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Investment Management Compliance Update: SEC Adopts Pay-To-Play Rule For Advisers

Introduction New rule 206(4)-5 of the Investment Advisers Act of 1940, recently adopted by the Securities and Exchange Commission (the "SEC"), will prohibit investment advisers who manage public pension assets and other types of government investment funds from making political contributions to officials who choose fund advisers. On June 30, 2010, the SEC voted 5-0 to ban advisers from offering services to pension plans for two years if they contribute to an elected official or a candidate who could be in a position to hire money managers. This prohibition on "pay-to-play" represents a significant step by the SEC in the decade-long attempt to crack down on such activity at both the federal and state levels.

Ban on Pay-to-Play

As described by the SEC in the release accompanying the announcement of the new rules, pay-to-play "is the practice of making campaign contributions and related payments to elected officials in order to influence the awarding of lucrative contracts for the management of public pension plan assets and similar government investment accounts." As noted, rule 206(4)-5 prohibits advisers from making contributions to elected officials who are in a position to influence the selection of the adviser. An adviser that makes a prohibited contribution may not receive compensation for providing advisory services to such government entity for two years, beginning on the date of the contribution. Particular executives and employees of the money managers, including general partners, managing members and executive officers, are also subject to the ban. The rule also contains a look-back provision, which attributes to an advisor contributions of "covered associates" [1] that were made prior to the covered associate becoming an associate of the adviser. This look-back period is for two years if the covered associate solicits government clients. Otherwise, the look-back is limited to six months. Rule 206(4)-5 prohibits advisers and covered associates from soliciting any person or political action committee to make or coordinate a contribution to an official or government entity to which the adviser is providing or seeking to provide investment advisory services. Through this prohibition, the SEC intends to prevent "bundling," the pooling of a large number of small contributions by the adviser's employees in order to make one large contribution to influence an election. Further, rule 206(4)-5 would bar executives of advisers from directing contributions by their spouses, lawyers, affiliated companies and private groups created to elect candidates or lobby for legislation. This provision of the rule seeks to prevent advisers from circumventing the prohibition by directing funds through outside, but related, channels. "The selection of investment advisers to manage public plans should be based on the best interests of the plans and their beneficiaries, not kickbacks and favors," said SEC Chairman Mary L. Schapiro. "These new rules will help level the playing field, allowing advisers of all sizes to compete for government contracts based on investment skill and quality of service."

De Minimis Contributions

A provision under rule 206(4)-5(b)(1) permits advisers to make de minimis contributions to candidates. Advisers may contribute $350 per candidate for each primary or general election to candidates connected to adviser selection if the adviser

is entitled to vote for the candidate. The rule limits contributions to $150 for any one candidate, per election, if the adviser cannot vote for the candidate.

Placement Agents

Rule 206(4)-5 prohibits advisers from retaining third parties to solicit funds from government entities unless the third parties, known as placement agents, are registered with the SEC as investment advisers or broker-dealers and subject to similar pay-to-play restrictions. The SEC failed to adopt a previous proposal that would have imposed an outright ban on investment advisers hiring so-called placement agents. In response to that proposed rule, smaller investment advisers and fund managers argued that they could not attract such business on their own, thus necessitating reliance on consultants and brokers to gain access to those assets. The new rule allows advisers to continue to utilize the services of such placement agents, but requires that these third-party solicitors comply with similar pay-to-play restrictions as those applicable to the advisers who retain them.

Record Keeping

In addition to adopting new rule 206(4)-5, the SEC also amended rule 204-2, which regulates the books and records that investment advisers must maintain. This amendment to the rule, in conjunction with rule 206(4)-5, will require investment advisers to maintain books and records that contain a list or other record of

> (a) the names, titles, and business and residence addresses of all covered associates of the investment adviser; (b) all government entities to which the adviser provides or has provided investment advisory services in the past five years; (c) all direct or indirect contributions made by the investment adviser or any of its associates to any government official or government entity; and (d) the name and business address of all placement agents utilized by the investment adviser.

Effective Dates

The effective date of rule 206(4)-5 is September 13, 2010. Investment advisers subject to rule 206(4)-5 must be in compliance with the rule by March 14, 2011. Such advisers must comply with the rules applicable to placement agents by September 13, 2011. Similarly, advisers to registered investment companies that are covered investment pools must comply with the rules by September 13, 2011. Advisers must comply with the amended 204-2 record-keeping rules by March 14, 2011. Advisers to registered investment companies that are covered investment pools must comply with the 204-2 record-keeping rules by September 13, 2011 with respect to those registered investment companies.

Steps to Be Taken by Managers and Investors

New Rule 206(4)-5 and the corresponding amendments to the record-keeping rules make clear that pay-to-play activity is at the forefront of the SEC's enforcement agenda. In light of several high-profile legal actions and settlements involving pay-to-play allegations, managers and investors must take special care to institute measures that protect against violations of these new rules. Internal policies and procedures should be reviewed and reworked to ensure compliance with the SEC's rules. In particular, the restrictions on indirect contributions and solicitations present myriad possible compliance issues that managers and investors must scrutinize closely going forward. Although the SEC retreated from its efforts to ban completely the use of placement agents by investment managers seeking to manage state and local governments' pension funds, investment managers should still consider alternative approaches to contracting with placement agents. From the outset, investment managers must institute measures to certify that all placement agents they use are registered investment advisers or broker-dealers subject to similar pay-to-play restrictions. Managers must impose stringent compliance requirements and certifications on placement agents, such as certifications on not making illegal payments to third parties. Managers should

also consider enhancing their internal marketing capabilities to interact directly with public pension fund staff and consultants as a way of getting on the radar screen of institutional investors without reliance on placement agents. Even after certifying the credentials of a proposed placement agent, managers accepting investments arranged by placement agents, whether or not they are aware of improper conduct, could potentially still find themselves faced with liability under state and federal law. Subject to the terms of the investment documents with investors, managers may also face breach of contract and failure to disclose material information claims for utilizing placement agents engaged in improper conduct. As noted, investment managers need to strengthen their compliance controls to ensure that policies and procedures are put in place that prevent violations of law from occurring. On the investor side, public institutional investors should institute rigorous policies and procedures governing due diligence practices for selecting managers and monitoring such managers' ongoing compliance. These polices and procedures should address the past practices of such managers, ensure strict compliance with the SEC rules, and require disclosure of finder's fees and other compensation paid to placement agents. In addition, institutional investors should consider an ongoing review of investment managers' back-office compliance processes. Managers and investors must also remain aware of pay-to-play restrictions that exist on the state and local level. The state of New Jersey; the state of Connecticut; the state of Illinois; New York City; the New York State Common Retirement Fund; the California Public Employees' Retirement System; and other states, localities and pension systems have put in place pay-to-play prohibitions.

Conclusion

The new rule 206(4)-5 increases federal regulation of the public investment sphere. Public pension plans, totaling more than $2.6 trillion of assets, represent more than one-third of all pension assets. Competition for the management of these assets continues at an ever-increasing rate. Increased regulation of this competition necessitates heightened compliance measures and close scrutiny of the newly adopted and amended rules. Members of Day Pitney's Investment Management Compliance Services team are available to answer any questions you may have regarding the new pay-to-play regime and to assist in developing appropriate compliance programs to address federal and state requirements in this regard.

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[1] Rule 206(4)-5 defines a "covered associate" of an adviser to include any (i) general partner, managing member or executive officer, or other individual with a similar status or function; (ii) employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the adviser or by a person described in the preceding paragraphs (i) or (ii).