of the Financial Industry Regulatory Authority, Inc. (FINRA).⁴ This limitation on the use of unregistered solicitors contrasts with the ban of the use of third-party solicitors that was contained in the version of the rule proposed by the SEC in 2009.

Record Keeping Requirements

In connection with the adoption of the Pay to Play Rule, the SEC has also added records related to registered investment advisers’ Covered Associates and registered investment advisers’ interactions with politicians to registered investment advisers’ required books and records under the Record Keeping Rule. Specifically, the SEC will require all registered investment advisers to maintain records regarding (1) the names, titles and business and residence addresses of all Covered Associates of the registered investment adviser; (2) all Government Entities for which the registered investment adviser is providing or has provided investment advisory services or which are or were investors in any covered investment pool that the registered investment adviser advises or has advised in the last five years (but not before the effectiveness of the Pay to Play Rule); (3) any direct or indirect contributions or payments made by the registered investment adviser or any of its Covered Associates to an official of a Government Entity, a political party or a PAC by the registered investment adviser or any of its Covered Associates; and (4) the name and business address or all third parties under the Pay to Play Rule that the registered investment adviser paid or agreed to directly or indirectly pay to solicit Government Entities. Any records relating

³ Contribution of time by a Covered Associate is not deemed to be a contribution so long as the time is provided outside of work hours, no resources of the Subject Adviser are used and the Covered Associate is not involved in soliciting or coordinating the solicitation of payments. Contributions to charitable organizations (even at the request of an Applicable Official) will not trigger the two-year time-out.

⁴ The Pay to Play Rule requires broker-dealers to be subject to the rules of a national securities association prohibiting the solicitation of a Government Entity if political contributions are made to an Applicable Official. The SEC has determined by order that the national securities association’s rule imposes similar or more stringent requirements as those in the Pay to Play Rule. Currently, FINRA has not adopted a similar rule, and, therefore, if the restrictions on the use of placement agents in the Pay to Play Rule were effective tomorrow, the only entities that could act as placement agents would be registered investment advisers. The SEC contemplates that FINRA will adopt a similar pay to play restriction within the year prior to the effectiveness of the rule.

to political contributions or payments must include the name and title of the contributor, the name and title of the recipients, the amount and date of each contribution or payments and whether any such contribution was returned to the investment adviser or covered person pursuant to the exemption referenced above. The above requirements of the Record Keeping Rule for Covered Associates and all political contributions only apply if the registered investment adviser provides advice to a Government Entity or a Government Entity invests in a covered investment pool.

Conclusion

The new requirements and limitations under the Pay to Play Rule will require advisers that provide or seek to provide advisory services to government plans to implement changes to their compliance programs. In order to ensure that such advisers can continue to solicit Government Entities for advisory services or investments in their covered investment pools, Subject Advisers will be required to implement new procedures (or enhance existing ones) to include mechanisms to monitor all political contributions by Covered Associates and to make requisite inquiries to certain employees at the time of hiring regarding their past political contributions. The penalties for violating the restrictions in the Pay to Play rule will be severe, including both the potential for regulatory sanctions and reputational harm. The Pay to Play Rule provides that if a Subject Adviser or its Covered Associates have made a prohibited contribution, the Subject Adviser would be forced to (1) waive all compensation from the Government Entity, rebate any past compensation in violation of the rule and provide investment advisory services for free, (2) terminate the advisory contract or redeem the Government Entity from covered investment pool and/or (3) apply for an exemption from the SEC staff.

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