

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 275**

**Release No. IA-3043; File No. S7-18-09**

**RIN 3235-AK39**

**Political Contributions by Certain Investment Advisers**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission is adopting a new rule under the Investment Advisers Act of 1940 that prohibits an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. The new rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser, unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay to play restrictions. Additionally, the new rule prevents an adviser from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The Commission also is adopting rule amendments that require a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees. The new rule and rule amendments address “pay to play” practices by investment advisers.

**DATES:** Effective Date: September 13, 2010.

Compliance Dates: Investment advisers subject to rule 206(4)-5 must be in compliance with the rule on March 14, 2011. Investment advisers may no longer use third parties to solicit government business except in compliance with the rule on September 13, 2011. Advisers to registered investment companies that are covered investment pools must comply with the rule by September 13, 2011. Advisers subject to rule 204-2 must comply with amended rule 204-2 on March 14, 2011. However, if they advise registered investment companies that are covered investment pools, they have until September 13, 2011 to comply with the amended recordkeeping rule with respect to those registered investment companies. See section III of this Release for further discussion of compliance dates.

**FOR FURTHER INFORMATION CONTACT:** Melissa A. Rovers, Senior Counsel, Matthew N. Goldin, Branch Chief, Daniel S. Kahl, Branch Chief, or Sarah A. Bessin, Assistant Director, at (202) 551-6787 or IARules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

**SUPPLEMENTARY INFORMATION:** The Commission is adopting rule 206(4)-5 [17 CFR 275.206(4)-5] and amendments to rules 204-2 [17 CFR 275.204-2] and 206(4)-3 [17 CFR 275.206(4)-3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (“Advisers Act” or “Act”).<sup>1</sup>

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<sup>1</sup> 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified, and when we refer to rule 206(4)-5, rule 204-2, rule 204A-1, rule 206(4)-3, or any paragraph of these rules, we are referring to 17 CFR 275.206(4)-5, 17 CFR 275.204-2, 17 CFR 275.204A-1 and 17 CFR 275.206(4)-3, respectively, of the Code of Federal Regulations, in which these rules are published.

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## I. BACKGROUND

Investment advisers provide a wide variety of advisory services to state and local governments,<sup>2</sup> including managing their public pension plans.<sup>3</sup> These pension plans have over \$2.6 trillion of assets and represent one-third of all U.S. pension assets.<sup>4</sup> They are among the largest and most active institutional investors in the United States;<sup>5</sup> the management of these funds affects publicly held companies<sup>6</sup> and the securities markets.<sup>7</sup> But most significantly, their management affects taxpayers and the beneficiaries of these

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<sup>2</sup> See SOFIA ANASTOPOULOS, AN INTRODUCTION TO INVESTMENT ADVISERS FOR STATE AND LOCAL GOVERNMENTS (2d ed. 2007); Werner Paul Zorn, *Public Employee Retirement Systems and Benefits*, LOCAL GOVERNMENT FINANCE, CONCEPTS AND PRACTICES 376 (John E. Peterson & Dennis R. Strachota eds., 1st ed. 1991) (discussing the services investment advisers provide for public funds).

<sup>3</sup> To simplify the discussion, we use the term “public pension plan” interchangeably with “government client” and “government entity” in this Release. However, our rule applies broadly to investment advisory activities for government clients, such as those mentioned here in this Section of the Release, regardless of whether they are retirement funds. For a discussion of how the proposed rule would apply with respect to investment programs or plans sponsored or established by government entities, such as “qualified tuition plans” authorized by section 529 of the Internal Revenue Code [26 U.S.C. 529] and retirement plans authorized by section 403(b) or 457 of the Internal Revenue Code [26 U.S.C. 403(b) or 457], see section II.B.2(e) of this Release.

<sup>4</sup> BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS AND OUTSTANDINGS, FOURTH QUARTER 2009 78 tbl.L.119 (Mar. 11, 2010). Since 2002, total financial assets of public pension funds have grown by 28%. *Id.*

<sup>5</sup> According to a recent survey, seven of the ten largest pension funds were sponsored by state and municipal governments. *The Top 200 Pension Funds/Sponsors*, PENS. & INV. (Sept. 30, 2008), available at <http://www.pionline.com/article/20090126/CHART/901209995>.

<sup>6</sup> See Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008) (“Collectively, public pension funds have the potential to be a powerful shareholder force, and the example of CalPERS and its activities have spurred many to advocate greater institutional activism.”).

<sup>7</sup> Federal Reserve reports indicate that, of the \$2.6 trillion in non-federal government plans, \$1.5 trillion is invested in corporate equities. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 4, at 78 tbl.L.119.

funds, including the millions of present and future state and municipal retirees<sup>8</sup> who rely on the funds for their pensions and other benefits.<sup>9</sup> Public pension plan assets are held, administered and managed by government officials who often are responsible for selecting investment advisers to manage the funds they oversee.

Elected officials who allow political contributions to play a role in the management of these assets and who use these assets to reward contributors violate the public trust. Moreover, they undermine the fairness of the process by which public contracts are awarded. Similarly, investment advisers that seek to influence government officials' awards of advisory contracts by making or soliciting political contributions to those officials compromise their fiduciary duties to the pension plans they advise and defraud prospective clients. These practices, known as "pay to play," distort the process by which advisers are selected.<sup>10</sup> They can harm pension plans that may subsequently receive inferior advisory services and pay higher fees. Ultimately, these violations of trust can harm the millions of retirees that rely on the plan or the taxpayers of the state and municipal governments that must honor those obligations.<sup>11</sup>

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<sup>8</sup> See PAUL ZORN, 1997 SURVEY OF STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT SYSTEMS 61 (1997) (hereinafter "1997 SURVEY") ("[t]he investment of plan assets is an issue of immense consequence to plan participants, taxpayers, and to the economy as a whole" as a low rate of return will require additional funding from the sponsoring government, which "can place an additional strain on the sponsoring government and may require tax increases").

<sup>9</sup> The most current census data reports that public pension funds have 18.6 million beneficiaries. 2007 Census of Governments, U.S. Bureau of Census, Number and Membership of State and Local Government Employee-Retirement Systems by State: 2006-2007 (2007) (at Table 5), available at <http://www.census.gov/govs/retire/2007ret05.html>.

<sup>10</sup> Among other things, pay to play practices may manipulate the market for advisory services by creating an uneven playing field among investment advisers. These practices also may hurt smaller advisers that cannot afford the required contributions.

<sup>11</sup> See 1997 SURVEY, *supra* note 8.

Pay to play practices are rarely explicit: participants do not typically let it be publicly known that contributions or payments are made or accepted for the purpose of influencing the selection of an adviser. As one court noted, “[w]hile the risk of corruption is obvious and substantial, actors in this field are presumably shrewd enough to structure their relations rather indirectly.”<sup>12</sup> Pay to play practices may take a variety of forms, including an adviser’s direct contributions to government officials, an adviser’s solicitation of third parties to make contributions or payments to government officials or political parties in the state or locality where the adviser seeks to provide services, or an adviser’s payments to third parties to solicit (or as a condition of obtaining) government business. As a result, the full extent of pay to play practice remains hidden and is often hard to prove.

Public pension plans are particularly vulnerable to pay to play practices. Management decisions over these investment pools, some of which are quite large, are typically made by one or more trustees who are (or are appointed by) elected officials. And the elected officials or appointed trustees that govern the funds are also often involved, directly or indirectly, in selecting advisers to manage the public pension funds’ assets. These officials may have the sole authority to select advisers,<sup>13</sup> may be members of a governing board that selects advisers,<sup>14</sup> or may appoint some or all of the board members who make the selection.<sup>15</sup>

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<sup>12</sup> *Blount v. SEC*, 61 F.3d 938, 945 (D.C. Cir. 1995), *cert. denied*, 517 U.S. 1119 (1996).

<sup>13</sup> *See, e.g.*, 2 N.Y. COMP. CODES R. & REGS. TIT. 2 § 320.2 (2009) (placement of state and local government retirement systems assets (valued at \$109 billion as of March 2009) is under the sole custodianship of the New York State Comptroller).

<sup>14</sup> *See, e.g.*, S.C. CODE ANN. §§ 9-1-20, 1-11-10 (2008) (board consists of all elected officials); CAL. GOV’T CODE § 20090 (Deering 2008) (board consists of some elected officials, some appointed members, and some representatives of interest groups chosen

Numerous developments in recent years have led us to conclude that the selection of advisers, whom we regulate under the Investment Advisers Act, has been influenced by political contributions and that, as a result, the quality of management service provided to public funds may be negatively affected. We have been particularly concerned that these contributions have been funneled through “solicitors” and “placement agents” that advisers engage (or believe they must engage) in order to secure a client relationship with a public pension plan or an investment from one.<sup>16</sup> As we will discuss in more detail below, in such an arrangement the contribution may be made in the form of a substantial fee for what may constitute no more than an introduction service by a “well connected” individual who may use the proceeds of the fee to make (or reimburse himself for having made) political contributions or provide some form of a “kickback” to an official or his or her family or friends.<sup>17</sup>

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by the members of those groups); MD. CODE ANN., STATE PERS. & PENS. § 21-104 (2008) (pension board consists of some elected officials, some appointed members, and some representatives of interest groups chosen by the members of those groups).

<sup>15</sup> See, e.g., ARIZ. REV. STAT. ANN. § 38-713 (2008) (governor appoints all nine members); HAWAII REV. STAT. § 88-24 (2008) (governor appoints three of eight members); IDAHO CODE ANN. § 59-1304 (2008) (governor appoints all five members).

<sup>16</sup> For example, in one recent action we alleged that, in connection with a pay to play scheme in New York State, investment advisers paid sham “placement agent” fees, portions of which were funneled to public officials, as a means of obtaining public pension fund investments in the funds those advisers managed and that participants, in some instances, concealed the third-party solicitor’s role in transactions from the investment management firms that paid fees to the solicitor by making misrepresentations about the solicitor’s involvement and covertly using one of the solicitor’s legal entities as an intermediary to funnel payments to the solicitor. *SEC v. Henry Morris, et al.*, Litigation Release No. 20963 (Mar. 19, 2009).

<sup>17</sup> See *id.* (along with the Commission’s complaint in the action, available by way of a hyperlink from the litigation release). See also, e.g., *In the Matter of Quadrangle Group LLC*, AGNY Investigation No. 2010-044 (Apr. 15, 2010) (finding that “private equity firms and hedge funds frequently use placement agents, finders, lobbyists, and other intermediaries . . . to obtain investments from public pension funds . . . , that these placement agents are frequently politically connected individuals selling access to public money. . .”); Complaint, *Cal. v. Villalobos, et al.*, No. SC107850 (Cal. Super. Ct., W.



The details of pay to play arrangements have been widely reported as a consequence of the growing number of actions that we and state authorities have brought involving investment advisers seeking to manage the considerable assets of the New York State Common Retirement Fund.<sup>18</sup> In addition, we have brought enforcement actions against the former treasurer of the State of Connecticut and other parties in which we alleged that the former treasurer awarded state pension fund investments to private equity fund managers in exchange for payments, including political contributions, funneled through the former treasurer's friends and political associates.<sup>19</sup> Criminal

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Dist. of L.A. County, May 5, 2010), *available at* [http://ag.ca.gov/cms\\_attachments/press/pdfs/n1915\\_filed\\_complaint\\_for\\_civil\\_penalties.pdf](http://ag.ca.gov/cms_attachments/press/pdfs/n1915_filed_complaint_for_civil_penalties.pdf) (alleging, *inter alia*, that a top executive and a board member at CalPERS accepted various gifts from a former CalPERS board member, "known among private equity firms as a person who attempts to exert pressure on CalPERS' representatives," who was acting as a placement agent trying to secure investments from the California public pension fund).

<sup>18</sup> See *SEC v. Henry Morris, et al.*, Litigation Release No. 21036 (May 12, 2009); *In the Matter of Quadrangle Group LLC*, AGNY Investigation No. 2010-044 (Apr. 15, 2010); *In the Matter of GKM Newport Generation Capital Servs., LLC*, AGNY Investigation No. 2010-017 (Apr. 14, 2010); *In the Matter of Kevin McCabe*, AGNY Investigation No. 2009-152 (Apr. 14, 2010); *In the Matter of Darius Anderson Platinum Advisors LLC*, AGNY Investigation No. 2009-153 (Apr. 14, 2010); *In the Matter of Global Strategy Group*, AGNY Investigation No. 2009-161 (Apr. 14, 2010); *In the Matter of Freeman Spogli & Co.*, AGNY Investigation No. 2009-174 (Feb. 1, 2010); *In the Matter of Falconhead Capital, LLC*, AGNY Investigation No. 2009-125 (Sept. 17, 2009); *In the Matter of HM Capital Partners I, LP*, AGNY Investigation No. 2009-117 (Sept. 17, 2009); *In the Matter of Ares Management LLC*, AGNY Investigation No. 2009-173 (Feb. 17, 2010); *In the Matter of Levine Leichtman Capital Partners*, AGNY Investigation No. 2009-124 (Sept. 17, 2009); *In the Matter of Access Capital Partners*, AGNY Investigation No. 09-135 (Sept. 17, 2009); *In the Matter of The Markstone Group*, AGNY Investigation No. 10-012 (Feb. 28, 2010); *In the Matter of Wetherly Capital Group, LLC and DAV/Wetherly Financial, L.P.*, AGNY Investigation No. 2009-172 (Feb. 8, 2010) (in each case, banning the use of third-party placement agents pursuant to a "Pension Reform Code of Conduct").

<sup>19</sup> See *SEC v. Paul J. Silvester, et al.*, Litigation Release No. 16759 (Oct. 10, 2000); Litigation Release No. 20027 (Mar. 2, 2007); Litigation Release No. 19583 (Mar. 1, 2006); Litigation Release No. 18461 (Nov. 17, 2003); Litigation Release No. 16834 (Dec. 19, 2000); *SEC v. William A. DiBella et al.*, Litigation Release No. 20498 (Mar. 14, 2008) (2007 U.S. Dist. LEXIS 73850 (D. Conn., May 8, 2007), *aff'd* 587 F.3d 553 (2nd Cir. 2009)). See also *U.S. v. Ben F. Andrews*, Litigation Release No. 19566 (Feb. 15,

authorities have in recent years brought cases in New York,<sup>20</sup> New Mexico,<sup>21</sup> Illinois,<sup>22</sup> Ohio,<sup>23</sup> Connecticut,<sup>24</sup> and Florida,<sup>25</sup> charging defendants with the same or similar conduct.

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- 2006); *In the Matter of Thayer Capital Partners, TC Equity Partners IV, L.L.C., TC Management Partners IV, L.L.C., and Frederick V. Malek*, Investment Advisers Act Release No. 2276 (Aug. 12, 2004); *In the Matter of Frederick W. McCarthy*, Investment Advisers Act Release No. 2218 (Mar. 5, 2004); *In the Matter of Lisa A. Thiesfield*, Investment Advisers Act Release No. 2186 (Oct. 29, 2003).
- <sup>20</sup> See *New York v. Henry “Hank” Morris and David Loglisci*, Indictment No. 25/2009 (NY Mar. 19, 2009) (alleging that the deputy comptroller and a “placement agent” engaged in enterprise corruption and state securities fraud for selling access to management of public funds in return for kickbacks and other payments for personal and political gain).
- <sup>21</sup> See *U.S. v. Montoya*, Criminal No. 05-2050 JP (D.N.M. Nov. 8, 2005) (the former treasurer of New Mexico pleaded guilty); *U.S. v. Kent Nelson*, Criminal Information No. 05-2021 JP, (D.N.M. 2007) (defendant pleaded guilty to one count of mail fraud); *U.S. v. Vigil*, 523 F. 3d 1258 (10th Cir. 2008) (affirming the conviction for attempted extortion of the former treasurer of New Mexico for requiring that a friend be hired by an investment manager at a high salary in return for the former treasurer’s willingness to accept a proposal from the manager for government business).
- <sup>22</sup> See Jeff Coen, et al., *State’s Ultimate Insider Indicted*, CHI. TRIB., Oct. 31, 2008, available at <http://www.chicagotribune.com/news/local/chi-cellini-31-oct31,0,6465036.story> (describing the thirteenth indictment in an Illinois pay to play probe); Ellen Almer, Oct. 27, 2000, available at <http://www.chicagobusiness.com/cgi-bin/news.pl?id=775> (discussing the guilty plea of Miriam Santos, the former treasurer of the City of Chicago, who told representatives of financial services firms seeking city business that they were required to raise specified campaign contributions for her and personally make up any shortfall in the amounts they raised). See also *SEC v. Miriam Santos, et al.*, Litigation Release No. 17839 (Nov. 14, 2002); Litigation Release No. 19269 (June 14, 2005) (355 F. Supp. 2d 917 (N.D. Ill. 2003)).
- <sup>23</sup> See Reginald Fields, *Four More Convicted in Pension Case: Ex-Board Members Took Gifts from Firm*, CLEVELAND PLAIN DEALER, Sept. 20, 2006 (addressing pay to play activities of members of the Ohio Teachers Retirement System).
- <sup>24</sup> See *U.S. v. Joseph P. Ganim*, 2007 U.S. App. LEXIS 29367 (2d Cir. 2007) (affirming the district court’s decision to uphold an indictment of the former mayor of Bridgeport, Connecticut, in connection with his conviction for, among other things, requiring payment from an investment adviser in return for city business); *U.S. v. Triumph Capital Group, et al.*, No. 300CR217 JBA (D. Conn. 2000) (the former treasurer, along with certain others, pleaded guilty—while others were ultimately convicted). One of the defendants, who had been convicted at trial, recently won a new trial. *U.S. v. Triumph Capital Group, et al.*, 544 F.3d 149 (2d Cir. 2008).
- <sup>25</sup> *United States v. Poirier*, 321 F.3d 1024 (11th Cir.), cert. denied sub nom. *deVegter v. United States*, 540 U.S. 874 (2003) (partner at Lazard Freres & Co., a municipal services firm, was convicted for conspiracy and wire fraud for fraudulently paying \$40,000

Allegations of pay to play activity involving state and municipal pension plans in other jurisdictions continue to be reported.<sup>26</sup> In the course of this rulemaking we received a letter from one public official detailing the role of pay to play arrangements in the selection of public pension fund managers and the harms it can inflict on the affected plans.<sup>27</sup> In addition, other public officials wrote to express support for a Commission rule to prohibit investment advisers from participating in pay to play arrangements.<sup>28</sup>

On August 3, 2009, we proposed a new antifraud rule under the Advisers Act designed to prevent investment advisers from obtaining business from government entities in return for political contributions or fund raising—*i.e.*, from participating in pay

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through an intermediary to Fulton County’s independent financial adviser to secure an assurance that Lazard would be selected for the Fulton County underwriting contract).

<sup>26</sup> See, e.g., Aaron Lester, et al., *Cahill Taps Firms Tied to State Pension Investor*, BOSTON.COM, Mar. 21, 2010 (suggesting that an investment adviser may have bundled out-of-state donations to the Massachusetts State Treasurer’s campaign in return for a state pension fund investment management contract); Kevin McCoy, *Do Campaign Contributions Help Win Pension Fund Deals*, USA TODAY, Aug. 28, 2009; Ted Sherman, *Pay to Play Alive and Well in New Jersey*, NJ.COM, Nov. 28, 2009 (noting more generally that pay to play continues to occur with government contracts of all kinds in New Jersey); Imogen Rose-Smith and Ed Leefeldt, *Pension Pay to Play Casts Shadow Nationwide*, INSTITUTIONAL INVESTOR, Oct. 1, 2009 (suggesting connections between a private equity fund principal’s fundraising activities and pension investments in the fund). See also sources cited *supra* note 17.

<sup>27</sup> Comment Letter of Suzanne R. Weber, Erie County Controller (Oct. 6, 2009) (“Weber Letter”) (“I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen.”). See also Comment Letter of David R. Pohndorf (Aug. 4, 2009) (“Pohndorf Letter”) (noting that when the sole trustee of a major pension fund changed several years ago, a firm managing some of the fund’s assets “began to receive invitations to fundraising events for the new trustee with suggested donation amounts.”).

<sup>28</sup> See, e.g., Comment Letter of New York State Comptroller Thomas P. DiNapoli (Oct. 2, 2009) (“DiNapoli Letter”); Comment Letter of New York City Mayor Michael R. Bloomberg (Sept. 9, 2009) (“Bloomberg Letter”). See also Comment Letter of Kentucky Retirement Systems Trustee Chris Tobe (Sept. 18, 2009) (“Tobe Letter”) (suggesting the negative effects of pay to play activities on the Kentucky Retirement System’s investment performance).

to play practices.<sup>29</sup> We modeled our proposed rule on those adopted by the Municipal Securities Rulemaking Board, or MSRB, which since 1994 has prohibited municipal securities dealers from participating in pay to play practices.<sup>30</sup> We believe these rules have significantly curbed pay to play practices in the municipal securities market.<sup>31</sup>

Along the lines of MSRB rule G-37,<sup>32</sup> our proposed rule would have prohibited an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates.<sup>33</sup> It also would have prohibited an adviser and certain of its executives and employees from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business.<sup>34</sup> In

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<sup>29</sup> *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 2910 (Aug. 3, 2009) [74 FR 39840 (Aug. 7, 2009)] (the “Proposing Release”).

<sup>30</sup> MSRB rule G-37 was approved by the Commission and adopted in 1994. *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule*, Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)]. The MSRB’s pay to play rules include MSRB rules G-37 and G-38. They are available on the MSRB’s Web site at <http://www.msrb.org/msrb1/rules/ruleg37.htm> and <http://www.msrb.org/msrb1/rules/ruleg38.htm>, respectively.

<sup>31</sup> *See* Proposing Release, at n.23. *See also infra* note 101; Comment Letter of the Municipal Securities Rulemaking Board (Oct. 23, 2009) (“MSRB Letter”); Comment Letter of Common Cause (Oct. 6, 2009) (“Common Cause Letter”).

<sup>32</sup> *See* MSRB rule G-37(b). Our proposal, like MSRB rule G-37, was designed to address our concern that pay to play activities were “undermining the integrity” of the relevant market, in particular the market for the provision of investment advisory services to government entity clients. *See Blount*, 61 F.3d at 939 (referring to the MSRB’s concerns that pay to play practices were “undermining the integrity of the \$250 billion municipal securities market” as its motivation for proposing MSRB rule G-37).

<sup>33</sup> Proposed rule 206(4)-5(a)(1). *See also* MSRB rule G-37(b).

<sup>34</sup> Proposed rule 206(4)-5(a)(2)(ii). *See also* MSRB rule G-37(c).

addition, similar to MSRB rule G-38,<sup>35</sup> our proposed rule would have prohibited the use of third parties to solicit government business.<sup>36</sup> We also proposed amendments to rule 204-2 under the Advisers Act that would have required registered advisers to maintain certain records regarding political contributions and government clients. As discussed in more detail below, our proposed rule departed in some respects from the MSRB rules to reflect differences between advisers and broker-dealers and the scope of the statutory authority we have sought to exercise.

We received some 250 comment letters on our proposal, many of which were from advisers, third-party solicitors, placement agents, and their representatives.<sup>37</sup> Public pension plans and their officials were divided—some embraced the rule, including one that stated that the rule is an important means to “increase transparency and public confidence in the investment activities of all public pension funds,”<sup>38</sup> while others were critical, arguing, for example, that our proposal “may result in unintended hardships being placed upon public pension funds.”<sup>39</sup> We received no letters from plan beneficiaries whom we sought to protect with the proposed rule,<sup>40</sup> although two public

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<sup>35</sup> See MSRB rule G-38(a).

<sup>36</sup> Proposed rule 206(4)-5(a)(2)(i).

<sup>37</sup> Other commenters included pension plans and their officials, trade associations, law firms, and public interest groups. Comments letters submitted in File No. S7-25-06 are available on the Commission’s web site at: <http://www.sec.gov/comments/s7-18-09/s71809.shtml>.

<sup>38</sup> Comment Letter of New York City Comptroller William C. Thompson, Jr. (Oct. 6, 2009) (“Thompson Letter”).

<sup>39</sup> Comment Letter of Executive Director and Secretary to the Board of Trustees of the State Retirement and Pension System of Maryland R. Dean Kenderdine (Oct. 5, 2009).

<sup>40</sup> We note, however, that subsequent to our proposal, AFSCME, which represents 1.6 million state and local employees and retirees, issued a report that strongly endorses sanctions to prevent pay to play activities. AFSCME, ENHANCING PUBLIC RETIREE PENSION PLAN SECURITY: BEST PRACTICE POLICIES FOR TRUSTEES AND PENSION

interest groups supported it strongly.<sup>41</sup> Advisers, third-party solicitors and placement agents, fund sponsors, and others whose business arrangements could be affected by the rule generally supported our goal of eliminating advisers' participation in pay to play practices involving public plans.<sup>42</sup> Nonetheless, most of them objected to our adoption under the Advisers Act of a rule similar to MSRB rules G-37 and G-38.<sup>43</sup> Most particularly opposed the proposed prohibition on payments to third parties for soliciting

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SYSTEMS (2010), *available at* <http://www.afscme.org/docs/AFSCME-report-pension-best-practices.pdf>.

<sup>41</sup> *See, e.g.*, Common Cause Letter; Comment Letter of Fund Democracy/Consumer Federation of America (Oct. 6, 2009) (“Fund Democracy/Consumer Federation Letter”).

<sup>42</sup> *See, e.g.*, Comment Letter of the Investment Adviser Association (Oct. 5, 2009) (“IAA Letter”) (noting “support [for] measures to combat pay to play activities, *i.e.*, the practice of investment advisers or their employees making political contributions intended to influence the selection or retention of advisers by government entities. Pay to play practices undermine the principle that advisers are selected on the basis of competence, qualifications, expertise, and experience. The practice is unethical and undermines the integrity of the public pension plan system and the process of selecting investment advisers.”); Comment Letter of John R. Dempsey (Aug. 8, 2009) (“Dempsey Letter”) (noting applause for efforts “to stop the ‘pay-to-play’ practice which only serves to undermine public trust in investment advisors and regulators.”); Comment Letter of Barry M. Gleicher (Sept. 7, 2009) (noting strong support for the proposal “with no modifications. . . . The Rule is necessary to curb elaborated practices that would deprive taxpayers and beneficiaries of cost effective and honest administration of pension funds”); Tobe Letter.

<sup>43</sup> *See, e.g.*, IAA Letter (“We respectfully submit, however, that the structure of the MSRB rules is not appropriately tailored to the investment advisory business. . . . We believe the Commission should make significant changes to the Proposal, which would permit it to accomplish its important goals.”); Comment Letter of Wesley Ogburn (Aug. 4, 2009) (“Ogburn Letter”); Comment Letter of the Third Party Marketers Association (Aug. 27, 2009) (“3PM Letter”); Comment Letter of Preqin (Aug. 28, 2009) (“Preqin Letter I”) (suggesting that institutional private equity investors polled favored a private equity specific proposal rather than relying on the framework from the municipal securities industry); Comment Letter of Dechert LLP (Oct. 22, 2009) (“Dechert Letter”); Comment Letter of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association (Oct. 13, 2009) (“ABA Letter”); Comment Letter of Fidelity Investments (Oct. 7, 2009) (“Fidelity Letter”); Comment Letter of Sutherland Asbill & Brennan LLP (Oct. 6, 2009) (“Sutherland Letter”); Comment Letter of the Investment Company Institute (Oct. 6, 2009) (“ICI Letter”); Comment Letter of the Massachusetts Mutual Life Insurance Company (Oct. 6, 2009) (“MassMutual Letter”); Comment Letter of Skadden, Arps, Slate, Meagher & Flom LLP (Oct. 6, 2009) (“Skadden Letter”); Comment Letter of the Managed Funds Association (Oct. 6, 2009) (“MFA Letter”).

or marketing to government entities modeled on MSRB rule G-38.<sup>44</sup> Several urged that, if we were to adopt a rule based on the approach taken in our proposal, we should broaden exceptions and exemptions under the rule to accommodate certain business arrangements.<sup>45</sup> We respond to these comments below.<sup>46</sup>

## II. DISCUSSION

As discussed in more detail below, we have decided to adopt rule 206(4)-5, which we have revised to reflect comments we received. For the reasons we discuss above and in the Proposing Release, we believe rule 206(4)-5 is a proper exercise of our rulemaking authority under the Advisers Act to prevent fraudulent and manipulative conduct.

The Commission regulates investment advisers under the Investment Advisers Act of 1940. Section 206(1) of the Advisers Act prohibits an investment adviser from employ[ing] any device, scheme or artifice to defraud any client or prospective client.”<sup>47</sup>

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<sup>44</sup> See, e.g., Comment Letter of Ounavarra Capital, LLC (Aug. 28, 2009) (“Ounavarra Letter”) (noting that banning third-party marketers in the municipal securities industry did not adversely affect most bankers’ ability to conduct basic marketing whereas banning third-party marketers for small advisers could have a stronger impact on advisers that have either no or very limited marketing capability of their own); Comment Letter of MVision Private Equity Advisers USA LLC (Sept. 2, 2009) (“MVision Letter”) (arguing that, whereas placement agents for municipal bond offerings are usually regulated entities, the restrictions in the municipal securities arena were targeted at consultants who offer only their contacts and influence with government officials and provided no valuable services to the financial services industry or investors); Comment Letter of Kalorama Capital (Sept. 8, 2009) (arguing that a better analogy, at least with respect to the operation of third-party marketers, is to the licensed professional presenting an IPO to a pension fund). For further discussion of these comments, see section II.B.2(b) of this Release.

<sup>45</sup> See, e.g., Comment Letter of the Committee on Investment Management Regulation and the Committee on Private Investment Funds of the Association of the Bar of the City of New York (Oct. 26, 2009) (“NY City Bar Letter”) (arguing that broker-dealer rules have sufficient safeguards and that adopting the proposed pay to play rule will interfere with traditional distribution arrangements); Dechert Letter; Sutherland Letter; MFA Letter.

<sup>46</sup> Particular comments on the various aspects of our proposal are summarized in the corresponding sub-sections of section II of this Release.

<sup>47</sup> 15 U.S.C. 80b-6(1).

Section 206(2) prohibits an investment adviser from engaging in “any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”<sup>48</sup> The Supreme Court has construed section 206 as establishing a federal fiduciary standard governing the conduct of advisers.<sup>49</sup>

We believe that pay to play is inconsistent with the high standards of ethical conduct required of fiduciaries under the Advisers Act. We have authority under section 206(4) of the Act to adopt rules “reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.”<sup>50</sup> Congress gave us this authority to prohibit “specific evils” that the broad antifraud provisions may be incapable of covering.<sup>51</sup> The provision thus permits the Commission to adopt prophylactic rules that may prohibit acts that are not themselves fraudulent.<sup>52</sup>

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<sup>48</sup> 15 U.S.C. 80b-6(2).

<sup>49</sup> *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

<sup>50</sup> 15 U.S.C. 80b-6(4).

<sup>51</sup> S. REP. NO. 1760, 86th Cong., 2d Sess. 4, 8 (1960). The Commission has used this authority to adopt seven rules addressing abusive advertising practices, custodial arrangements, the use of solicitors, required disclosures regarding advisers’ financial conditions and disciplinary histories, proxy voting, compliance procedures and practices, and deterring fraud with respect to pooled investment vehicles. 17 CFR 275.206(4)-1; 275.206(4)-2; 275.206(4)-3; 275.206(4)-4; 275.206(4)-6; 275.206(4)-7; and 275.206(4)-8.

<sup>52</sup> Section 206(4) was added to the Advisers Act in Pub. L. No. 86-750, 74 Stat. 885, at sec. 9 (1960). See H.R. REP. NO. 2197, 86th Cong., 2d Sess., at 7-8 (1960) (“Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit . . . [Section 206(4)] would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of business which are fraudulent, deceptive, or manipulative. This is comparable to Section 15(c)(2) of the Securities Exchange Act [15 U.S.C. 78o(c)(2)] which applies to brokers and dealers.”). See also S. REP. NO. 1760, 86th Cong., 2d Sess., at 8 (1960) (“This [section 206(4) language] is almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers.”). The Supreme Court, in *United States v. O’Hagan*,



Investment advisers that seek to influence the award of advisory contracts by public pension plans, by making political contributions to, or soliciting them for, those officials who are in a position to influence the awards, compromise their fiduciary obligations to the public pension plans they advise and defraud prospective clients.<sup>53</sup> In making such contributions, the adviser hopes to benefit from officials who “award the contracts on the basis of benefit to their campaign chests rather than to the governmental entity”,<sup>54</sup> or by retaining a contract that might otherwise not be renewed. If pay to play is a factor in the selection or retention process, the public pension plan can be harmed in

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interpreted nearly identical language in section 14(e) of the Securities Exchange Act [15 U.S.C. 78n(e)] as providing the Commission with authority to adopt rules that are “definitional and prophylactic” and that may prohibit acts that are “not themselves fraudulent ... if the prohibition is ‘reasonably designed to prevent ... acts and practices [that] are fraudulent.’” *United States v. O’Hagan*, 521 U.S. 642, 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Securities Exchange Act. *See also Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] (stating, in connection with the suggestion by commenters that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under a particular rule, “We believe our authority is broader. We do not believe that the commenters’ suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors.”).

<sup>53</sup> *See* Proposing Release, at section I; *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999) [64 FR 43556 (Aug. 10, 1999)] (“1999 Proposing Release”). As a fiduciary, an adviser has a duty to deal fairly with clients and prospective clients, and must make full disclosure of any material conflict or potential conflict. *See, e.g., Capital Gains Research Bureau*, 375 U.S. at 189, 191-92; *Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)]. Most public pension plans establish procedures for hiring investment advisers, the purpose of which is to obtain the best possible management services. When an adviser makes political contributions for the purpose of influencing the selection of the adviser to advise a public pension plan, the adviser seeks to interfere with the merit-based selection process established by its prospective clients—the public pension plan. The contribution creates a conflict of interest between the adviser (whose interest is in being selected) and its prospective client (whose interest is in obtaining the best possible management services).

<sup>54</sup> *See Blount*, 61 F.3d at 944-45.

several ways. The most qualified adviser may not be selected or retained, potentially leading to inferior management or performance. The pension plan may pay higher fees because advisers must recoup the contributions, or because contract negotiations may not occur on an arm's-length basis. The absence of arm's-length negotiations may enable advisers to obtain greater ancillary benefits, such as "soft dollars," from the advisory relationship, which might be used for the benefit of the adviser, potentially at the expense of the pension plan, thereby using the pension plan's assets for the adviser's own purposes.<sup>55</sup>

As we discuss above, pay to play practices are rarely explicit and often hard to prove.<sup>56</sup> In particular, when pay to play involves granting of government advisory business in exchange for political contributions, it may be difficult to prove that an adviser (or one of its executives or employees) made political contributions for the purpose of obtaining the government business, or that it engaged a solicitor for his or her political influence rather than substantive expertise.<sup>57</sup> Pay to play practices by advisers to public pension plans, which may generate significant contributions for elected officials and yield lucrative management contracts for advisers, will not stop through voluntary efforts. This is, in part, because these activities create a "collective action" problem in

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<sup>55</sup> *Cf. In re Performance Analytics, et al.*, Investment Advisers Act Release No. 2036 (June 17, 2002) (settled enforcement action in which an investment consultant for a union pension fund entered into a \$100,000 brokerage arrangement with a soft dollar component in which the investment consultant would continue to recommend the investment adviser to the pension fund as long as the investment adviser sent its trades to one particular broker-dealer).

<sup>56</sup> *Cf. Blount*, 61 F.3d at 945 ("no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic").

<sup>57</sup> *See id.* at 944 ("actors in this field are presumably shrewd enough to structure their relations rather indirectly").

two respects.<sup>58</sup> First, government officials who participate may have an incentive to continue to accept contributions to support their campaigns for fear of being disadvantaged relative to their opponents. Second, advisers may have an incentive to participate out of concern that they may be overlooked if they fail to make contributions.<sup>59</sup> Both the stealth in which these practices occur and the inability of markets to properly address them argue strongly for the need for us to adopt the type of prophylactic rule that section 206(4) of the Advisers Act authorizes.

#### **A. First Amendment Considerations**

The Commission believes that rule 206(4)-5 is a necessary and appropriate measure to prevent fraudulent acts and practices in the market for the provision of investment advisory services to government entities by prohibiting investment advisers from engaging in pay to play practices. We have examined a range of alternatives to our proposal, carefully considered some 250 comments we received on the proposal and made revisions to the proposed rule where we concluded it was appropriate. We believe the rule represents a balanced response to the developments we discuss above regarding pay to play activities occurring in the market for government investment advisory services. The rule provides specific prohibitions to help ensure that adviser selection is based on the merits, not on the amount of money given to a particular candidate for

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<sup>58</sup> Collective action problems exist, for example, where participants may prefer to abstain from an unsavory practice (such as pay to play), but nonetheless participate out of concern that, even if they abstain, their competitors will continue to engage in the practice profitably and without adverse consequences. As a result, collective action problems, such as those raised by pay to play practices, call for a regulatory response. For further discussion, *see infra* note 459 and accompanying text.

<sup>59</sup> In our view, the collective action problem we are trying to address is analogous to the one noted in the case upholding MSRB rule G-37. *See Blount*, 61 F.3d at 945 (“Moreover, there appears to be a collective action problem tending to make the misallocation of resources persist”). For a discussion of concerns raised regarding our proposed rule that are similar to those raised regarding MSRB rule G-37, see section II.A of this Release.

office, while respecting the rights of industry participants to participate in the political process. The rule is not unique; Congress, for instance, has barred federal contractors from making contributions to public officials.<sup>60</sup>

Before we address particular aspects of the rule, we would like to respond to commenters' assertions that the fact that the rule's limitations on compensation are triggered by political contributions represents an infringement on the First Amendment guarantees of freedom of speech and association.<sup>61</sup> These commenters acknowledge that selection of an investment adviser by a government entity should not be a "pay back" for political contributions, but argue that the rule impermissibly restricts the ability of advisers and certain of their employees to demonstrate support for state and local officials.

The Commission is sensitive to, and has carefully considered, these constitutional concerns in adopting the rule. Though it is not a ban on political contributions or an attempt to regulate state and local elections, we acknowledge that the two-year time out provision may affect the propensity of investment advisers to make political contributions. Although political contributions involve both speech and associational rights protected by the First Amendment, a "limitation upon the amount that any one person or group may contribute to a candidate or political committee entails only a

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<sup>60</sup> 2 U.S.C. 441c.

<sup>61</sup> *See, e.g.*, Comment Letter of W. Hardy Callcott (Aug. 3, 2009) ("Callcott Letter I"); Comment Letter of W. Hardy Callcott (Jan. 21, 2010) ("Callcott Letter II"); Comment Letter of the National Association of Securities Professionals, Inc. (Oct. 6, 2009) ("NASP Letter"); Comment Letter of Caplin & Drysdale, Chartered (Oct. 6, 2009) ("Caplin & Drysdale Letter"); Comment Letter of the Securities Industry and Financial Markets Association (Oct. 5, 2009) ("SIFMA Letter"); ABA Letter; Sutherland Letter; Comment Letter of IM Compliance LLC (Oct. 6, 2009) ("IM Compliance Letter"); Comment Letter of the American Bankers Association (Oct. 6, 2009) ("American Bankers Letter").

marginal restriction upon the contributor's ability to engage in free communication.”<sup>62</sup>

Limitations on contributions are permissible if justified by a sufficiently important government interest that is closely drawn to avoid unnecessary abridgment of protected rights.<sup>63</sup>

Prevention of fraud is a sufficiently important government interest.<sup>64</sup> We believe that payments to state officials as a *quid pro quo* for obtaining advisory business as well as other forms of “pay to play” violate the antifraud provisions of section 206 of the Advisers Act. As discussed in our Proposing Release, “pay to play” arrangements are inconsistent with an adviser’s fiduciary obligations, distort the process by which investment advisers are selected, can harm advisers’ public pension plan clients and the beneficiaries of those plans, and can have detrimental effects on the market for investment advisory services.<sup>65</sup> The restrictions inherent in rule 206(4)-5 are in the

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<sup>62</sup> *Buckley v. Valeo*, 424 U.S. 1, 20 (1976). See also *SpeechNow.org, et al. v. FEC*, 599 F.3d 686 (D.C. Cir. 2010); *McConnell v. FEC*, 540 U.S. 93, 135-36 (2003).

<sup>63</sup> *Buckley*, 424 U.S. at 25. See also *FEC v. Wisconsin Right to Life, Inc.*, 551 U.S. 449 (2007); *Republican Nat’l Comm. v. FEC*, No. 08-1953, 2010 U.S. Dist. LEXIS 29163 (D.D.C. Mar. 26, 2010) (three judge panel). This standard is lower than the strict scrutiny standard employed in reviewing such forms of expression as independent expenditures. Under the higher level of scrutiny, a restriction must be narrowly tailored to serve a compelling governmental interest. *Blount*, 61 F.3d at 943. See also *Citizens United v. FEC*, 130 S. Ct. 876 (2010) (distinguishing restrictions on “independent expenditures” from restrictions on “direct contributions” and leaving restrictions on direct contributions untouched while striking down a restriction on independent expenditures as unconstitutional). We note that in *Blount*, 61 F.3d at 949, the court upheld MSRB rule G-37 even assuming that strict scrutiny applied. For the reasons stated by the court in that decision, we believe that Rule 206(4)-5 would be upheld under a strict scrutiny standard as well as under the standard the Supreme Court has applied to contribution restrictions.

<sup>64</sup> *Blount*, 61 F.3d at 944.

<sup>65</sup> See Proposing Release, at section I. The prohibitions on solicitation and coordination of campaign contributions are justified by the same overriding purposes which support the two-year time out provisions. The provisions are intended to prevent circumvention of the time out provisions in cases where an investment adviser has or is seeking to establish a business relationship with a government entity. Absent these restrictions, solicitation and coordination of contributions could be used as effectively as political contributions to

nature of conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries.<sup>66</sup> Pursuant to our authority under section 206(4) of the Advisers Act, which we discuss above, we may adopt rules that are reasonably designed to prevent such acts, practices and courses of business.

As detailed in the following pages, we have closely drawn rule 206(4)-5 to accomplish its goal of preventing *quid pro quo* arrangements while avoiding unnecessary burdens on the protected speech and associational rights of investment advisers and their covered employees. The rule is therefore closely drawn in terms of the conduct it prohibits, the persons who are subject to its restrictions, and the circumstances in which it is triggered. The United States Court of Appeals for the District of Columbia Circuit upheld the similarly designed MSRB rule G-37 in *Blount v. SEC*.<sup>67</sup> Indeed, the *Blount* opinion has served as an important guidepost in helping us shape our rule.<sup>68</sup>

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distort the adviser selection process. The solicitation and coordination restrictions relate only to fundraising activities and would not prevent advisers and their covered employees from expressing support for candidates in other ways, such as volunteering their time.

<sup>66</sup> See *In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule*, Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)] (noting, in connection with the Commission’s approval of MSRB rule G-37, that the restrictions inherent in that pay to play rule “are in the nature of conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries.”).

<sup>67</sup> 61 F.3d at 947-48.

<sup>68</sup> Notwithstanding the *Blount* decision, some commenters asserted that subsequent Supreme Court jurisprudence, including *Randall v. Sorrell*, 548 U.S. 230 (2006), and *Citizens United*, 130 S. Ct. 876 (decided following the closing of the comment period for rule 206(4)-5), would result in the proposed rule being found unconstitutional because it is not narrowly tailored to advance the Commission’s interests in addressing pay to play by investment advisers. See, e.g., Callcott Letter I; Callcott Letter II; NASP Letter; American Bankers Letter. We disagree. The cases cited by commenters are distinguishable. *Citizens United* deals with certain independent expenditures (rather than contributions to candidates), which are not implicated by our rule. *Randall* involved a

First, the rule is limited to contributions to officials of government entities who can influence the hiring of an investment adviser in connection with money management mandates.<sup>69</sup> These restrictions are triggered only in situations where a business relationship exists or will be established in the near future between the investment adviser and a government entity.<sup>70</sup>

Second, the rule does not in any way impinge on a wide range of expressive conduct in connection with elections. For example, the rule imposes no restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches, and other conduct.<sup>71</sup>

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generally applicable state campaign finance law limiting overall contributions (and expenditures), which the Court feared would disrupt the electoral process by limiting a candidate's ability to amass sufficient resources and mount a successful campaign. *Randall*, 548 U.S. at 248-49. By contrast, our rule is not a general prohibition or limitation, but rather is a focused effort to combat *quid pro quo* payments by investment advisers seeking governmental business. Comparable restrictions targeted at a particular industry have been upheld under *Randall* because the loss of contributions from such a small segment of the electorate "would not significantly diminish the universe of funds available to a candidate to a non-viable level." *Green Party of Conn. v. Garfield*, 590 F. Supp. 2d 288, 316 (D. Conn. 2008). See also *Preston v. Leake*, 629 F. Supp. 2d 517, 524 (E.D.N.C. 2009) (differentiating the "broad sweep of the Vermont statute" that "restricted essentially any potential campaign contribution" from a statute that "only applies to lobbyists"); *In re Earle Asphalt Co.*, 950 A.2d 918, 927 (N.J. Super. Ct. App. Div. 2008), *aff'd* 957 A.2d 1173 (N.J. 2008) (holding that a limitation on campaign contributions by government contractors and their principals did not have the same capacity to prevent candidates from amassing the resources necessary for effective campaigning as the statute in *Randall*). One commenter expressly dismissed arguments that *Randall* would have implications for the Commission's proposed rule. Fund Democracy/Consumer Federation Letter.

<sup>69</sup> See section II.B.2(a)(2) of this Release (discussing the definition of "official" of a government entity for purposes of rule 206(4)-5).

<sup>70</sup> See section II.B.2(a)(1) of this Release (discussing the prohibition on compensation for providing advisory services to the client during rule 206(4)-5's two-year time out).

<sup>71</sup> See *Citizens United*, 130 S. Ct. at 908-09 (noting that a government interest cannot be sufficiently compelling to limit independent expenditures by corporate entities). See also *SpeechNow.org*, 599 F.3d at 692 (spelling out the different standards of constitutional review established by the Supreme Court for restrictions on independent expenditures and direct contributions). Some commenters expressed concern, for example, that rule 206(4)-5 may quell volunteer activities, deter employees of investment

Third, it does not prevent anyone from making a contribution to any candidate, as covered employees may contribute \$350 to candidates for whom they may vote, and \$150 to other candidates. A limitation on the amount of a contribution involves little direct restraint on political communication, because a person may still engage in the symbolic expression of support evidenced by a contribution.<sup>72</sup> Furthermore, the rule takes the form of a restriction on providing compensated advisory business following the making of contributions rather than a prohibition on making contributions in excess of the relevant ceilings.<sup>73</sup>

Fourth, the rule only applies to investment advisers that are registered with us,<sup>74</sup> or unregistered in reliance on section 203(b)(3) of the Advisers Act, that have (or that are seeking) government clients.<sup>75</sup> It applies only to the subset of the significantly broader

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advisers from running for office, or chill charitable contributions. *See, e.g.,* Caplin & Drysdale Letter; NASP Letter. We have expressly clarified that volunteer activities and charitable contributions generally would not trigger the rule’s time out provision and that employees running for office would not be subject to the contribution limitation. *See infra* notes 157 and 139, respectively.

<sup>72</sup> *Buckley*, 424 U.S. at 21. *See also* section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to covered associates’ contributions triggering the two-year time out). Some commenters raised constitutional concerns regarding the levels of the *de minimis* exception in our proposal. *See, e.g.,* Callcott Letter I; Callcott Letter II; Caplin & Drysdale Letter; IM Compliance Letter; Sutherland Letter. As discussed below, we have both raised the amount of the *de minimis* exception in line with inflation and added an additional exception.

<sup>73</sup> *See* section II.B.2(a)(1) of this Release (discussing the two-year time out on receiving compensation for advisory services).

<sup>74</sup> Unless indicated expressly otherwise, each time we refer to a “registered” investment adviser in this Release, we mean an adviser registered with the Commission.

<sup>75</sup> *See* section II.B.1 of this Release (discussing advisers covered by the rule). One commenter raised constitutional concerns by arguing that the rule would apply beyond the advisory business of an adviser that solicits government clients, no matter how separate the other product or service offerings of the adviser are from the governmental business. ABA Letter. But we believe we have made clear that the rule’s time out provisions, which are designed to eliminate *quid pro quo* arrangements and ameliorate market distortions, apply only with respect to the provision of advisory services to



set of advisers over which we have antifraud authority that we believe are most likely to be engaged by government clients to manage public assets either directly or through investment pools.<sup>76</sup>

Finally, the rule is not a restriction on contributions that is applicable to the public and is not intended to eliminate corruption in the electoral process. Rather, it is focused exclusively on conduct by professionals subject to fiduciary duties, seeking profitable business from governmental entities. The rule is targeted at those employees of an adviser whose contributions raise the greatest danger of *quid pro quo* exchanges,<sup>77</sup> and it covers only contributions to those governmental officials who would be the most likely targets of pay to play arrangements because of their authority to influence the award of advisory business.<sup>78</sup>

**B. Rule 206(4)-5**

We are today adopting new rule 206(4)-5 under the Advisers Act that is designed to protect public pension plans and other government investors from the consequences of pay to play practices by deterring advisers' participation in such practices.<sup>79</sup> As we noted

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government clients, which is consistent with our authority under the Advisers Act. *See* section II.B.2(a)(1) of this Release.

<sup>76</sup> *See* section II.B.1 of this Release.

<sup>77</sup> *See* section II.B.2(a)(4) of this Release (discussing the definition of "covered associates," whose contributions could trigger the two-year time out).

<sup>78</sup> *See* section II.B.2(a)(2) of this Release (discussing the definition of "official" of a government entity for purposes of the rule 206(4)-(5)). Some commenters argued that the definition of "official" we included in our proposal was ambiguous. *See, e.g.,* Caplin & Drysdale Letter. In response, we have provided additional guidance. *See* section II.B.2(a)(2) of this Release.

<sup>79</sup> Rule 206(4)-5 is targeted to a concrete business relationship between contributors and candidates' governmental entities. It is not intended to restrict the voices of persons and interest groups, reduce the overall scope of election campaigns, or equalize the relative ability of all votes to affect electoral outcomes. Indeed, if investment advisers do not seek government business from those to whom they and their covered associates make

in the Proposing Release, advisers and government officials might, in order to circumvent our rule, attempt to structure their transactions in a manner intended to hide the true purpose of a contribution or payment.<sup>80</sup> Therefore, our pay to play restrictions are intended to capture not only direct political contributions by advisers, but also other ways that advisers may engage in pay to play arrangements. Rule 206(4)-5 prohibits several principal avenues for pay to play activities.

First, the rule makes it unlawful for an adviser to receive compensation for providing advisory services to a government entity for a two-year period after the adviser or any of its covered associates makes a political contribution to a public official of a government entity or candidate for such office who is or will be in a position to influence the award of advisory business.<sup>81</sup> Importantly, as we noted in the Proposing Release, rule 206(4)-5 would not ban or limit the amount of political contributions an adviser or its covered associates could make; rather, it would impose a two-year time out on conducting compensated advisory business with a government client after a contribution

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contributions or for whom they solicit contributions, the rule's limitations will not be triggered. Rather, the rule is intended to prevent direct *quid pro quo* arrangements, fraudulent and manipulative acts and practices, and improve the mechanism of a free and open market for investment advisory services for government entity clients. With pay to play activities, the conflict of interest is apparent, the likelihood of stealth in the arrangements is great, and our regulatory purpose is prophylactic. *See Blount*, 61 F.3d at 945 (describing the court's similar characterization of MSRB rule G-37).

<sup>80</sup> Proposing Release, at section II.A.

<sup>81</sup> Rule 206(4)-5(a)(1) makes it unlawful for any investment adviser covered by the rule to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate, as defined in the rule, of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made). As noted below, an "official" includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has the authority to appoint any person who is directly or indirectly responsible for or can influence the outcome of the hiring of an investment adviser. *See* section II.B.2(a)(2) of this Release.

is made.<sup>82</sup> This first prohibition is substantially similar to our proposal. However, as discussed below, we have made certain modifications to some of the definitions of terms in this prohibition.<sup>83</sup>

Second, the rule generally prohibits advisers from paying third parties to solicit government entities for advisory business unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay to play restrictions.<sup>84</sup> That is, an adviser is prohibited from providing or agreeing to provide, directly or indirectly, payment to any person for solicitation of government advisory business on behalf of such adviser unless that person is registered with us and subject to pay to play restrictions either under our rule or the rules of a registered national securities association.<sup>85</sup> This represents a modification from our proposal, which included a flat ban without an exception for any brokers or investment advisers.<sup>86</sup> As discussed below,

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<sup>82</sup> Proposing Release, at section II.A.

<sup>83</sup> See generally section II.B.2(a) of this Release.

<sup>84</sup> Rule 206(4)-5(a)(2)(i) makes it unlawful for any investment adviser covered by the rule and its covered associates (as defined in the rule) to provide or agree to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless such person is a regulated person or is an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the investment adviser. “Regulated person” is defined in rule 206(4)-5(f)(9). See section II.B.2(b) of this Release for a discussion of this definition.

<sup>85</sup> See section II.B.2(b) of this Release. While our rule would apply to any registered national securities association, the Financial Industry Regulatory Authority, or FINRA, is currently the only registered national securities association under section 19(a) of the Exchange Act [15 U.S.C. 78s(b)]. As such, for convenience, we will refer directly to FINRA in this Release when describing the exception for certain broker-dealers from the rule’s ban on advisers paying third parties to solicit government business on their behalf. The Commission’s authority to consider rules proposed by a registered national securities association is governed by section 19(b) of the Exchange Act [15 U.S.C. 78s(b)] (“No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.”).

<sup>86</sup> See Proposing Release, at section II.A.3(b).

commenters persuaded us that the objective of the rule in eliminating pay to play activities of advisers could be preserved if the third parties they hire are themselves registered investment advisers subject to Commission oversight or are broker-dealers subject to pay to play restrictions imposed by a registered national securities association that the Commission must approve.

Third, the rule makes it unlawful for an adviser itself or any of its covered associates to solicit or to coordinate: (i) contributions to an official of a government entity to which the investment adviser is seeking to provide investment advisory services; or (ii) payments to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.<sup>87</sup> We are adopting this aspect of the rule as proposed.

Fourth, as it is not possible for us to anticipate all of the ways advisers and government officials may structure pay to play arrangements to attempt to evade the prohibitions of our rule, the rule includes a provision that makes it unlawful for an adviser or any of its covered associates to do anything indirectly which, if done directly, would result in a violation of the rule.<sup>88</sup> This provision in the rule we are adopting today is identical to our proposal.<sup>89</sup>

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<sup>87</sup> Rule 206(4)-5(a)(2)(ii) makes it unlawful for any investment adviser covered by the rule and its covered associates to coordinate, or to solicit any person [including a political action committee] to make, any: (A) contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or (B) payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity. *See* section II.A.2.(c) of this Release.

<sup>88</sup> Rule 206(4)-5(d) makes it unlawful for any investment adviser covered by the rule and its covered associates to do anything indirectly which, if done directly, would result in a violation of this section. *See* section II.B.2(d) of this Release.

<sup>89</sup> *See* Proposing Release, at section II.A.3(d).

Finally, for purposes of our rule, an investment adviser to certain pooled investment vehicles in which a government entity invests or is solicited to invest will be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity.<sup>90</sup> This provision is substantially similar to our proposal, although we have made certain modifications described below.<sup>91</sup>

### **1. Advisers Subject to the Rule**

Rule 206(4)-5 applies to registered investment advisers and certain advisers exempt from registration. In particular, it applies to any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)).<sup>92</sup> The rule would not, however, apply to most small advisers that are registered with state securities authorities instead of the Commission,<sup>93</sup> or advisers that are unregistered in reliance on exemptions other than section 203(b)(3) of the Advisers Act.<sup>94</sup>

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<sup>90</sup> Rule 206(4)-5(c) states that, for purposes of rule 206(4)-5, an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest, shall be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity. See section II.B.2(e) of this Release.

<sup>91</sup> See section II.B.2(e) of this Release.

<sup>92</sup> Rule 206(4)-5(a)(1) and (2). Section 203(b)(3) [15 U.S.C. 80b-3(b)(3)] 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. We are including this category of exempt advisers within the scope of the rule in order to make the rule applicable to the many advisers to private investment companies that are not registered under the Advisers Act.

<sup>93</sup> Advisers with less than \$25 million of assets under management are prohibited from registering with the Commission by section 203A of the Advisers Act [15 U.S.C. 80b-3A].

<sup>94</sup> The rule would also not apply to certain other advisers that are exempt from registration with the Commission. See, e.g., section 203(b)(1) of the Advisers Act [15 U.S.C. 8b-3(b)(1)] (exempting from registration intrastate investment advisers). As explained in the Proposing Release, we believe these advisers are unlikely to advise public pension plans.

We received limited comment on this aspect of the rule. One commenter explicitly agreed with the scope of our proposed rule, noting that it would capture most, if not all, advisers that provide discretionary management with respect to public pension fund assets, regardless of whether they are registered.<sup>95</sup> Other commenters recommended that the rule apply more broadly to all advisers that may manage assets of government entities.<sup>96</sup> The primary effect of such an expansion of the rule would be to apply it to smaller firms, the regulatory responsibility for which Congress has previously allocated to the state securities authorities.<sup>97</sup> It is our understanding that few of these firms manage public pension plans or other public funds.<sup>98</sup> Accordingly, we have decided to adopt this provision as proposed.

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*See* Proposing Release, at n.64 and accompanying text. The rule would also not apply to persons who are excepted from the definition of investment adviser under section 202(a)(11) of the Advisers Act [15 U.S.C. 80b-2(a)(11)]. For a discussion, in particular, of the exclusion of banks and bank holding companies which are not investment companies from the Advisers Act's definition of "investment adviser," see *infra* note 274.

<sup>95</sup> Comment Letter of the California Public Employees' Retirement System (Oct. 6, 2009) ("CalPERS Letter") ("CalPERS agrees that the scope of the proposed rule would capture most if not all external managers who have discretion over the investment of public pension fund assets, including hedge fund managers, real estate managers, private equity managers, traditional long-only managers, money managers, and others, regardless of whether the managers are registered investment advisers. CalPERS supports application of the rule to investment advisers, as defined in the proposed rule.").

<sup>96</sup> These suggestions included applying the rule to all registered (including SEC-registered and state-registered) and unregistered advisers (*see, e.g.*, 3PM Letter (arguing that selective application of the rule could lead to convoluted organizational structures designed to bypass its reach and that the proposal represents the kind of patchwork regulation that will lead to the kind of inconsistency the Commission is seeking to correct), and extending the rule to state-registered advisers (*see, e.g.*, Comment Letter of the Cornell Securities Law Clinic (Oct. 6, 2009) ("Cornell Law Letter"))).

<sup>97</sup> Amendments to the Advisers Act in 1996 placed the regulatory responsibility for these advisers in the hands of state regulators. *See* section 203A of the Advisers Act [15 U.S.C. 80b-3a] enacted as part of Title III of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

<sup>98</sup> *See* Proposing Release, at n.64. We did not receive any comment challenging our understanding.

## 2. Pay to Play Restrictions

### (a) Two-Year “Time Out” for Contributions

Rule 206(4)-5(a)(1) prohibits investment advisers from receiving compensation for providing advice to a “government entity” within two years after a “contribution” to an “official” of the government entity has been made by the investment adviser or by any of its “covered associates.”<sup>99</sup> The rule does not ban political contributions and does not limit the amount of any political contribution. Instead, the rule imposes a ban—a “time out”—on receiving compensation for conducting advisory business with a government client for two years after certain contributions are made. The two-year time out is intended to discourage advisers from participating in pay to play practices by requiring a “cooling-off period” during which the effects of a political contribution on the selection process can be expected to dissipate.

Rule 206(4)-5(a)(1) is based largely on MSRB rule G-37 under which a broker-dealer is prohibited from engaging in the municipal securities business for two years after making a political contribution.<sup>100</sup> As noted above and as explained in the Proposing Release, we modeled the rule on the MSRB rules because we believe that they have significantly curbed pay to play practices in the municipal securities market.<sup>101</sup> We also

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<sup>99</sup> Rule 206(4)-5(a)(1).

<sup>100</sup> Proposing Release, at section II.A.2.

<sup>101</sup> *See id.* at n.23 (citing others, including the MSRB, who agree that the MSRB rules have been effective: MSRB, *MSRB Notice 2009-62, Amendments Filed to Rule G-37 Regarding Contributions to Bond Ballot Campaigns* (Dec. 4, 2009), available at <http://msrb.org/msrb1/archive/2009/2009-62.asp> (“Rule G-37, in effect since 1994, has provided substantial benefits to the industry and the investing public by greatly reducing the direct connection between political contributions given to issuer officials and the awarding of municipal securities business to brokers, dealers and municipal securities dealers (“dealers”), thereby effectively assisting with eliminating pay-to-play practices in the new issue municipal securities market.”); MSRB, *MSRB Notice 2009-35, Request for Comment: Rule G-37 on Political Contributions and Prohibitions on Municipal*

pointed out that our approach would minimize the compliance burdens on firms that would be subject to both rule regimes. But we requested comment on our proposed approach and whether alternative models might be appropriate.

Several commenters supporting the rule explicitly addressed the appropriateness of the MSRB approach. One, for example, asserted that the proposed rule “appropriately expands upon MSRB G-37 and G-38.”<sup>102</sup> Another agreed that the MSRB rules “provide an appropriate regulatory analogy for addressing [pay to play] issues.”<sup>103</sup> Many other commenters, however, sought to distinguish advisers and municipal securities dealers, and asserted that, because of the differences between the two, MSRB rule G-37 is an

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*Securities Business – Bond Ballot Campaign Committee Contributions* (June 22, 2009) (“The MSRB believes the rule has provided substantial benefits to the industry and the investing public by greatly reducing the direct connection between political contributions given to issuer officials and the awarding of municipal securities business to dealers, thereby effectively eliminating pay-to-play practices in the new issue municipal securities market.” [footnote omitted]); MSRB, *MSRB Notice 2003-32, Notice Concerning Indirect Rule Violations: Rules G-37 and G-38* (Aug. 6, 2003) (“The impact of Rules G-37 and G-38 has been very positive. The rules have altered the political contribution practices of municipal securities dealers and opened discussion about the political contribution practices of the entire municipal industry.”); Letter from Darrick L. Hills and Linda L. Rittenhouse of the CFA Institute to Jill C. Finder, Asst. Gen. Counsel of the MSRB (Oct. 19, 2001), *available at* <http://www.cfainstitute.org/Comment%20Letters/20011019.pdf> (stating, “We generally believe that the existing [MSRB] pay-to-play prohibitions have been effective in stemming practices that compromise the integrity of the [municipal securities] market by using political contributions to curry favor with politicians in positions of influence.”); COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (Nov. 30, 2006), *available at* [http://www.capmksreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf) (stating, upon describing MSRB Rule G-37 and the 2005 amendments to MSRB Rule G-38, “Taken together, the MSRB’s rules have largely put an end to the old “pay to play” practices in municipal underwriting.”). *See also* Comment letter of Professors Alexander W. Butler, Larry Fauver and Sandra Mortal (Sept. 30, 2009) (“Butler Letter”) (citing Alexander W. Butler, Larry Fauver & Sandra Mortal, *Corruption, Political Integrity, and Municipal Finance*, 22 R. OF FIN. STUD. 2673-705 (2009)).

<sup>102</sup> Common Cause Letter.

<sup>103</sup> Comment Letter of Credit Suisse Securities (USA) LLC (Sept. 14, 2009) (“Credit Suisse Letter”).



inappropriate model on which to base an investment adviser pay to play rule.<sup>104</sup> Some argued that the long-term nature of advisory relationships is fundamentally different from discrete municipal underwriting transactions, and consequently, the two-year time out is more disruptive and severe for advisers and the governments that retain them than for municipal securities dealers who are simply banned from obtaining “new” business as opposed to terminating a long-term relationship.<sup>105</sup> Some commenters asserted that the relationships are different because advisers provide ongoing and continuous advice as a fiduciary, rather than a one-time transaction such as an underwriting, and that advisory services are typically subject to an open competitive bid process instead of through negotiated transactions that are typical of municipal underwritings.<sup>106</sup>

We disagree that the differences between municipal securities underwriting and money management are sufficient to warrant an alternative approach. Commenters are correct that municipal securities underwriters provide episodic services rather than ongoing services often provided by money managers. But underwriters seek to provide

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<sup>104</sup> See, e.g., IAA Letter; ICI Letter; SIFMA Letter; ABA Letter; Dechert Letter; Skadden Letter; Comment Letter of Jones Day (Oct. 5, 2009) (“Jones Day Letter”); Comment Letter of Simpson Thacher & Bartlett LLP on behalf of Park Hill Group LLC and its affiliates (Sept. 21, 2009) (“Park Hill Letter”); Comment Letter of Monument Group, Inc. (Sept. 18, 2009) (“Monument Group Letter”). One commenter suggested, in particular, that the rule’s two-year time out provision is outside of our authority because it imposes an “automatic penalty, subject only to discretionary post facto review.” Comment Letter of Edwin C. Laurenson (Dec. 31, 2009). We disagree. The two-year time out is not a penalty. Rather, it is a “cooling-off period” to dissipate any effects of a *quid pro quo*. A violation of the provision would result from receiving, or continuing to receive, payment after making the contribution, not from the making of the contribution itself.

<sup>105</sup> See, e.g., IAA Letter; ABA Letter; Dechert Letter; Skadden Letter; Jones Day Letter; Park Hill Letter; Monument Group Letter. *But see* Credit Suisse Letter (“G-37 and G-38 provide an appropriate regulatory analogy”); Butler Letter (“This practice [municipal underwriting pay to play] was analogous to the type of pay to play currently under consideration by the Commission”).

<sup>106</sup> See, e.g., IAA Letter; ICI Letter; SIFMA Letter; ABA Letter; Dechert Letter; Skadden Letter; Jones Day Letter; Park Hill Letter; Monument Group Letter.

repeated, if not ongoing, services, and the imposition of a two-year time out can have considerable competitive consequences to a broker-dealer whose government client must employ the services of a competitor whose services it may continue to employ after MSRB rule G-37's two-year time out has run its course. That advisers are in a fiduciary relationship with their public pension plan clients argues for at least as significant consequences for participation in pay to play practices that can harm these clients.

Our decision to adopt a rule based on the MSRB model is influenced primarily by our judgment that the MSRB rules have significantly curbed pay to play practices in the municipal securities market<sup>107</sup> and that alternative approaches, including those suggested by commenters, would fail to provide an adequate deterrent to pay to play activities. We considered each of the principal suggestions offered by commenters.

Some commenters suggested requiring advisers to disclose their contributions to state and local officials.<sup>108</sup> Statutes requiring disclosure of political contributions are, in part, designed to inform voters about a candidate's financial supporters; an informed electorate can then use the information to vote for or against a candidate.<sup>109</sup> But voters' possible reactions, if any, to such disclosure would not necessarily resolve the concerns we are trying to address in this rulemaking. Our concern is protecting advisory clients and investors whom we have the responsibility to protect under the Advisers Act—

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<sup>107</sup> See *supra* notes 31 and 101 and accompanying text.

<sup>108</sup> See, e.g., SIFMA Letter; Preqin Letter I; Comment Letter of Triton Pacific Capital, LLC (Sept. 1, 2009) (“Triton Pacific Letter”); Comment Letter of the State Association of County Retirement Systems (Sept. 8, 2009); Comment Letter of CapLink Partners (Sept. 9, 2009) (“CapLink Letter”); Comment Letter of Parenteau Associates, LLC (Aug. 7, 2009) (“Parenteau Letter”).

<sup>109</sup> See *Buckley*, 424 U.S. at 67 (1976) (noting that campaign financing disclosure requirements “deter actual corruption and avoid the appearance of corruption by exposing large contributions and expenditures to the light of publicity”).

namely, the public pension plans and their beneficiaries who are affected by pay to play practices.<sup>110</sup> Disclosure to a plan's trustees might be insufficient where the trustee (particularly a sole trustee) has received the contributions and is presumably well aware of the conflicts involved. Moreover, and as we pointed out in the Proposing Release, requiring advisers to disclose political contributions to beneficiaries would be unlikely to protect them since most cannot act on the information by moving their pension assets to a different plan or by reversing the plan trustees' adviser hiring decisions.<sup>111</sup> Not all beneficiaries may be entitled to vote (or withhold their vote) for the official to whom a contribution was made, and those that are may need to wait a substantial period of time until a future election to exercise their vote. Further, as beneficiaries may constitute only a small proportion of the electorate, they may not be able to influence an election; therefore, reliance on the electoral process may be insufficient to protect government plans and their beneficiaries from pay to play. In addition, even if the fact of a contribution is disclosed (which is required in many states), the contribution's true purpose is unlikely to be disclosed.

Several commenters suggested that the Commission adopt a requirement that an adviser include in its code of ethics<sup>112</sup> a policy that prohibits contributions made for the

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<sup>110</sup> As discussed above, our purposes in this rulemaking are preventing fraud, protecting investors and maintaining the integrity of the adviser selection process, not campaign finance reform. *See* section I of this Release.

<sup>111</sup> *See* Proposing Release, at section II.A.2. Some commenters made the same points. *See, e.g.,* NY City Bar Letter; Cornell Law Letter; 3PM Letter. *See also Blount*, 61 F.3d at 947 (explaining, in the context of the municipal securities industry, the potential inadequacy of disclosure to address pay to play concerns, that "disclosure would not likely cause market forces to erode 'pay to play . . .'" because the ". . . purpose of protecting the integrity of the market [would] . . . 'be achieved less effectively.'").

<sup>112</sup> Registered investment advisers are required to have codes of ethics under the Advisers Act. *See* Advisers Act rule 204A-1.

purpose of influencing the selection of the adviser.<sup>113</sup> Several commenters recommended, similarly, that we require advisers to adopt policies and procedures<sup>114</sup> reasonably designed to prevent and detect contributions designed to influence the selection of an adviser.<sup>115</sup> Many of these commenters suggested that preclearance of employee contributions could be required under an adviser's code of ethics or compliance policies and procedures.<sup>116</sup> One commenter asserted that an advantage of this approach is that it would allow an adviser to customize sanctions based on the severity of the violation.<sup>117</sup>

We do not, however, believe that codes of ethics or compliance procedures alone would be adequate to stop pay to play practices, particularly when the adviser or senior officers of the adviser are involved either directly or indirectly. First, it is those senior officers who, as noted below, have the greatest incentives to engage in pay to play and therefore are most likely to make contributions, who would themselves ultimately be responsible for enforcing *their own* compliance with the firm's ethics code or compliance procedures. Second, violations of codes of ethics or compliance procedures do not themselves establish violations of the federal securities laws. Moreover, the comments suggesting these alternatives would have us require the codes or procedures be designed to prevent or detect contributions *intended to influence* the selection of the adviser by a

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<sup>113</sup> See, e.g., IAA Letter; ABA Letter; Comment letter of the National Society of Compliance Professionals, Inc. (Oct. 6, 2009) ("NSCP Letter"); NY City Bar Letter; Fidelity Letter.

<sup>114</sup> Registered investment advisers are required to adopt and implement policies and procedures reasonably designed to prevent violation by the adviser or its supervised persons of the Advisers Act and the rules the Commission has adopted thereunder. See Advisers Act rule 206(4)-7.

<sup>115</sup> See, e.g., ABA Letter; NY City Bar Letter; IAA Letter; ICI Letter; NSCP Letter.

<sup>116</sup> See, e.g., IAA Letter; NY City Bar Letter; ABA Letter.

<sup>117</sup> ABA Letter.

government entity. As discussed extensively above and in our Proposing Release, pay to play is an area in which intent is often very difficult to prove, and is often hidden in the guise of legitimate conduct.<sup>118</sup> Political contributions are made ostensibly to support a candidate; the burden on a regulator or prosecutor of proving a different intent presents substantial challenges absent unusual evidence. Commenters would thus have us give the adviser, which stands to benefit from the contribution, the discretion to determine whether contributions were intended to influence its selection by the government entity. We do not believe codes of ethics or policies and procedures alone, without a rule providing for specific, prophylactic prohibitions, are adequate to address this type of conduct.<sup>119</sup>

On balance, we believe that adopting a two-year time out for investment advisers similar to the two-year time out applicable to broker-dealers underwriting municipal securities is appropriate. Our years of experience with MSRB rule G-37 suggests that the “strong medicine” provided by that rule has both significantly curbed participation in pay to play and provides a reasonable cooling-off period to mitigate the effect of a political contribution. We are sensitive about potential implications of the operation of the rule on public pension funds, which could lose the services of an investment adviser subject to a time out. While we have designed the rule to reduce its impact,<sup>120</sup> investment advisers are best positioned to protect these clients by developing and enforcing robust

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<sup>118</sup> See, e.g., Proposing Release, at n.16 and accompanying text.

<sup>119</sup> We note that, under our rules, an adviser’s code of ethics must require compliance with the rule we are today adopting (rule 204A-1(a)(2)) and the adviser must adopt policies and procedures designed to prevent violation of the rule (rule 206(4)-7(a)).

<sup>120</sup> See, e.g., section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to the two-year time out); section II.B.2(f) of this Release (discussing the rule’s exemptive provision).

compliance programs designed to prevent contributions from triggering the two-year time out.

**(1) Prohibition on Compensation**

As noted above, investment advisers subject to new rule 206(4)-5 are not prohibited from providing advisory services to a government client, even after triggering the two-year time out. Instead, an adviser is prohibited from receiving *compensation* for providing advisory services to the government client during the time out.<sup>121</sup> We have taken this approach to enable an adviser to act consistently with its fiduciary obligations so it will not have to abandon a government client after making a triggering contribution, but rather may provide uncompensated advisory services for a reasonable period of time to allow the government client to replace the adviser.<sup>122</sup> We are adopting this element of the rule as proposed.

One commenter supported the prohibition on compensation as the least disruptive option to government clients,<sup>123</sup> while others argued that the prohibition on compensation

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<sup>121</sup> Rule 206(4)-5(a)(1) makes it unlawful for investment advisers covered by the rule to provide investment advisory services *for compensation* to a government entity within two years after a triggering contribution. Under the rule, the two-year time out begins to run once the contribution is made and not when the contribution is discovered either by our examination staff or by the adviser. The adviser, therefore, should return all such compensation promptly upon discovering the triggering contribution. For the application of the rule to investments by government entities in pooled investment vehicles, see section II.B.2(e) of this Release.

<sup>122</sup> Proposing Release, at section II.A.3(a)(1). An investment adviser's fiduciary duties may require it to continue providing advisory services for a reasonable period of time under these circumstances. For another instance in which an adviser's fiduciary duties may require its continued provision of services, see *Temporary Exemption for Certain Investment Advisers*, Investment Advisers Act Release No. 1736 (July 22, 1998) [63 FR 40231, 40232 (July 28, 1998)] (describing an investment adviser's fiduciary duties to an investment company in the case of an assignment of the advisory contract).

<sup>123</sup> Cornell Law Letter.

was unreasonable and, in some cases, difficult or near impossible to implement.<sup>124</sup> A coalition of commenters representing state and local governments asserted that, due to restrictions on accepting uncompensated services under state and local law, it was unlikely that government entities would accept uncompensated services even if an adviser were willing or required to provide them.<sup>125</sup> Commenters representing advisers took the opposite view, expressing concern that they would be locked into providing uncompensated services for extended periods of time as a result, and wanted the Commission to provide guidelines as to what a reasonable amount of time is for a government client to claim or move its assets.<sup>126</sup> One asserted that it would be unreasonable to require advisers to provide uncompensated services altogether.<sup>127</sup>

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<sup>124</sup> See, e.g., ICI Letter; Jones Day Letter. Some commenters argued for more flexibility in sanctions (Skadden Letter; ABA Letter; Fidelity Letter; ICI Letter; MassMutual Letter; Comment Letter of Wells Fargo Advisors (Oct. 6, 2009) (“Wells Fargo Letter”); IAA Letter).

<sup>125</sup> Comment Letter of the National Conference of State Legislatures, National Association of Counties, National League of Cities, International City/County Management Association, National Association of State Auditors, Comptrollers and Treasurers, Government Finance Officers Association, National Association of State Retirement Administrators, National Conference on Public Employee Retirement Systems, and National Council on Teacher Retirement (Oct. 6, 2009) (“National Organizations Letter”). With respect to direct advisory relationships, because restrictions on governments receiving services without payment would be a function of particular state or local laws, we believe government entities and their advisers are in the best position to work out arrangements that are consistent with both state and local law and the compensation prohibition of our rule. With respect to investments by government entities in pooled investment vehicles, in particular, such restrictions could be avoided. See section II.B.2(e)(2) of this Release (describing possible arrangements for continued payment to investment pools even after a time out is triggered).

<sup>126</sup> See, e.g., Comment Letter of Davis Polk & Wardwell LLP (Oct. 6, 2009) (“Davis Polk Letter”) (recommending that three months would be reasonable); ICI Letter (suggesting 30 days). Other commenters raised concern regarding the potential harm of a time out to government investors for whom identifying new managers may be a lengthy process. See, e.g., NASP Letter. We believe, however, that, on balance, pension funds and their beneficiaries are best served by the rule’s deterrent effect against engaging in pay to play activities. An adviser’s fiduciary obligations to continue to provide services for a reasonable amount of time, combined with the extended compliance dates described in section III of this Release which should afford the ability of market participants to

Few of the commenters who opposed this provision appeared to favor its elimination, which would require the adviser to immediately cease providing advisory services upon making a triggering contribution.<sup>128</sup> Rather, they appeared to oppose the two-year time out more generally.<sup>129</sup>

We are not persuaded by their arguments. We believe the prohibition on compensation is both appropriate and administrable. The incentives to engage in pay to play may be significant, precisely because of the long-term nature of many advisory relationships from which the adviser could benefit for several years. As a result, the consequences of engaging in pay to play need to be commensurate with these incentives for the prophylactic rule to have a meaningful deterrent effect.<sup>130</sup> We acknowledge that the rule will involve compliance costs and could adversely affect an adviser's business.<sup>131</sup> On the other hand, a political contribution would not affect the ability of an adviser to provide compensated services to other clients, including other government clients.

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organize themselves in a way to adapt to the rule's requirements, should be sufficient to minimize the impact on pension plans to the extent they need to prepare to transition to a new money manager after a two-year time out is triggered.

<sup>127</sup> Jones Day Letter. Other commenters argued that the specter of a two-year time out might cause some firms to ban or require pre-clearance of all employees' contributions. *See, e.g.,* Caplin & Drysdale Letter. Although the rule does not require this approach, as a result of commenters' assertions, we address this possibility in our cost-benefit analysis. *See* section IV of this Release.

<sup>128</sup> *See, e.g.,* Davis Polk Letter; ICI Letter.

<sup>129</sup> *See, e.g.,* National Organizations Letter; ICI Letter; Jones Day Letter; Dechert Letter.

<sup>130</sup> This deterrent effect is the basis for our view that the two-year time out should not apply only to "new business" and that advisers should not be able to "negotiate" for lesser consequences. *See supra* note 124 (pointing to commenters who called for more flexibility regarding the two-year time out). As we point out above, our concerns extend to contributions designed to enable advisers to retain contracts that might not otherwise be renewed.

<sup>131</sup> For a discussion of costs and other burdens that may be imposed by our rule, see generally sections IV-V of this Release.



Moreover, the fiduciary obligations of an adviser would not require it to provide uncompensated advice indefinitely—rather, the adviser may need to continue to provide advice for only a reasonable period of time during which its client can seek to obtain advisory services from others.<sup>132</sup>

Some commenters urged us to permit advisers to continue to receive compensation during the two-year time out for services provided pursuant to an existing management contract,<sup>133</sup> without distinguishing whether the contract was acquired as a result of political contributions. One commenter further suggested specifically that we permit advisory services to continue to be provided by the adviser at cost during the time out to remove the profit motive of pay to play.<sup>134</sup> We are also not persuaded by their suggestions. Allowing contracts acquired as a result of political contributions to continue uninterrupted would eviscerate the rule. Were a “free pass” available for contracts

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<sup>132</sup> See *supra* note 122 and accompanying text. The amount of time a client might need in good faith to find and engage a successor to the adviser would, in our view, be the primary consideration of the length of a reasonable period, which may depend in part on such matters as applicable law, the client’s customary process of finding and engaging advisers and the types of assets managed by the adviser that is subject to the time out. In some cases, a client may be able to quickly engage a “transition adviser” to manage its assets until a permanent successor is found. See, e.g., *Illinois State Board Sets Transition Manager RFP*, PENSIONS & INVESTMENTS, Feb. 8, 2010 available at <http://www.pionline.com/article/20100208/PRINTSUB/302089976>. In other cases, the client may be required by the law under which it operates to undertake a specified process to obtain a new manager, such as a solicitation for proposals from potential managers.

<sup>133</sup> See, e.g., Dechert Letter; Fidelity Letter; ICI Letter; Jones Day Letter (in some instances, pointing to the MSRB’s approach of not necessarily applying MSRB rule G-37’s two-year time out when a contribution is made after a business contract is signed). See MSRB, *Interpretation on the Effect of a Ban on Municipal Securities Business under Rule G-37 Arising During a Pre-Existing Engagement Related to Municipal Fund Securities*, MSRB Rule G-37 Interpretive Notice (April 2, 2002), available at <http://msrb.org/msrb1/archive/ContributionsNotice.htm>). As we explain above, due to the long-term nature of typical advisory contracts and our belief that the consequences of giving a contribution need to be commensurate with the potential benefits obtained, we are not taking this approach.

<sup>134</sup> Dechert Letter.

merely because they were entered into prior to discovery of a contribution, advisers would be strongly incentivized against “discovering” contributions.<sup>135</sup> Because no new business from a government client may even be available to the adviser until the two-year period has run its course, advisers whose contributions succeeded in acquiring a management contract for two years or more could escape any consequences under such an exception.<sup>136</sup> Further, in our judgment, the potential loss of profits will not operate as an adequate deterrent. It is our understanding that being selected to manage public pension plan assets has a reputational value that itself contributes to advisory profits by attracting additional assets under management regardless of the profits derived directly from the management of government client assets.<sup>137</sup>

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<sup>135</sup> An approach that applied the two-year time out only to new business would preclude the adviser from receiving compensation only from additional contracts that *might* be awarded by the government entity during the two-year period. In our judgment, the risk of the potential loss of additional advisory contracts for a two-year period would provide an inadequate deterrent to contributions designed to influence the award of such additional advisory contracts.

<sup>136</sup> We are concerned that limiting application of the rule to new business could invite abuse. For example, pension officials seeking contributions after a contract has been awarded could attempt to offer an adviser additional assets to manage under the existing contract with the condition that the adviser subsequently make political contributions.

<sup>137</sup> See, e.g., Kevin McCoy, *Do Campaign Contributions Help Win Pension Fund Deals*, USA TODAY, Aug. 28, 2009, available at [http://www.usatoday.com/money/perfi/funds/2009-08-26-pension-fund-political-donations\\_N.htm](http://www.usatoday.com/money/perfi/funds/2009-08-26-pension-fund-political-donations_N.htm) (referring to advisory firms winning management mandates from pension funds, stating: “The awards generate lucrative fees and lend prestige that could help lure new clients.”); Louise Story, *Quadrangle Facing Questions Over Pension Funds*, N.Y. TIMES, Apr. 21, 2009, available at <http://www.nytimes.com/2009/04/22/business/22quadrangle.html> (highlighting an indirect benefit of a pension fund investment, stating: “the prestige associated with it helped the firm lure other big investors.”).

## (2) Officials of a Government Entity

The rule's two-year time out is triggered by a contribution to an "official" of a "government entity."<sup>138</sup> An official includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or 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.<sup>139</sup> Government entities include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457, and 529 plans.<sup>140</sup>

The two-year time out is thus triggered by contributions, not only to elected officials who have legal authority to hire the adviser, but also to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser. We have not modified this approach from our proposal.<sup>141</sup> As we noted in the Proposing Release, a person appointed by an elected official is likely to be subject to that official's

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<sup>138</sup> Rule 206(4)-5(a)(1) makes it unlawful for covered investment advisers to provide investment advisory services for compensation to a government entity within two years after a contribution to an *official* of the *government entity* is made by the investment adviser or any of its covered associates.

<sup>139</sup> Rule 206(4)-5(f)(6). For purposes of the rule, we would not interpret the definition of "official" as covering an individual who is also a "covered associate" of the adviser. Accordingly, under the rule, a covered associate who is an incumbent or candidate for office is not limited to contributing the *de minimis* amount to his or her own campaign. The MSRB takes a similar view with respect to its rule G-37. MSRB, *Questions and Answers Concerning Political Contributions and Prohibitions on Municipal Securities Business: Rule G-37*, MSRB rule G-37 Interpretive Notice, available at <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx> ("MSRB Rule G-37 Q&A"), Question II.10 (May 24, 1994).

<sup>140</sup> Rule 206(4)-5(f)(5).

<sup>141</sup> See Proposing Release, at section II.A.3(a)(2).

influences and recommendations.<sup>142</sup> It is the scope of authority of the particular *office* of an official, not the influence actually exercised by the individual, that would determine whether the individual has influence over the awarding of an investment advisory contract under the definition.<sup>143</sup> We are adopting these provisions as proposed.<sup>144</sup>

Some commenters asserted that the rule should be more specific as to which public officials to whom a contribution is made would trigger application of the rule in order to reduce uncertainty and compliance burdens.<sup>145</sup> But state and municipal statutes vary substantially with respect to whom they entrust with the management of public

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<sup>142</sup> *Id.*

<sup>143</sup> As such, executive officers or legislators whose official position gives them the authority to influence the hiring of an investment adviser generally would be “government officials” under the rule. For example, a state may have a pension fund whose board of directors, which has authority to hire an investment adviser, is constituted, at least in part, by appointees of the governor and members of the state legislature. *See, e.g.,* The Commonwealth of Pennsylvania Public School Employees’ Retirement Board, *Statement of Organization, By-Laws and Other Procedures* (rev. Jun. 11, 2009), art. II, sec. 2.1, available at [http://www.pfers.state.pa.us/org/board/policies/201001\\_bylaws.pdf](http://www.pfers.state.pa.us/org/board/policies/201001_bylaws.pdf) (noting that the board shall be composed of, *inter alia*, two persons appointed by the Pennsylvania State Governor, two Pennsylvania state senators and two members of the Pennsylvania state house of representatives). In such circumstances, the governor and the members of the state legislature serving on the board would be officials of the government entity. Conversely, a public official who is tasked with performing an audit of the selection process but has no influence over hiring outcomes would not be an official of a government entity for purposes of the rule.

<sup>144</sup> These definitions and their application are substantively the same as those in MSRB rule G-37. *See* MSRB rule G-37(g)(ii) and (g)(vi).

<sup>145</sup> *See, e.g.,* IAA Letter; NSCP Letter; Comment Letter of T. Rowe Price Associates, Inc. (Oct. 6, 2009) (“T. Rowe Letter”); MFA Letter; Davis Polk Letter. For a discussion of the potential costs involved in identifying officials to whom contributions could trigger the rule’s prohibitions, see section IV of this Release (presenting our cost-benefit analysis). Another commenter suggested that advisers should be able to rely on certifications from candidates and officials regarding whether their office would render them an “official” for purposes of the rule—*i.e.*, identifying the range, if any, of public investment vehicles over which the relevant office directly or indirectly influences the selection of investment advisers or appoints individuals who do). Caplin & Drysdale Letter. We are concerned that such a safe harbor would undercut the purposes of the rule, not least because officials will be incentivized to offer such certifications liberally (and will presumably sometimes do so inappropriately) to encourage contributions.

funds, and any effort we make in a rule of general application to identify specific officials who are in a position to influence the selection of an adviser would certainly be over-inclusive in some circumstances and under-inclusive in others.<sup>146</sup> Others urged that triggering contributions should be limited to contributions to officials directly responsible for the selection of advisers.<sup>147</sup> Excluding from the application of the rule contributions to those who are in a position to *indirectly* influence the selection of an investment adviser could simply lead officials to re-structure their relationships to avoid application of the rule to advisers that may contribute to those officials.

Two commenters argued that the rule should not cover contributions to candidates for federal office,<sup>148</sup> while another contended that it should.<sup>149</sup> Under our rule, as proposed, a candidate for federal office could be an “official” under the rule not because of the office he or she is running for, but as a result of an office he or she currently holds.<sup>150</sup> So long as an official has influence over the hiring of investment advisers as a function of his or her current office, contributions by an adviser could have the same effect, regardless to which of the official’s campaigns the adviser contributes. For that

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<sup>146</sup> Like us, the MSRB does not specify which officials have the authority to influence the granting of government business for purposes of its rule G-37. *See* MSRB, *Campaign for Federal Office*, MSRB Rule G-37 Interpretive Notice (May 31, 1995), *available at* <http://msrb.org/msrb1/rules/interp37.htm> (“The Board does not make determinations concerning whether a particular individual meets the definition of “official of an issuer.”).

<sup>147</sup> *See, e.g.*, IAA Letter; NASP Letter; NY City Bar Letter; Davis Polk Letter.

<sup>148</sup> *See, e.g.*, NSCP Letter; Dechert Letter.

<sup>149</sup> Fund Democracy/Consumer Federation Letter.

<sup>150</sup> As a result, if a state or municipal official were, for example, a candidate for the U.S. Senate, House of Representatives, or presidency, an adviser’s contributions to that official would be covered by the rule. MSRB rule G-37’s time out provision is also triggered by contributions to state and local officials running for federal office. *See* MSRB Rule G-37 Q&A, Questions IV.2-3.

reason, we are not persuaded that an incumbent state or local official should be excluded from the definition solely because he or she is running for federal office.<sup>151</sup>

### (3) Contributions

The rule's time out provisions are triggered by *contributions* made by an adviser or any of its covered associates.<sup>152</sup> A contribution is defined to include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such an election.<sup>153</sup> It also includes transition or inaugural expenses incurred by a successful candidate for state or local office.<sup>154</sup> The definition is the same as we proposed and as the one used in MSRB rule G-37.<sup>155</sup>

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<sup>151</sup> Under certain circumstances, a state or municipal official running for federal office could remove herself from being an "official" for purposes of rule 206(4)-5 by eliminating her ability to influence the outcome of the hiring of an investment adviser. This might occur, for example, if she were to: (i) formally withdraw from participation in or influencing adviser hiring decisions; (ii) be leaving office, so that he or she could not participate in subsequent decision-making; and (iii) have held direct influence over the adviser hiring process (as opposed to, for example, having designated an appointee with such influence who would remain in a position to influence such hiring).

<sup>152</sup> Rule 206(4)-5(a)(1) makes it unlawful for covered investment advisers to provide investment advisory services for compensation to a government entity within two years after a *contribution* to an official of the government entity is made by the investment adviser or any of its covered associates. As suggested above, we are concerned that contributions may be used "as the cover for what is much like a bribe: a payment that accrues to the private advantage of the official and is intended to induce him to exercise his discretion in the donor's favor, potentially at the expense of the polity he serves." *Blount*, 61 F.3d at 942 (describing the Commission's approval of MSRB rule G-37 as based on a wish to curtail this function).

<sup>153</sup> Rule 206(4)-5(f)(1).

<sup>154</sup> MSRB rule G-37 also covers payment of transition or inaugural expenses as contributions for purposes of its time out provision. *See* MSRB Rule G-37 Q&A, Question II.6. However, under neither rule does a contribution include the transition or inaugural expenses of a successful candidate for *federal* office. Contributions to political parties are not specifically covered by the definition and thus would not trigger the rule's two-year time out unless they are a means to do indirectly what the rule prohibits if done directly (for example, the contributions are earmarked or known to be provided for the benefit of a particular political official). We also note that "contributions" are not intended to include independent "expenditures," as that term is defined in 2 U.S.C. 431 &

We received requests that we clarify the application of the rule to some common circumstances that may arise in the course of an adviser's relationship with a government client.<sup>156</sup> We would not consider a donation of time by an individual to be a contribution, provided the adviser has not solicited the individual's efforts and the adviser's resources, such as office space and telephones, are not used.<sup>157</sup> Similarly, we would not consider a charitable donation made by an investment adviser to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code,<sup>158</sup> or its equivalent in a foreign jurisdiction, at the request of an official of a government entity to be a contribution for purposes of rule 206(4)-5.<sup>159</sup>

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441b (the federal statutory provisions limiting contributions and expenditures by national banks, corporations, or labor organizations invalidated by *Citizens United v. Federal Election Commission*, 130 S. Ct. 876 (2010) (holding that corporate funding of independent political broadcasts in candidate elections cannot be limited under the First Amendment)). Indeed, it is our intent that, under the rule, advisers and their covered associates "are not in any way restricted from engaging in the vast majority of political activities, including making direct expenditures for the expression of their views, giving speeches, soliciting votes, writing books, or appearing at fundraising events." *Blount*, 61 F.3d at 948.

<sup>155</sup> MSRB rule G-37(g)(i).

<sup>156</sup> See, e.g., Caplin & Drysdale Letter; Callcott Letter I (volunteer activities); NASP Letter (charitable contributions); Sutherland Letter; IAA Letter (entertainment expenses and conference expenses). We address entertainment and conference expenses in section II.B.2(c) of this Release (which discusses the prohibition on soliciting or coordinating contributions from others).

<sup>157</sup> See Proposing Release, at n.91. A covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the adviser is not otherwise paying the employee's salary (e.g., an unpaid leave of absence). But see rule 206(4)-5(d) (prohibiting an adviser from doing indirectly what the rule would prohibit if done directly). The MSRB deals similarly with this issue. See MSRB Rule G-37 Q&A, Question II.19.

<sup>158</sup> Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. 501(c)(3)) contains a list of charitable organizations that are exempt from federal income taxation.

<sup>159</sup> The MSRB deals similarly with this issue. See MSRB Rule G-37 Q&A, Question II.18. But see rule 206(4)-5(d) (prohibiting an adviser from doing indirectly what the rule would prohibit if done directly).

The few commenters that addressed the definition of “contribution” generally urged us to adopt a narrower version. Some, for example, recommended that contributions be expressly limited to political contributions and more explicitly exclude expenditures not clearly made for the purpose of influencing an election.<sup>160</sup> We are not narrowing our definition. We are instead adopting our definition as proposed due to our concern that “contributions” may also take the form of payment of election-related debts and transition or inaugural expenses. Further, our definition of “contribution” already requires that the payment be made for the purpose of influencing an election for a federal, state or local office.<sup>161</sup> We believe that the scope of our proposed definition is appropriate in light of the conduct we are seeking to address.

Commenters were divided as to whether contributions to PACs or local political parties should trigger the two-year time out.<sup>162</sup> Such contributions were not explicitly covered by the proposed rule and do not necessarily trigger the two-year time out in MSRB rule G-37.<sup>163</sup> In some cases, such contributions may effectively operate as a

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<sup>160</sup> See, e.g., National Organizations Letter; NASP Letter.

<sup>161</sup> Rule 206(4)-5(f)(1).

<sup>162</sup> See, e.g., CalPERS Letter; NSCP Letter (should not apply to contributions to PACs or state or local parties, unless a particular candidate directly solicits contributions for those entities); Comment Letter of James J. Reilly (Aug. 24, 2009) (“Reilly Letter”) (contributions to political parties should be included because in state and local elections contributions to political parties may effectively amount to contributions to an individual candidate); SIFMA Letter.

<sup>163</sup> See, e.g., MSRB, *Payments to Non-Political Accounts of Political Organizations*, MSRB rule G-37 Interpretive Letter (Sept. 25, 2007), available at <http://msrb.org/msrb1/rules/interpg37.htm> (explaining that not all payments to political organizations that, in turn, make contributions to officials trigger Rule G-37’s time out). With regard to solicitations from a PAC or a political party with no indication of how the collected funds will be disbursed, advisers should inquire how any funds received from the adviser or its covered associates would be used. For example, if the PAC or political party is soliciting funds for the purpose of supporting a limited number of government officials, then, depending upon the facts and circumstances, contributions to the PAC or payments to the political party might well result in the same prohibition on compensation



funnel to the campaigns of the government officials.<sup>164</sup> In other cases, however, they may fund general party political activities or the campaigns of other candidates.<sup>165</sup> Therefore, we have decided not to explicitly include all such contributions among those that trigger the time out, although they may violate the provision of the rule, discussed below, which prohibits an adviser or any of its covered persons from indirect actions that would result in a violation of the rule if done directly.<sup>166</sup>

The MSRB rule G-37 definition of “contribution” has, in our view, proved to be workable. The types of contributions relevant to money managers and elected officials are unlikely to be different than those made to influence the awarding of municipal securities business by broker-dealers. On balance, we believe that the MSRB’s definition of “contribution,” which we mirrored in our proposal, achieves the goals of this rulemaking. Therefore, we are adopting the definition as proposed.

#### (4) Covered Associates

Contributions made to influence the selection process are typically made not by the firm itself, but by officers and employees of the firm who have a direct economic stake in the business relationship with the government client.<sup>167</sup> Accordingly, under the

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for providing investment advisory services to a government entity as would a contribution made directly to the official. Our approach is consistent with the MSRB’s. See MSRB Rule G-37 Q&A, Question III.5.

<sup>164</sup> See, e.g., Reilly Letter.

<sup>165</sup> See, e.g., Caplin & Drysdale Letter (explaining that “leadership PACs,” for example, are commonly established by officeholders to donate to other candidates and issues).

<sup>166</sup> See section II.B.2(d) of this Release. For the MSRB’s approach to this issue, see MSRB Rule G-37 Q&A, Question III.4. *But see* rule 206(4)-5(d) (noting that the rule’s definition of “official” of a government entity includes any election committee for that person).

<sup>167</sup> Proposing Release, at section II.A.3(a)(4). Based on enforcement actions, we believe that such persons are more likely to have an economic incentive to make contributions to influence the advisory firm’s selection. See *id.*

rule, contributions by each of these persons, which the rule defines as “covered associates,” trigger the two-year time out.<sup>168</sup> A “covered associate” of an investment adviser is defined as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any 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 investment adviser or by any of its covered associates.<sup>169</sup>

*Owners.* Contributions by sole proprietors are contributions by the adviser itself.<sup>170</sup> If the adviser is a partnership, the rule covers contributions by the adviser’s general partners.<sup>171</sup> If the adviser is a limited liability company, the rule covers contributions made by managing members.<sup>172</sup> A contribution by an owner that is a limited partner or non-managing member (of a limited liability company) is not covered, however, unless the limited partner or non-managing member is also an executive officer or solicitor (or person who supervises a solicitor) covered by the rule, or unless the contribution is an indirect contribution by the adviser, executive officer, solicitor, or supervisor.<sup>173</sup> Similarly, if the adviser is a corporation, shareholder contributions are not covered unless the shareholder is also an executive officer or solicitor covered by the

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<sup>168</sup> Rule 206(4)-5(a)(1).

<sup>169</sup> Rule 206(4)-5(f)(2).

<sup>170</sup> We note, however, that a sole proprietor may, in a personal capacity, avail herself or himself of the *de minimis* exceptions described in section II.B.2(a)(6) of this Release.

<sup>171</sup> Rule 206(4)-5(f)(2)(i).

<sup>172</sup> *Id.*

<sup>173</sup> See rule 206(4)-5(a)(1), (d) and (f)(2)(i)-(ii).

rule, or unless the contribution is an indirect contribution by the adviser, executive officer, solicitor, or supervisor.<sup>174</sup>

*Executive Officers.* Contributions by an executive officer of an investment adviser trigger the two-year time out.<sup>175</sup> Executive officers include: (i) the president; (ii) any vice president in charge of a principal business unit, division or function (such as sales, administration or finance); (iii) any other officer of the investment adviser who performs a policy-making function; or (iv) any other person who performs similar policy-making functions for the investment adviser.<sup>176</sup> Whether a person is an executive officer depends on his or her function, not title; for example, an officer who is the chief executive of an advisory firm but whose title does not include “president” is nonetheless an executive officer for purposes of the rule.

The definition reflects changes we have made from our proposal that are designed to clarify the rule and to tailor it to apply to those officers of an investment adviser whose position in the organization is more likely to incentivize them to obtain or retain clients for the investment adviser (and, therefore, to engage in pay to play practices) while still achieving our objectives. We have clarified that “other executive officers” under the rule—*i.e.*, those other than the president and vice presidents in charge of principal business units or functions—include only those officers or other persons who perform a policy-making function for the investment adviser.<sup>177</sup> This limitation, which was

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<sup>174</sup> *Id.*

<sup>175</sup> The definition of “covered associate” includes, among others, any executive officer or other individual with a similar status or function. Rule 206(4)-5(f)(2)(i).

<sup>176</sup> Rule 206(4)-5(f)(4).

<sup>177</sup> Rule 206(4)-2(f)(4). This modification also aligns the definition more closely with the definition of “executive officer” in our other rules. *See, e.g.*, rule 205-3(d)(4) under the Advisers Act [17 CFR 275.205-3(d)(4)] (defining executive officer for purposes of

recommended by commenters,<sup>178</sup> excludes persons who enjoy certain titles as a formal matter but do not engage in the kinds of activities that we believe should trigger the prohibitions in the rule.<sup>179</sup> We have also modified the definition to remove the limitation that the officer, as part of his or her regular duties, performs or supervises any person who performs advisory services for the adviser, or solicits or supervises any person who solicits for the adviser. We agree with the commenter who asserted that “. . . all of the adviser’s executive officers should be included because the nature of their status alone

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determinations of who is a qualified client exempting an adviser from the prohibition on entering into, performing, renewing or extending an investment advisory contract that provides for compensation on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, under the Advisers Act) and rule 3c-5(a)(3) [17 CFR 270.3c-5(a)(3)] under the Investment Company Act of 1940 [15 U.S.C. 80a] (“Investment Company Act”) (defining executive officer for purposes of determinations of the number of beneficial owners of a company excluded from the definition of “investment company” by section 3(c)(1) of the Investment Company Act, and whether the outstanding securities of a company excluded from the definition of “investment company” by section 3(c)(7) of the Investment Company Act are owned exclusively by qualified purchasers, as defined in that Act). It also more closely aligns the definition to the MSRB approach. *See* MSRB rule G-37(g)(v).

<sup>178</sup> *See, e.g.,* Sutherland Letter.

<sup>179</sup> Several commenters urged us expressly to exclude from the definition the CEO, officers and employees of a parent company. *See, e.g.,* SIFMA Letter; ICI Letter; MFA Letter; Skadden Letter. Depending on facts and circumstances, there may be instances in which a supervisor of an adviser’s covered associate (who, for example, engages in solicitation of government entity clients for the adviser) formally resides at a parent company, but whose contributions should trigger the two-year time out because they raise the same conflict of interest issues that we are concerned about, irrespective of that person’s location or title. In other words, whether a person is a covered associate ultimately depends on the activities of the individual and not his or her title. We recently considered a similar issue in a report addressing whether MSRB rule G-37 could include contributions by employees of parent companies as triggering that rule’s time out provision, *see Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: JP Morgan Securities, Inc.*, Exchange Act Release No. 61734 (Mar. 18, 2010), *available at* <http://www.sec.gov/litigation/investreport/34-61734.htm> (“This Report serves to remind the financial community that placing an executive who supervises the activities of a broker, dealer or municipal securities dealer outside of the corporate governance structure of such broker, dealer or municipal securities dealer does not prevent the application of MSRB Rule G-37 to that individual's conduct.”). The MSRB also takes the view that it is an individual’s activities and not his or her title that may render his or her contributions a trigger for that rule’s time out provision. *See* MSRB Rule G-37 Q&A, Question IV.18.

creates a strong incentive to engage in pay to play practices.”<sup>180</sup> Even if these senior officers are not directly involved in advisory or solicitation activities, as part of senior management, their success within the advisory firm is likely to be tied to the firm’s success in obtaining clients.<sup>181</sup>

*Employees who Solicit Government Clients.* Contributions by any employee who solicits a government entity for the adviser would trigger the two-year time out.<sup>182</sup> An employee need not be primarily engaged in solicitation activities to be a “covered associate” under the rule.<sup>183</sup> We are also including persons who supervise employees who solicit government entities because we believe these persons are strongly incentivized to engage in pay to play activities to obtain government entity clients.<sup>184</sup> We

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<sup>180</sup> See Fund Democracy Letter.

<sup>181</sup> Commenters also suggested that our definition exclude vice presidents in charge of business units, divisions or functions whose function is unrelated to investment advisory or solicitation activities. See, e.g., IAA Letter. For the reasons described above, we do not believe such an exclusion is appropriate.

<sup>182</sup> We are not adopting the suggestion of several commenters that we treat third-party solicitors the same way as employees. See, e.g., 3PM Letter; Triton Pacific Letter; Comment Letter of Arrow Partners, Inc. Partner Ken Rogers (Sept. 2, 2009) (“Arrow Letter”). We explained in the Proposing Release that we determined not to propose this approach out of concern for the difficulties that advisers may have when monitoring the activities of their third-party solicitors. See Proposing Release, at nn.135 and accompanying text. Commenters did not persuade us that these concerns can reasonably be expected to be overcome. Therefore, whereas contributions by covered associates of the adviser trigger the two-year compensation time out, an adviser is prohibited from hiring third parties to solicit government business on its behalf unless the third party is a “regulated person.” See section II.B.2(b) of this Release. Our approach is similar to MSRB’s rule G-38, which restricts third-party solicitation activities differently from the two-year time out. See MSRB rule G-38.

<sup>183</sup> The MSRB also takes the approach that an associated person need not be “primarily engaged” in activities that would make his or her contributions trigger rule G-37’s time out provision, particularly where he or she engages in soliciting business. See MSRB Rule G-37 Q&A, Question IV.8.

<sup>184</sup> Rule 206(4)-5(f)(2)(ii). The proposed rule would only have applied to *senior officers* who supervise employee solicitors. See proposed rule 206(4)-5(f)(4)(ii). MSRB rule G-37 also applies to supervisors of persons who solicit relevant business from government entities. See MSRB Rule G-37 Q&A, Question IV.14.

have revised this aspect of the definition to include *all* supervisors of those solicitors that solicit government entities because we believe the incentives to engage in pay to play exist for all such supervisors, not just those that have a certain level of seniority.

Rule 206(4)-5 defines “solicit” to mean, with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser.<sup>185</sup> Commenters asked us to provide further guidance on what we mean by “solicit.”<sup>186</sup> The determination of whether a particular communication is a solicitation is dependent upon the specific facts and circumstances relating to such communication. As a general proposition any communication made under circumstances reasonably calculated to obtain or retain an advisory client would be considered a solicitation unless the circumstances otherwise indicate that the communication does not have the purpose of obtaining or retaining an advisory client. For example, if a government official asks an employee of an advisory firm whether the adviser has pension fund advisory capabilities, such employee generally would not be viewed as having solicited advisory business if he or she provides a limited affirmative response, together with either providing the government official with contact information for a covered associate of the adviser or informing the government official that advisory personnel who handle government advisory business will contact him or her.<sup>187</sup>

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<sup>185</sup> Rule 206(4)-5(f)(10)(i). We are adopting this definition as proposed.

<sup>186</sup> *See, e.g.,* Skadden Letter.

<sup>187</sup> Similarly, if a government official is discussing governmental asset management issues with an employee of an adviser, the employee generally would not be viewed as having solicited business if he or she provides a limited communication to the government official that such alternative may be appropriate, together with either providing the government official with contact information for a covered associate or informing the

*Political Action Committees.* A covered associate includes a political action committee controlled by the investment adviser or by any of its covered associates.<sup>188</sup>

Under the rule, we would regard an adviser or its covered associate to have “control” over a political action committee if the adviser or its covered associate has the ability to direct or cause the direction of the governance or operations of the PAC.<sup>189</sup>

Two commenters asserted that we should narrow the definition of “covered associate” with respect to political action committees.<sup>190</sup> Specifically, they asserted that the definition should only include PACs controlled by the adviser and not those controlled by other covered associates, which could be a separate legal entity over which

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government official that advisory personnel who handle asset management for government clients will contact him or her. In these examples, however, if the adviser’s employee receives compensation such as a finder’s or referral fee for such business or if the employee engages in other activities that could be deemed a solicitation with respect to such business, the employee generally would be viewed as having solicited the advisory business. Our interpretation of what it means to “solicit” government business is consistent with the MSRB’s. *See MSRB, Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), available at <http://msrb.org/msrb1/rules/notg38.htm>.

<sup>188</sup> Rule 206(4)-5(f)(2)(iii) (which we are adopting as proposed). One commenter suggested that we define a “political action committee,” or PAC, as any organization required to register as a political committee under federal, state or local law. Caplin & Drysdale Letter. But we have not included this definition of PAC because we do not believe a definition linked to the registration status of a political committee would serve our purpose of deterring evasion of the rule as registration requirements vary among election laws. We note, however, that we would construe the term PAC to include (but not necessarily be limited to) those political committees generally referred to as PACs, such as separate segregated funds or non-connected committees within the meaning of the Federal Election Campaign Act, or any state or local law equivalent. *See Federal Election Commission, Quick Answers to PAC Questions*, available at [http://www.fec.gov/ans/answers\\_pac.shtml#pac](http://www.fec.gov/ans/answers_pac.shtml#pac). Determination of whether an entity is a PAC covered by our rule would not, in our view, turn on whether the PAC was, or was required to be, registered under relevant law.

<sup>189</sup> One commenter suggested a similar interpretation of “control.” Caplin & Drysdale Letter. For the MSRB’s approach to this definition, see MSRB Rule G-37 Q&A, Question IV.24.

<sup>190</sup> SIFMA Letter; Sutherland Letter.

the adviser may have little influence.<sup>191</sup> We are not adopting this suggestion. As we discussed in the Proposing Release, PACs are often used to make political contributions.<sup>192</sup> The recommended changes would permit an executive of the adviser or another covered person of the adviser to use a PAC he or she controls to evade the rule. Even where the adviser itself does not control such PACs directly, we are concerned about their use to evade our rule where they are controlled by covered associates (whose positions in the organization, as we note above, are more likely to incentivize them to obtain or retain clients for the investment adviser).<sup>193</sup>

*Other Persons.* Several commenters urged that our definitions be broadened to encompass other persons whose contributions should trigger the two-year time out.<sup>194</sup> One urged that in some cases all employees should be covered associates because of the likelihood they could directly benefit from engaging in pay to play.<sup>195</sup> Another urged that the definition of covered associate include affiliates of the adviser that solicit government business on the adviser's behalf, any director of the adviser, and any significant owner of the adviser.<sup>196</sup> These suggestions would expand the rule to a range of persons that could

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<sup>191</sup> *Id.*

<sup>192</sup> Proposing Release, at n.101.

<sup>193</sup> Advisers are responsible for supervising their supervised persons, including their covered associates. We have the authority to seek sanctions where an investment adviser, or an associated person, has failed reasonably to supervise, with a view to preventing violations of the federal securities laws or rules, a person who is subject to the adviser's (or its associated person's) supervision and who commits such violations. Sections 203(e)(6) and 203(f) of the Advisers Act [15 U.S.C. 80b-3(e)(6) and (f)].

<sup>194</sup> *See, e.g.*, Fund Democracy/Consumer Federation Letter; DiNapoli Letter (suggesting the rule also cover contributions from family members); Ounavarra Letter.

<sup>195</sup> Ounavarra Letter.

<sup>196</sup> Fund Democracy/Consumer Federation Letter.



engage in pay to play activities.<sup>197</sup> In our judgment, however, contributions from these types of persons are less likely to involve pay to play unless the contributions were made by these persons for the purpose of avoiding application of the rule, which could result in the adviser's violation of a separate provision of the rule.<sup>198</sup> We do not believe that the incremental benefits of capturing conduct of other individuals less likely to engage in pay to play based on the record before us today outweigh the additional burden such an expansion would impose.<sup>199</sup> Thus, we are not expanding the definition as these commenters have suggested.

Other commenters urged us to narrow our definition of "covered associate" to include fewer persons.<sup>200</sup> For example, one commenter recommended that the definition of "covered associate" expressly exclude all "support personnel."<sup>201</sup> Another suggested that we limit the definition to those who solicit government clients with a "major purpose" of obtaining that government client.<sup>202</sup> Expressly excluding all "support personnel" is unnecessary because, in almost all cases, such persons would not be

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<sup>197</sup> See, e.g., *supra* note 179 (discussing why we have chosen not to limit the definition of "executive officer" in other ways as suggested by some commenters).

<sup>198</sup> See Rule 206(4)-5(d). We also note that the MSRB takes a similar approach. See, e.g., MSRB Rule G-37 Q&A, Question IV.9 (noting that the universe of those whose contributions above the *de minimis* level *per se* trigger the two-year time out is limited and does not include their consultants, lawyers or spouses). The MSRB also leaves contributions by affiliates and personnel beyond those identified as triggering the two-year time out to be addressed by a provision prohibiting municipal securities dealers from doing indirectly what they are prohibited from doing directly under rule G-37. See MSRB Rule G-37(d).

<sup>199</sup> In this instance, as in others, we are sensitive to First Amendment concerns that further expansion of the scope of covered associates could broaden the rule's scope beyond what is necessary to accomplish its purposes.

<sup>200</sup> See, e.g., T. Rowe Price Letter; NSCP Letter; Skadden Letter.

<sup>201</sup> T. Rowe Price Letter.

<sup>202</sup> Skadden Letter.

“covered associates,” as that term is defined in the rule. We have not limited the definition to those who solicit government clients with a “major purpose” of obtaining that government client because we believe that our rule’s definition of “solicit,” as discussed above, adequately takes into account the purpose of the communication and adding an additional element of intent may exclude employees who have an incentive to engage in pay to play practices.

**(5) “Look Back”**

The rule attributes to an adviser contributions made by a person within two years (or, in some cases, six months) of becoming a covered associate of that adviser.<sup>203</sup> In other words, when an employee becomes a covered associate, the adviser must “look back” in time to that employee’s contributions to determine whether the time out applies to the adviser.<sup>204</sup> If, for example, the contribution were made more than two years (or, pursuant to the exception described below for non-solicitors, six months) prior to the employee becoming a covered associate, the time out has run; if the contribution was made less than two years (or six months) from the time the person becomes a covered associate, the rule prohibits the adviser that hires or promotes the contributing covered associate from receiving compensation for providing advisory services from the hiring or

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<sup>203</sup> Rule 206(4)-5(a)(1). The “look back” applies to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the rule. A person becomes a covered associate for purposes of the rule’s look-back provision at the time he or she is hired or promoted to a position that meets the definition of “covered associate” in rule 206(4)-5(f)(2). For a discussion of the definition of “covered associate,” see section II.B.2(a)(4) of this Release.

<sup>204</sup> Rule 206(4)-5(a)(1) (including among those covered associates whose contributions can trigger the two-year time out a person who becomes a covered associate within two years after the contribution is made); Rule 206(4)-5(b)(2) (excepting from the two-year look back those contributions made by a natural person more than six months prior to becoming a covered associate of the investment adviser unless such person, after becoming a covered associate, solicits clients on behalf of the investment adviser).

promotion date until the two-year period has run.<sup>205</sup> The look-back provision, which is similar to that in MSRB rule G-37, is designed to prevent advisers from circumventing the rule by influencing the selection process by hiring persons who have made political contributions.<sup>206</sup>

We received many comments on our proposed look-back provision,<sup>207</sup> which would have applied the two-year look back with respect to all contributions of new covered associates.<sup>208</sup> One commenter asserted that such a provision is necessary to prevent advisers from circumventing the prohibitions on pay to play.<sup>209</sup> Most commenters, however, argued that the rule should not contain a look-back provision or should contain a shorter one because it could prevent advisers from hiring qualified

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<sup>205</sup> In no case would the prohibition imposed by the rule be longer than two years from the date the covered associate makes a covered contribution. If, for example, a covered associate becomes employed by an investment adviser (and engages in solicitation activity for it) one year and six months after making a contribution, the new employer would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. We also note that the rule's exemptive process may be available in instances where an adviser believes application of the look-back provision would yield an unintended result. Rule 206(4)-5(e). For a discussion of the rule's exemptive provision, see section II.B.2(f) of this Release.

<sup>206</sup> Similarly, to prevent advisers from channeling contributions through departing employees, advisers must "look forward" with respect to covered associates who cease to qualify as covered associates or leave the firm. The covered associate's employer at the time of the contribution would be subject to the proposed rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate or remains employed by the adviser. Thus, dismissing a covered associate would not relieve the adviser from the two-year time out. MSRB rule G-37 also includes a "look-forward provision." See MSRB Rule G-37 Q&A, Question IV.17 ("... any contributions by [an] associated person [who leaves the dealer's employ] (other than those that qualify for the *de minimis* exception under Rule G-37(b)) will subject the dealer to the rule's ban on municipal securities business for two years from the date of the contribution").

<sup>207</sup> See, e.g., Fund Democracy/Consumer Federation Letter; ICI Letter; Davis Polk Letter; NY City Bar Letter; Fidelity Letter; Wells Fargo Letter; MFA Letter; IAA Letter; NASP Letter; American Bankers Letter; Comment Letter of Seward & Kissel LLP (Oct. 6, 2009) ("Seward & Kissel Letter"); Park Hill Letter; Dechert Letter; Skadden Letter.

<sup>208</sup> See Proposing Release, at section II.A.3(a)(5).

<sup>209</sup> Fund Democracy/Consumer Federation Letter.

individuals who have made unrelated political contributions,<sup>210</sup> or it could be disruptive to public pension plans seeking to hire qualified managers.<sup>211</sup> While some urged that we eliminate the look-back provision altogether,<sup>212</sup> most asked us to shorten the period to three to six months.<sup>213</sup> Others suggested alternative approaches to the look back, including adopting a higher contribution threshold to trigger the look-back provision<sup>214</sup> or permitting advisers to hire and promote persons to be covered associates who have made prohibited contributions, but not permitting them to solicit government clients or otherwise create firewalls between them and government clients.<sup>215</sup>

Upon consideration of the comments, we believe that applying the full two-year look back to all new covered associates may be unnecessary to achieve the goals of the rulemaking. We are adopting a suggestion offered by several commenters to shorten the look-back period with respect to certain new covered associates whose contributions are less likely to be involved in pay to play.<sup>216</sup> Under an exception to the rule, the two-year

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<sup>210</sup> See, e.g., ICI Letter; Davis Polk Letter; NY City Bar Letter; Fidelity Letter; Wells Fargo Letter; MFA Letter.

<sup>211</sup> See, e.g., Comment Letter of Connecticut Treasurer Denise L. Nappier (Sept. 10, 2009) (“CT Treasurer Letter”); CalPERS Letter.

<sup>212</sup> See, e.g., IAA Letter; ICI Letter; Wells Fargo Letter; NASP Letter; American Bankers Letter; MFA Letter; Seward & Kissel Letter.

<sup>213</sup> See, e.g., ICI Letter (three-month look back); IAA Letter (six-month look back); Park Hill Letter (six-month look back); Wells Fargo Letter (six-month look back); Davis Polk Letter (six-month look back); Dechert Letter (six-month look back); MFA Letter (six-month look back).

<sup>214</sup> See, e.g., Wells Fargo Letter; NSCP Letter.

<sup>215</sup> See, e.g., Comment Letter of Strategic Capital Partners (Oct. 1, 2009) (“Strategic Capital Letter”); Comment Letter of B. Jack Miller (Oct. 3, 2009); Comment Letter of RP Realty Partners, LLC Chief Financial Officer Jerry Gold (Oct. 2, 2009); SIFMA Letter.

<sup>216</sup> See, e.g., MFA Letter; Fidelity Letter; Dechert Letter; Wells Fargo Letter; Skadden Letter. The MSRB shortened the look-back period under MSRB rule G-37 to six months for certain municipal finance professionals in response to similar industry concerns about the impact on hiring. See MSRB, *Amendments Filed to Rule G-37 Concerning the*

time out is not triggered by a contribution made by a natural person more than six months prior to becoming a covered associate, unless he or she, after becoming a covered associate, solicits clients.<sup>217</sup> As a result, the two-year look back applies only to covered associates who solicit for the investment adviser.<sup>218</sup>

The potential link between obtaining advisory business and contributions made by an individual prior to his or her becoming a covered associate that is uninvolved in solicitation activities is likely more attenuated and therefore, in our judgment, should be subject to a shorter look back. We have modeled this shortened look-back period<sup>219</sup> on the MSRB's six-month look back for certain personnel, which it implemented as a result of feedback it received from dealers that indicated the two-year look back was negatively affecting in-firm transfers and promotions and "preclud[ing] them from hiring individuals

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*Exemption Process and the Definition of Municipal Finance Professional* (Sept. 26, 2002), available at <http://www.msrb.org/msrb1/archive/g%2D37902notice.htm>.

<sup>217</sup> Rule 206(4)-5(b)(2). An adviser is subject to the two-year time out regardless of whether it is "aware" of the political contributions. Thus, statements by prospective employees regarding whether they have made relevant contributions are insufficient to inoculate the adviser, as some commenters urged (*see, e.g.*, IAA Letter; ICI Letter; NSCP Letter; Caplin & Drysdale Letter), to ensure that investment advisers are not encouraged to relax their efforts to promote compliance with the rule's prohibitions. Nonetheless, advisers who advise or are considering advising any government entity should consider requiring full disclosure of any relevant political contributions from covered associates or potential covered associates to ensure compliance with rule 206(4)-5. Advisers are required to request similar reports about securities holdings by Advisers Act rule 204A-1(b)(1)(ii) [17 CFR 275.204A-1(b)(1)(ii)], which requires each of a firm's "access persons" to submit an initial "holdings report" of securities he or she beneficially owns at the time he or she becomes an access person, even though the securities would likely have been acquired in transactions prior to becoming an access person. For a discussion of an adviser's recordkeeping obligations with regard to records of contributions by a new covered associate during that new covered associate's look-back period, see *infra* note 428.

<sup>218</sup> See rule 206(4)-5(f)(2) (defining covered associate of an investment adviser as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee).

<sup>219</sup> See rule 206(4)-5(b)(2).

who had made contributions, even though the contributions (which may have been relatively small) were made at a time when the individuals had no reason to be familiar with Rule G-37.”<sup>220</sup> This approach balances commenters’ concerns about the implications for their hiring decisions with the need to protect against individuals marketing to prospective investment adviser employers their connections to, or influence over, government entities those advisers might be seeking as clients.<sup>221</sup>

### (6) Exceptions for De Minimis Contributions

Rule 206(4)-5 permits individuals to make aggregate contributions without triggering the two-year time out of up to \$350, per election, to an elected official or candidate for whom the individual is entitled to vote,<sup>222</sup> and up to \$150, per election, to

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<sup>220</sup> MSRB, *Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Amendments to Rules G-37, on Political Contributions and Prohibitions on Municipal Securities Business, G-8, on Books and Records, Revisions to Form G-37/G-38 and the Withdrawal of Certain Rule G-37 Questions and Answers*, Exchange Act Release No. 47609 (April 1, 2003) [67 FR 17122 (Apr. 8, 2003)]. See also MSRB, *Self-Regulatory Organizations; Order Granting Approval of a Proposed Rule Change and Amendment No. 1 Thereto by the Municipal Securities Rulemaking Board Relating to Amendments to Rules G-37, on Political Contributions and Prohibitions on Municipal Securities Business, G-8, on Books and Records, Revisions to Form G-37/G-38 and the Withdrawal of Certain Rule G-37 Questions and Answers*, Exchange Act Release No. 47814 (May 8, 2003) [68 FR 25917 (May 14, 2003)] (Commission order approving amendments to MSRB rule G-37); MSRB rule G-37(b)(iii).

<sup>221</sup> We are not adopting the suggestion of commenters to exclude from the look-back provision contributions made before a merger or acquisition by an adviser by not attributing the contributions of the acquired adviser to the acquiring adviser. See, e.g., Dechert Letter; ICI Letter. We believe that an acquisition of another adviser could raise identical concerns where the acquired adviser has made political contributions designed to benefit the acquiring adviser. Rule 206(4)-5 is not intended to prevent mergers in the investment advisory industry or, once a merger is consummated, to hinder the surviving adviser’s government advisory business unless the merger was an attempt to circumvent rule 206(4)-5. Thus, the adviser may wish to seek an exemption from the ban on receiving compensation pursuant to rule 206(4)-5(a) from the Commission. The MSRB takes the same approach to this issue. See MSRB Rule G-37 Q&A, Question II.16.

<sup>222</sup> For purposes of rule 206(4)-5, a person would be “entitled to vote” for an official if the person’s principal residence is in the locality in which the official seeks election. For example, if a government official is a state governor running for re-election, any covered

an elected official or candidate for whom the individual is not entitled to vote.<sup>223</sup> These *de minimis* exceptions are available only for contributions by individual covered associates, not the investment adviser itself.<sup>224</sup> Under both exceptions, primary and general elections would be considered separate elections.<sup>225</sup>

We proposed a \$250 *de minimis* exception for contributions to candidates for whom a covered associate is entitled to vote,<sup>226</sup> which reflects the current *de minimis* exception in MSRB rule G-37.<sup>227</sup> Many commenters urged us to increase the *de minimis* amount (either to a larger number or by indexing it to inflation), arguing that a

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associate of an adviser who resides in that state may make a *de minimis* contribution to the official without causing a ban on that adviser being compensated for providing advisory services for that government entity. In the example of a government official running for President, any covered associate in the country can contribute the *de minimis* amount to the official's Presidential campaign. The MSRB has issued a similar interpretation of what it means to be "entitled to vote" for purposes of MSRB rule G-37. *See MSRB Reports*, Vol. 16. No. 1 (January 1996) at 31-34.

<sup>223</sup> *See* Rule 206(4)-5(b)(1) (excepting "*de minimis*" contributions to "officials" (*see supra* note 139 and accompanying text) from the rule's two-year time out provision).

<sup>224</sup> *Id.* Under the rule, each covered associate, taken separately, would be subject to the *de minimis* exceptions. In other words, the limit applies per covered associate and is not an aggregate limit for all of an adviser's covered associates. *But see supra* note 170 (pointing out that a sole proprietor may, in a personal capacity, avail herself or himself of the *de minimis* exceptions even though his or her contributions are otherwise considered contributions of the adviser itself).

<sup>225</sup> Accordingly, a covered person of an investment adviser could, without triggering the prohibitions of the rule, contribute up to the limit in both the primary election campaign and the general election campaign of each official for whom the person making the contribution would be entitled to vote. The MSRB takes the same approach of excepting from rule G-37's time out trigger contributions up to the rule's *de minimis* amount for *each* election (including a primary and general election). *See* MSRB Rule G-37 Q&A, Question II.8. *See also In the Matter of Pryor, McClendon, Counts & Co., Inc., et al.*, Exchange Act Release No. 48095 (June 26, 2003) (noting that contributions must be limited to MSRB rule G-37's *de minimis* amount *before* the primary, with the same *de minimis* amount allowed *after* the primary for the general election).

<sup>226</sup> *See* Proposing Release, at section II.A.3(a)(6).

<sup>227</sup> *See* MSRB rule G-37(b)(i).

contribution as large as \$1,000 would be unlikely to influence the award of an advisory contract by a public pension plan.<sup>228</sup>

The \$1,000 amount suggested by some commenters strikes us as a rather large contribution that could influence the hiring decisions, depending upon the size of the jurisdiction, the amount of campaign contributions to opposing candidates, and the competitiveness of the primary or prospective election. Instead, we are taking the suggestion of several commenters<sup>229</sup> that we should increase the *de minimis* amount to reflect the effects of inflation since the MSRB first established its \$250 *de minimis* amount in 1994.<sup>230</sup> We may consider increasing the \$350 amount in the future if, for example, the value of it decreases materially as a result of further inflation.

Commenters also urged us to eliminate the condition that a covered associate must be able to vote for the candidate.<sup>231</sup> They asserted that persons can have a legitimate interest in contributing to campaigns of people for whom they are unable to

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<sup>228</sup> See, e.g., SIFMA Letter; NASP Letter; Comment Letter of Philip K. Holl (Oct.5, 2009) (“Holl Letter”); NSCP Letter; Caplin & Drysdale Letter; Cornell Law Letter; ICI Letter; MFA Letter; Seward & Kissel Letter; Callcott Letter II; Comment Letter of the California State Teachers’ Retirement System (Oct. 6, 2009) (adopted policies that limit contributions to board members by those seeking investment relationships with the fund to \$1,000). Several commenters suggested our proposed *de minimis* limit could be subject to a challenge on constitutional grounds. For a discussion of, and response to, these comments, see *supra* note 72 and accompanying text.

<sup>229</sup> See, e.g., Caplin & Drysdale Letter (recommending that we index the *de minimis* threshold for inflation); Cornell Law Letter (recommending that we index the *de minimis* threshold for inflation). See also Callcott Letter I.

<sup>230</sup> We multiplied the \$250 *de minimis* amount that we proposed (which was adopted by the MSRB in 1994) by the annual consumer price index (a measure of inflation) change since 1994, as reported by the Bureau of Labor Statistics (*available at* <http://www.bls.gov/data/>). The result was approximately \$365 in 2009; we rounded it down to \$350 for administrative convenience.

<sup>231</sup> See, e.g., T. Rowe Price Letter; Dechert Letter; MFA Letter; NASP Letter; Callcott Letter I; Cornell Law Letter; IAA Letter.



vote.<sup>232</sup> We acknowledge that persons can have such an interest, such as in large metropolitan areas where a covered associate may work and live in different jurisdictions. But commenters did not confine their recommendations to such circumstances and we remain concerned that contributions by executives of advisers living in distant jurisdictions may be less likely to be made for purely civic purposes. Accordingly, we have added a *de minimis* exception for contributions of up to \$150 to officials for whom a covered associate is not entitled to vote, which is lower than the *de minimis* exception of \$350 for candidates for whom a covered associate is entitled to vote. We believe that \$150 is a reasonable amount for the additional *de minimis* exception we are adopting because of the more remote interest a covered associate is likely to have in contributing to a person for whom he or she is not entitled to vote.

#### **(7) Exception for Certain Returned Contributions**

We are adopting, largely as proposed, an exception that will provide an adviser with a limited ability to cure the consequences of an inadvertent political contribution to an official for whom the covered associate making it is *not* entitled to vote.<sup>233</sup> The exception is available for contributions that, in the aggregate, do not exceed \$350 to any one official, per election.<sup>234</sup> The adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution<sup>235</sup> and,

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<sup>232</sup> See, e.g., T. Rowe Price Letter; Dechert Letter; MFA Letter; NASP Letter; Callcott Letter I; Cornell Law Letter.

<sup>233</sup> Rule 206(4)-5(b)(3).

<sup>234</sup> Rule 206(4)-5(b)(3)(i). We note that a contribution would not trigger the two-year ban at all to the extent it falls within the *de minimis* exception described in rule 206(4)-5(b)(1). See section II.B.2(a)(6) of this Release for a discussion of this exception.

<sup>235</sup> *Id.*

within 60 days after learning of the triggering contribution, the contributor must obtain the return of the contribution.<sup>236</sup>

The scope of this exception is limited to the types of contributions that we believe are less likely to raise pay to play concerns. The prompt return of the contribution provides an indication that the contribution would not affect an official of a government entity's decision to award an advisory contract.<sup>237</sup> The relatively small amount of the contribution, in conjunction with the other conditions of the exception, suggests that it was unlikely to be made for the purpose of influencing the award of an advisory contract. Repeated triggering contributions suggest otherwise or that the adviser has not implemented effective compliance controls. Therefore, the rule limits an adviser's reliance on the exception to no more than two or three per 12-month period (based on the size of the adviser),<sup>238</sup> and no more than once for each covered associate,<sup>239</sup> regardless of the time period.<sup>240</sup>

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<sup>236</sup> Rule 206(4)-5(b)(3)(i).

<sup>237</sup> The 60-day limit is designed to give contributors sufficient time to seek its return, but still require that they do so in a timely manner. Also, this provision is consistent with MSRB rule G-37(j)(i). If the recipient will not return the contribution, the adviser would still have available the opportunity to apply for an exemption under paragraph (e) of the rule. Paragraph (e), which sets forth factors we would consider in determining whether to grant an exemption, includes as a factor whether the adviser has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution.

<sup>238</sup> Rule 206(4)-5(b)(3)(ii). The approach we have taken will generally create some flexibility to accommodate a limited number of contributions by covered associates that would otherwise trigger the two-year time out. In a modification from our proposal that we believe is responsive to certain commenters' concerns (*see* note 251 and accompanying text below), "larger" advisers may avail themselves of three automatic exceptions, instead of two, in any calendar year. Rule 206(4)-5(b)(3)(ii). In contrast, our proposal would have permitted each adviser, regardless of its size, to rely on the automatic exception twice each year. The rule identifies a "larger" adviser for these purposes as any adviser who has reported in response to Item 5.A on its most recently filed Form ADV, Part 1A [17 CFR 279.1] that it has more than 50 employees. *Id.* Investment Adviser Registration Depository (IARD) data as of April 1, 2010 indicate that

Commenters who addressed it generally supported our inclusion of an automatic exception provision,<sup>241</sup> although several suggested modifications.<sup>242</sup> Some urged us to eliminate the requirement that the contributor succeed in obtaining the return of the contribution.<sup>243</sup> We are not making this change, which could undermine our goals in adopting the rule if it led to contributors asking for the return of a contribution where such requests were expected to be refused by the government official. We would have to discern whether the contributor itself, who may (or whose employer may) be seeking to influence government officials, has tried “hard enough” to get the contribution back.

Other commenters recommended an alternative exception for inadvertent contributions that would not require that an otherwise-triggering contribution be

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approximately 10 percent of registered advisers have more than 50 employees (and would therefore be limited to three “automatic” exceptions per calendar year instead of two). In particular, the data indicate that there are 11,607 registered investment advisers. Of those, 1,072 advisers (9.2% of the total) have indicated in their responses to Item 5.A of Part 1A of Form ADV that they have more than 50 employees. We chose the 50 employee cut-off because the number of employees is independently reported on Form ADV (and therefore cross-verifiable)—each adviser filing Form ADV must check a box indicating an approximation of the number of employees it has, choosing among 1-5, 6-10, 11-50, 51-250, 251-500, 501-1,000, or more than 1,000—and because we believe that inadvertent violations of the rule are more likely at advisers with greater numbers of employees. We think that the twice per year limit is appropriate for small advisers and the three times per year limit is appropriate for larger advisers. We do not believe it is appropriate for there to be greater variation in the number of times advisers may rely on the exception than that based either on their size or on other characteristics. We are seeking to encourage robust monitoring and compliance.

<sup>239</sup> Rule 206(4)-5(b)(3)(iii). Once a covered associate has been made aware of an “inadvertent” violation, a justification for a second violation would be more questionable.

<sup>240</sup> Although we have included different allowances for larger and smaller advisers (based on the number of employees they report on Form ADV), our approach otherwise generally tracks MSRB rule G-37’s “automatic exemption” provision. *See* MSRB rule G-37(j).

<sup>241</sup> *See, e.g.*, T. Rowe Price Letter; NSCP Letter; CT Treasurer Letter; Skadden Letter; ICI Letter; IAA Letter.

<sup>242</sup> *See, e.g.*, NY City Bar Letter; Dechert Letter; IAA Letter.

<sup>243</sup> *See, e.g.*, T. Rowe Price Letter; NSCP Letter; CT Treasurer Letter.

returned.<sup>244</sup> They contended that such an exception should be available to advisers with policies and procedures in place to prevent pay to play that include sanctions for employees violating the policies.<sup>245</sup> Such an approach excludes any objective indication that the contribution was inadvertent. As noted above, policies and procedures are required to ensure compliance with our rule. But policies and procedures alone, without critical objective criteria, such as obtaining a return of the contribution, are insufficient in our view to justify an exception to our prophylactic rule.

Some commenters urged us to modify or eliminate the requirement that the contribution be discovered by the adviser within four months.<sup>246</sup> We believe, however, that four months is the appropriate timeframe. We believe advisers should have a reasonable amount of time to discover contributions made by covered associates if, for example, their covered associates disclose their contributions to the adviser on a quarterly basis.<sup>247</sup> The absence of such a time limitation would encourage advisers not to seek to

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<sup>244</sup> See, e.g., IAA Letter (suggesting that we require, as a condition for such an exception, that “such contribution resulted in an inadvertent violation, meaning violations that are not reasonably known or condoned by the investment adviser and where the contributor lacked intent to influence the award of the advisory contract or violate the rule in making the contribution, as evidenced by the facts and circumstances surrounding such contribution”).

<sup>245</sup> See, e.g., IAA Letter; Dechert Letter; NY City Bar Letter.

<sup>246</sup> See, e.g., T. Rowe Price Letter (arguing that, if an adviser has in place procedures to require covered associates to report all contributions no less frequently than quarterly, and an associate fails to report a contribution in violation of the procedures, the discovery of a prohibited contribution outside this four-month window should not preclude the use of this exception.). *But see* Fund Democracy/Consumer Federation Letter (urging us to consider shortening the time in which a contribution must be discovered for the exception to be available to one month).

<sup>247</sup> Quarterly compliance reporting is familiar to advisory personnel. See, e.g., rule 204A-1 under the Advisers Act (requiring that, under an adviser’s code of ethics, personnel report personal securities trading activity at least quarterly). We do not believe the exception should be available where it takes longer for advisers to discover contributions made by covered associates because they might enjoy the benefits of a contribution’s potential

discover such contributions if they believed they could simply rely on the exception any time a contribution happened to come to light.

A number of commenters suggested the exception be allowed for *all* contributions regardless of dollar amount, while a few recommended raising the dollar amount to \$1,000.<sup>248</sup> As we noted above, we view the limitation on the amount of such a contribution, in conjunction with the other conditions of the exception, important to the rule because it is more likely that the contribution was, in fact, inadvertent. We have modified this “automatic” exception from our proposal by raising the limit on contributions eligible for the exception to \$350, the same amount we have adopted as a *de minimis* threshold for contributions to an official for whom a covered associate is entitled to vote.<sup>249</sup> In addition, at the suggestion of commenters who argued that our proposed limitation on the annual use of such exception failed to take into consideration the different size of advisers,<sup>250</sup> we have modified our proposal to permit use of the exception three times in any year by an adviser that has reported on its Form ADV

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influence for too long a period of time. The condition that the contribution be discovered within four months is consistent with the MSRB’s approach. *See* MSRB rule G-37(j)(i).

<sup>248</sup> *See, e.g.*, SIFMA Letter; NASP Letter; Holl Letter; NSCP Letter; ICI Letter; MFA Letter.

<sup>249</sup> Rule 206(4)-5(3)(i)(B). No automatic exception is available for any contributions to an official for whom the covered associate is entitled to vote that exceed the *de minimis* \$350 amount. As explained above, we believe that \$350 is the appropriate *de minimis* threshold for contributions to officials for whom a covered associate is entitled to vote and \$150 is the appropriate *de minimis* threshold for contributions to officials for whom a covered associate is not entitled to vote. *See* section II.B(6) of this Release. Because these thresholds are different, we anticipate that covered associates could mistakenly make contributions up to the higher threshold under the mistaken belief that they are entitled to vote for an official when in fact they are not entitled to do so. So long as those contributions are returned and the other conditions of the exception are met, we believe they should be eligible for the automatic exception.

<sup>250</sup> *See, e.g.*, Skadden Letter; T. Rowe Price Letter; NSCP Letter; ICI Letter; IAA Letter.

registration statement that it had more than 50 employees who perform investment advisory functions.<sup>251</sup>

The exception is intended to provide advisers with the ability to undo certain mistakes. Because it operates automatically,<sup>252</sup> we believe it should be subject to conditions that are objective and limited in order to capture only those contributions that are unlikely to raise pay to play concerns.<sup>253</sup>

**(b) Ban on Using Third Parties to Solicit Government Business**

Rule 206(4)-5 makes it unlawful for any investment adviser subject to the rule or any of the adviser's covered associates to provide or agree to provide, directly or indirectly, payment<sup>254</sup> to any person to solicit<sup>255</sup> government clients for investment

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<sup>251</sup> See *supra* note 238.

<sup>252</sup> The exception is “automatic” in the sense that an adviser relying on it may do so without notifying the Commission or its staff. However, we note that the recordkeeping obligations for registered advisers mandate specifically that an adviser maintain records regarding contributions with respect to which the adviser has invoked this exception. Rule 204-2(a)(18)(ii)(D). See also section II.D of this Release.

<sup>253</sup> As discussed below in section II.B.2(f) of this Release, in other circumstances, advisers can apply to the Commission for an exemption from the rule's two-year time out. See rule 206(4)-5(e).

<sup>254</sup> The term “payment” is defined in rule 206(4)-5(5)(f) as any gift, subscription, loan, advance, or deposit of money or anything of value. Depending on the specific facts and circumstances, payment can include *quid pro quo* arrangements whereby a non-affiliated person solicits advisory business for the adviser in exchange for being hired by the adviser to provide other unrelated services. This approach is consistent with the MSRB's with regard to MSRB rule G-38's third-party solicitor ban. See MSRB, *Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), available at <http://msrb.org/msrb1/rules/notg38.htm>. But see *infra* note 257 (discussing the provision of professional services by third parties).

<sup>255</sup> For the definition of what it means to “solicit” a client or prospective client to provide investment advisory services, which we are adopting as proposed, see text accompanying note 185. This definition is consistent with the definition the MSRB employs for similar purposes in rule G-38, the MSRB's rule that restricts third-party solicitation activity. MSRB rule G-38(b)(i).

advisory services on its behalf.<sup>256</sup> The prohibition is limited to third-party solicitors. Thus, the prohibition does not apply to any of the adviser's employees, general partners, managing members, or executive officers.<sup>257</sup> Contributions by these persons, however, may trigger the two-year time out. As discussed in more detail below, the prohibition also does not apply to certain "regulated persons" that themselves are subject to prohibitions against engaging in pay to play practices.<sup>258</sup>

We proposed to prohibit advisers from paying third parties in order to prevent advisers from circumventing the rule.<sup>259</sup> We observed in the Proposing Release that solicitors or "placement agents" have played a central role in actions that we and other authorities have brought involving pay to play schemes;<sup>260</sup> in several instances, advisers allegedly made significant payments to placement agents and other intermediaries in order to influence the award of advisory contracts.<sup>261</sup> We noted that government authorities in New York and other jurisdictions have prohibited or are considering

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<sup>256</sup> Rule 206(4)-5(a)(2)(i). *See also* Proposing Release, at section II.A.3(b).

<sup>257</sup> Rule 206(4)-5(a)(2)(i). We note that, so long as non-affiliated persons providing legal, accounting, or other professional services in connection with specific investment advisory business are not being paid directly or indirectly by an investment adviser for communicating with a government entity (or its representatives) for the purpose of obtaining or retaining investment advisory business for the adviser—*i.e.*, they are paid solely for their provision of legal, accounting, or other professional services with respect to the business—they would not become subject to the ban on payments by advisers to third-party solicitors. This approach is similar to the MSRB's with regard to MSRB rule G-38's third-party solicitor ban. *See MSRB, Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), available at <http://msrb.org/msrb1/rules/notg38.htm>.

<sup>258</sup> This exception, which is responsive to commenters' concerns, is a modification of our proposal. As discussed below, we also eliminated an exception in our proposal that would have applied to "related persons" of the adviser and, if such "related person" were a company, an employee of the "related person." *See* Proposing Release, at section II.A.3(b).

<sup>259</sup> *See* Proposing Release, at section II.A.3(b).

<sup>260</sup> *Id.* at sections I and II.A.3(b).

<sup>261</sup> *Id.* at section II.A.3(b).

limiting or prohibiting the use of consultants, solicitors, or placement agents by investment advisers to solicit government business.<sup>262</sup> We considered the MSRB's experience with solicitors, which ultimately led it to ban municipal securities dealers from hiring consultants to solicit government clients after concluding that less restrictive approaches were ineffective to prevent circumvention of MSRB rule G-37.<sup>263</sup> We recalled comment letters we received in 1999 from advisers asserting that they should not

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<sup>262</sup> *Id.* Since our proposal, a few state and local governments have undertaken actions to prohibit or regulate pay to play practices involving placement agents in response to concerns about to pay to play activities in their jurisdictions. For example, New York City Comptroller John C. Liu announced reforms relating to how the New York City pension funds make investments (including prohibitions on gifts and campaign contributions, strict rules on employees of the Office of New York City Comptroller, employees and trustees of the New York City pension systems, fund managers, and placement agents, and an expansion of the ban on private equity placement agents to include placement agents to other types of funds while providing an exclusion for legitimate placement agents who provide value-added services). *See* Office of the New York City Comptroller, *Comptroller Liu Announces Major Reforms to Pension Fund Investments*, Press Release, Feb. 18, 2010, available at [http://www.comptroller.nyc.gov/press/2010\\_releases/pr10-02-022.shtm](http://www.comptroller.nyc.gov/press/2010_releases/pr10-02-022.shtm). A bill was introduced in California that would treat placement agents soliciting government entity clients as lobbyists and therefore restrict them from charging contingency fees. *See* Assem. B. 1743, 2009-10 Leg., Reg. Sess. (Cal. 2010), available at [http://info.sen.ca.gov/pub/09-10/bill/asm/ab\\_1701-1750/ab\\_1743\\_bill\\_20100208\\_introduced.html](http://info.sen.ca.gov/pub/09-10/bill/asm/ab_1701-1750/ab_1743_bill_20100208_introduced.html). *See also* Cal. Gov't. Code §86205(f) (Deering 2010). Another law was passed in California on an emergency basis imposing new disclosure obligations and prohibitions regarding placement agents. *See* Assem. B. 1854, 2009-10 Leg., Reg. Sess. (Cal. 2010) available at [http://info.sen.ca.gov/pub/09-10/statute/ch\\_0301-0350/ch\\_301\\_st\\_2009\\_ab\\_1584](http://info.sen.ca.gov/pub/09-10/statute/ch_0301-0350/ch_301_st_2009_ab_1584). *See also* CalPERS, *CalPERS Releases Placement Agent Disclosures*, Press Release, Jan. 14, 2010, available at <http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2010/jan/agent-disclosures.xml>. (discussing recent actions by CalPERS to make public more than 600 placement agent disclosures from the fund's external managers).

<sup>263</sup> *See* Proposing Release, at n.130 and accompanying text. *See also* MSRB Letter (“Due to concerns regarding questionable practices by some consultants and a determination by the MSRB that it would be in the public interest to make the process of soliciting municipal securities business fully subject to the MSRB rules of fair practice and professionalism, the MSRB rescinded its original rule in 2005 and adopted new Rule G-38, on solicitation of municipal securities business, to prohibit dealers from using paid third-party consultants to obtain municipal securities business on their behalf.”).



be held accountable for the political contributions of their third-party solicitors whom, they asserted, advisers lacked the ability to control.<sup>264</sup>

The record before us raised deeply troubling concerns about advisers' use of third-party solicitors to engage in pay to play activities.<sup>265</sup> We were concerned that a rule that failed to address the use of these solicitors would be ineffective were advisers simply to begin using solicitors and placement agents that have made political contributions or payments funded in part or in whole by the fees they receive from advisers.<sup>266</sup> Therefore, we proposed to prohibit advisers from engaging third parties to solicit government clients on their behalf.<sup>267</sup> In doing so, we requested comments on alternative approaches we

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<sup>264</sup> In 1999, the Commission proposed a similar rule, which also would have been codified as rule 206(4)-5 under the Advisers Act, had it been adopted. *See Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999) [64 FR 43556 (Aug. 10, 1999)] ("1999 Proposing Release"). Comments on that proposal received electronically (comment file S7-19-99) are *available at* <http://www.sec.gov/rules/proposed/s71999.shtml>. Among the commenters on the 1999 Proposing Release who argued that advisers should not be held accountable for the political contributions of their third-party solicitors are: Comment Letter of Davis Polk (Nov. 1, 1999); Comment Letter of Legg Mason (Nov. 1, 1999); Comment Letter of MSDW (Nov. 1, 1999). At least one commenter on our 2009 proposal, although opposing the proposed third-party solicitor ban, took the same view. *See* MFA Letter ("We strongly agree with the SEC's comment in the Release that "covered associates" should not include employees of entities unaffiliated with an investment adviser, such as the employees of a third-party placement agent. An investment adviser would not have the authority or capability to monitor and restrict political contributions made by individuals not employed by the adviser.").

<sup>265</sup> *See* Proposing Release, at section I; section I of this Release. Moreover, "no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic." *Blount*, 61 F.3d at 945.

<sup>266</sup> *See* Proposing Release, at section II.A.3(b). Some commenters have supported this approach. *See, e.g.,* Fund Democracy/Consumer Federation Letter ("Permitting advisers to circumvent pay-to-play restrictions by hiring solicitors would eviscerate the heart of the direct prohibition against advisers' bribing politicians in return for money management contracts."). We also noted commenters' concerns regarding the difficulties advisers face in monitoring the activities of their third-party solicitors. *See* Proposing Release, at section II.A.3(b).

<sup>267</sup> *See* Proposing Release, at section II.A.3(b).

could take.<sup>268</sup> We wanted to know whether there might be a more effective means to accomplish our objectives, or means that would be less restrictive.

We received a large number of comments on this question. We received letters from the New York State Comptroller and New York City Comptroller that expressed strong support for the ban on using third parties to solicit government plans.<sup>269</sup> One commenter supporting the ban pointed out the key role that placement agents have played in pay to play practices.<sup>270</sup> It expressed concern that adopting the rule without the ban would exacerbate the problem by placing more pressure on advisers to pay “well-connected” placement agents for access since the advisers will be limited in their contributions.<sup>271</sup> Another commenter expressed the view that “the most egregious violations of the public trust in this area have come from placement agents and those seeking finder’s fees. The outright ban on their use to deter pay-to-play schemes is entirely appropriate.”<sup>272</sup>

Most commenters, including many representing advisers, broker-dealers, placement agents and solicitors, and some government officials, however, strongly opposed the ban. Many asserted that solicitors, consultants and placement agents provide valuable services both for advisers seeking clients and for the public pension plans that

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<sup>268</sup> *See id.*

<sup>269</sup> DiNapoli Letter; Thompson Letter (as indicated in note 262 above, NYC Comptroller Liu recently announced his office’s approach to third-party solicitors).

<sup>270</sup> Fund Democracy/Consumer Federation Letter.

<sup>271</sup> *Id.*

<sup>272</sup> Common Cause Letter. *See also* Cornell Law Letter (generally supporting the prohibition on using third-party solicitors “given that third-party solicitors have played a central role in each of the enforcement actions against investment advisers that the Commission has brought in the past several years involving pay-to-play schemes.”).

employ them and that banning their use would have several deleterious effects.<sup>273</sup>

Several claimed that the rule would favor banks because banks are excluded from the definition of “investment adviser” under the Advisers Act and therefore are not subject to the Commission’s rules, including rule 206(4)-5.<sup>274</sup> Others claimed the rule would favor larger investment advisers (which have internal marketing departments) over smaller firms.<sup>275</sup> Other commenters asserted the ban would harm smaller pension funds that do

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<sup>273</sup> See, e.g., Comment Letter of Senator Christopher J. Dodd (Feb. 2, 2010) (“Dodd Letter”); NY City Bar Letter; Dechert Letter; ABA Letter; Comment Letter of Teacher Retirement System of Texas (Oct. 12, 2009); Comment Letter of Bryant Law (Oct. 9, 2009) (“Bryant Law Letter”); Comment Letter of Probitas Partners (Oct. 6, 2009) (“Probitas Letter”); Comment Letter of Larry Simon (Oct. 6, 2009) (“Simon Letter”); Comment Letter of MarketCounsel, LLC (Oct. 6, 2009); ICI Letter; Comment Letter of Colorado Public Employees’ Retirement Association (Oct. 6, 2009); Skadden Letter.

<sup>274</sup> See Advisers Act section 202(a)(11)(A) [15 U.S.C. 80b-2(a)(11)(A)] (excepting from the definition of “investment adviser,” and therefore from regulation under the Advisers Act, “a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company . . .”). We discuss possible competitive effects of our rule’s inapplicability to banks in section VI of this Release. We believe that the concerns the rule is designed to address, as discussed throughout this Release, warrant its adoption, notwithstanding these potential competitive effects.

<sup>275</sup> See, e.g., SIFMA Letter; IAA Letter; MFA Letter; Comment Letter of National Conference on Public Employee Retirement Systems (Oct. 6, 2009) (“NCPERS Letter”); Comment Letter of European Private Equity & Venture Capital Association (Sept. 9, 2009) (“EVCA Letter”); Seward & Kissel Letter; Comment Letter of Sadis & Goldberg LLP (Oct. 2, 2009) (“Sadis & Goldberg Letter”); Comment Letter of State of Wisconsin Investment Board (Aug. 31, 2009) (“WI Board Letter”); Comment Letter of the Executive Director of Georgia Firefighters’ Pension Fund, James R. Meynard, (Sept. 3, 2009) (“GA Firefighters Letter”); Comment Letter of Minnesota State Board of Investment (Sept. 8, 2009) (“MN Board Letter”); Comment Letter of Illinois Public Pension Fund Association (Sept. 29, 2009) (“IL Fund Association Letter”); Comment Letter of Melvyn Aaronson, Sandra March and Mona Romain, Trustees of the Teachers’ Retirement System of the City of New York (Oct. 1, 2009) (“NYC Teachers Letter”); Comment Letter of the Texas Association of Public Employee Retirement Systems (Oct. 6, 2009) (“TX Public Retirement Letter”); Comment Letter of the Pennsylvania Public School Employees’ Retirement Board (Oct. 6, 2009) (“PA Public School Retirement Letter”); Comment Letter of the California State Association of County Retirement Systems (Sept. 8, 2009) (“CA Assoc. of County Retirement Letter”); Caplin & Drysdale Letter; Comment Letter of Paul Ehrmann (Aug. 10, 2009) (“Ehrmann Letter”); Comment Letter of Joseph Finn (Aug. 10, 2009) (“Finn Letter”); Comment Letter of the Managing Partner of The Savanna Real Estate Fund I, LLP, Nicholas Bienstock (Aug. 11, 2009) (“Savanna Letter”); Comment Letter of Atlantic-Pacific Capital, Inc. (Aug. 12, 2009) (“Atlantic-Pacific Letter”); Comment Letter of Tricia Peterson (Aug. 14, 2009)

not have the resources to conduct a search for advisers on their own, and harm advisers that rely on the services that placement agents provide.<sup>276</sup> A number of commenters argued that the prohibition would reduce competition by reducing the number of advisers competing for government business,<sup>277</sup> and limit the universe of investment opportunities presented to public pension funds.<sup>278</sup>

Many of these commenters conceded that there is a problem with placement agents and other intermediaries, but asserted it is caused by a few bad actors, for which an entire industry should not be penalized.<sup>279</sup> A common theme among many

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(“Peterson Letter”); Comment Letter of Devon Self Storage Holdings (US) LLC (Aug. 21, 2009) (“Devon Letter”); Comment Letter of Thomas Capital Group, Inc. (Aug. 24, 2009) (“Thomas Letter”); Comment Letter of Stephen R. Myers (Aug. 26, 2009) (“Myers Letter”); Comment Letter of Chaldon Associates LLC (Aug. 26, 2009) (“Chaldon Letter”); Comment Letter of The Meridian Group (Aug. 26, 2009) (“Meridian Letter”); Comment Letter of Benedetto, Gartland & Company, Inc. (Sept. 30, 2009) (“Benedetto Letter”); Comment Letter of the Partners of CSP Securities, LP and Capstone Partners, LP (Sept. 17, 2009) (“Capstone Letter”); Comment Letter of Presidio Partners LLC Managing Partner Alan R. Braxton (Sept. 21, 2009) (“Braxton Letter”); Comment Letter of Littlejohn & Co., LLC (Sept. 14, 2009) (“Littlejohn Letter”); Comment Letter of Alta Communications (Sept. 18, 2009) (“Alta Letter”); Comment Letter of Charles River Realty Investors LLC (Sept. 23, 2009) (“Charles River Letter”); Comment Letter of W. Allen Reed (Sept. 19, 2009) (“Reed Letter”); Comment Letter of Glovista Investments LLC (Sept. 23, 2009) (“Glovista Letter”); Comment Letter of The Blackstone Group (Sept. 14, 2009) (“Blackstone Letter”); Park Hill Letter. Two commenters noted that the ban would result in less transparency as these services go “in-house.” CalPERS Letter; Bryant Law Letter. Others commented on the effects on minority and women-owned firms. *See, e.g.*, NYC Teachers Letter, Myers Letter; GA Firefighters Letter; MN Board Letter; Blackstone Letter.

<sup>276</sup> *See, e.g.*, Dodd Letter; NY City Bar Letter; Dechert Letter; ABA Letter; Probitas Letter; Seward & Kissel Letter; MFA Letter.

<sup>277</sup> *See, e.g.*, Seward & Kissel Letter; Meridian Letter; NY City Bar Letter; Probitas Letter; Simon Letter; MFA Letter.

<sup>278</sup> *See, e.g.*, SIFMA Letter; IAA Letter; Strategic Capital Letter; Alta Letter; Benedetto Letter; Comment Letter of Jim Glantz (Sept. 24, 2009) (“Glantz Letter”); Comment Letter of Venera Kurmanaliyeva (Sept. 15, 2009) (“Kurmanaliyeva Letter”); Park Hill Letter.

<sup>279</sup> *See, e.g.*, Comment Letters of Brady Pyeatt (Aug. 4, 2009) & (Oct. 6, 2009); Comment Letter of Andrew Wang (Aug. 10, 2009); Comment Letter of Monomoy Capital Management, LLC (Aug. 25, 2009) (“Monomoy Letter”); Comment Letter of Ted Carroll

commenters was that the rule failed to distinguish “illegitimate” consultants and placement agents from the “legitimate” ones who provide an important service.<sup>280</sup>

We believe that many of the comments overstate the likely consequences of adoption of the rule. First, the rule will not prevent public pension plans from hiring their own consultants—*i.e.*, using their own resources—to assist them in their search for an investment adviser.<sup>281</sup> These consultants would have access to information about smaller advisers whose services may be appropriate for the plan. Many public pension plans already make—or are required to make—specific accommodations for so-called “emerging money managers” that otherwise may have difficulty getting noticed by public pension plans.<sup>282</sup> Second, these commenters failed to consider the potentially significant

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(Aug. 4, 2009); Comment Letter of James C. George (Sept. 10, 2009) (“George Letter”); Comment Letter of Ariane Capital Partners LLC (Sept. 17, 2009); Blackstone Letter; Comment Letter of Nancy Fossland (Sept. 16, 2009); Comment Letter of Steven A. Friedmann (Sept. 14, 2009); Comment Letter of Keith P. Harney (Sept. 15, 2009); Comment Letter of Robert F. Muhlhauser III (Sept. 14, 2009); Comment Letter of XT Capital Partners, LLC (Sept. 30, 2009); CapLink Letter.

<sup>280</sup> See, *e.g.*, Bryant Law Letter; Comment Letter of Hedgeforce (Oct. 6, 2009) (“Hedgeforce Letter”).

<sup>281</sup> See Fund Democracy/Consumer Federation Letter (“The proposed ban would “deny access” to nothing. There is nothing [in the proposed rule] preventing pension funds from retaining their own consultants whose sole responsibility is to the pension fund and its beneficiaries.”).

<sup>282</sup> See, *e.g.*, Randy Diamond, *CalPERS CIO Joe Dear says Emerging Managers Don’t Need Placement Agents*, PENSIONS & INVESTMENTS, Feb. 24, 2010, available at <http://www.pionline.com/article/20100224/REG/100229965>; Michael Marois, *CalPERS, Blackstone Clash over Placement Agent ‘Jackpot’ Fees*, BLOOMBERG (Apr. 7, 2010), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acPNrTn1q7pw> (quoting CalPERS CIO Joe Dear, “There’s clear evidence in past practice that it’s possible to develop an investment relationship with us by making a normal approach, without the assistance of a contingent-paid placement agent.”); Ohio Pub. Employees Ret. Sys., *Ohio-Qualified and Minority Manager Policy* (May 2006), available at <https://www.opers.org/pdf/investments/policies/Ohio-Qualified-Minority-Manager-Policy.pdf>; Teachers’ Ret. Sys. of the State of Ill., Fiscal Year 2009 Annual Report on the use of Women, Minority and Disabled-Owned (W/MBE) Investment Advisors and Broker/Dealers (Aug. 31, 2009), available at

costs of hiring consultants and placement agents,<sup>283</sup> which already may make them unavailable to smaller advisers. Eliminating the cost of pay to play may, in fact, provide greater access to pension plans by those advisers which are unable to afford the costs of direct or indirect political contributions or placement agent fees.<sup>284</sup> We expect that prohibiting pay to play may reduce the costs to plans and their beneficiaries of inferior asset management services arising from adviser selection based on political contributions rather than investment considerations.<sup>285</sup> Finally, commenters failed to identify any

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<http://trs.illinois.gov/subsections/investments/minorityrpt.pdf>; Md. State Ret. and Pension Sys., *Terra Maria: The Maryland Developing Manager Program*, available at <http://www.sra.state.md.us/Agency/Investment/Downloads/TerraMariaDevelopingManagerProgram-Description.pdf>; Thurman V. White, Jr., Progress Inv. Mgmt. Co., *Successful Emerging Manager Strategies for the 21<sup>st</sup> Century*, 3 (2008), available at [http://www.progressinvestment.com/content/files/successful\\_emerging\\_manager\\_strategies.pdf](http://www.progressinvestment.com/content/files/successful_emerging_manager_strategies.pdf) (containing a “representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies”).

<sup>283</sup> One commenter made a similar point: “The proposed ban would simply replace the indirect cost of placement agents incurred by pension plan sponsors with the direct cost of hiring their own placement agents—without the conflict of interest and potential for abuse that relying on advisers’ placement agents creates. It is not the cost of independent advice that the Commission has not accounted for in its proposal, but the cost of conflicts that critics have failed to acknowledge in their analysis.” Fund Democracy/Consumer Federation Letter.

<sup>284</sup> At least one commenter agreed. See Butler Letter (“[W]e find some evidence that the pay to play practices by underwriters [before rule G-37 was adopted] distorted not only the fees, but which firms were allocated business. The current proposal mentions that pay to play practices may create an uneven playing field among investment advisers by hurting smaller advisers that cannot afford to make political contributions. We find evidence that is consistent with this view [in our research on pay to play by municipal underwriters]. During the pay to play era, municipal bonds were underwritten by investment banks with larger underwriting market shares compared to afterward. One interpretation of this result is that smaller underwriters were passed over in favor of larger underwriters (who presumably had deeper pockets for political contributions).”). As we indicated in the Proposing Release, pay to play practices may hurt smaller advisers that cannot afford the required contributions. Curtailing pay to play arrangements enables advisory firms, particularly smaller advisory firms, to compete on merit, rather than their ability or willingness to make contributions. See Proposing Release, at sections I and IV.

<sup>285</sup> See Tobe Letter (describing an under-performing money manager that was fired after the commenter, a pension official, began to inquire into how it was selected); Weber Letter (“I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the

meaningful way in which our rule might distinguish “legitimate” from “illegitimate” solicitors or placement agents. Even solicitors and placement agents that engage in pay to play may appear to operate “legitimately.”<sup>286</sup>

Some commenters suggested alternatives to our proposed ban to address our concern that pay to play activities are often carried out through or with the assistance of third parties.<sup>287</sup> Several commenters, for example, suggested that we instead require greater disclosure by advisers of payments to solicitors.<sup>288</sup> Such an approach could be

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fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen.”).

<sup>286</sup> See *Blount*, 61 F.3d at 944 (“actors in this field are presumably shrewd enough to structure their relations rather indirectly”).

<sup>287</sup> We note that, in addition to the alternatives discussed below, some commenters called for approaches outside the scope of our authority, such as an outright ban on all political contributions by third-party solicitors, the imposition of criminal penalties, or modification of the structure of pension boards. See, e.g., Monomoy Letter (arguing that the Commission or the appropriate criminal authority should mandate jail time for public officials and intermediaries where the official gets a benefit from a public fund investment in a particular fund, that all managers of intermediaries who receive fees in such transactions should be banned from the financial services industry for life, and that all members of the general partner (manager) of the fund in which the investment is made be banned from the financial services industry for life); NCPERS Letter (arguing that the most effective method of eliminating pay to play is by having multiple trustees on public pension boards); Thomas Letter (suggesting that stronger internal control procedures, segregation of duties and dispersed or committee approval of granting pension business could help prevent pay to play activities, each of which historically has involved a complicit senior public plan fund official); Comment Letter of the Massachusetts Pension Reserves Investment Management Board (Aug. 26, 2009) (“PRIM Board Letter”); Preqin Letter I (acknowledging that it is outside the remit of the Commission, but arguing that there should be better oversight of public pension funds, and investment committees should consist of a minimum number of members in order to prevent a sole official being responsible for the investment-decision process); Triton Pacific Letter (arguing that the Commission should adopt regulation of pension officials who are often responsible for initiating pay to play arrangements).

<sup>288</sup> Several commenters urged us to require advisers to disclose to clients their payments to third-party solicitors and placement agents. See, e.g., ABA Letter; 3PM Letter; ICI Letter; NY City Bar Letter; Comment Letter of Forum Capital Securities, LLC (Oct. 5, 2009) (“Forum Letter”); Jones Day Letter; CapLink Letter. Some asserted that existing disclosure requirements, such as those included in the Commission’s investment adviser cash solicitation rule, are sufficient to address pay to play. See, e.g., Comment Letter of

helpful to give plan fiduciaries information necessary for them to satisfy their legal obligations and uncover abuses,<sup>289</sup> but it would not be useful when plan fiduciaries themselves are participants in the pay to play activities.<sup>290</sup> In addition, as one commenter pointed out, the MSRB had already sought unsuccessfully to address the problem of placement agents and consultants engaging in pay to play activities on their principals' behalf through mandating greater disclosure.<sup>291</sup>

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Steven Rubenstein (Aug. 17, 2009) (“Rubenstein Letter”) (noting that Advisers Act rule 206(4)-3 [17 CFR 275.206(4)-3], the “cash solicitation rule,” is adequate as is, but “just needs to be followed”); Thomas Letter (supporting “enforcement of existing disclosure rules”); Chaldon Letter (arguing that, in the scandals that have recently occurred, if the fee sharing arrangements had been disclosed to pension fund boards, no law or regulation would have been violated, and that third-party marketers should adhere to current law instead of banning a legitimate business practice); Comment Letter of Ray Wirta (Sept. 4, 2009) (arguing that all that is necessary is that penalties should be heightened, enforcement stepped up and results highly publicized); Arrow Letter (arguing that enforcement of the Advisers Act and FINRA requirements have ensured lawful and ethical business practices for decades); 3PM Letter (arguing that the rule’s scope could be extended to include various additional disclosures). But we do not believe, for the reasons described above, that enforcement of existing obligations alone is sufficient to deter pay to play activities.

<sup>289</sup> Some public pension plans have adopted policies requiring advisers they hire to disclose information about placement agents, including their political connections. *See, e.g.,* Cal. Pub. Employees Ret. Sys., *CalPERS Adopts Placement Agent Policy – Requires Disclosure of Agents, Fees*, Press Release (May 11, 2009), available at <http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2009/may/adopts-placement-agent-policy.xml>.

<sup>290</sup> For examples of cases in which plan fiduciaries themselves have allegedly participated in pay to play activities involving placement agents, see *New York v. Henry “Hank” Morris and David Loglisci*, Indictment No. 25/2009 (NY Mar. 19, 2009) (a public official was alleged to be a beneficiary of the pay to play activities); *SEC v. Paul J. Silvester, et al.*, Litigation Release No. 16759, Civil Action No. 3:00-CV-19411 DJS (D. Conn. 2000) (former Connecticut State Treasurer was alleged to be a beneficiary of a pay to play scheme in which an investment adviser to a private equity fund had paid third-party solicitors to obtain public pension fund investments in the fund). *See also* Proposing Release, at n.49 (discussing additional reasons why we believe a disclosure approach would not effectively address our concerns regarding pay to play activities).

<sup>291</sup> Cornell Law Letter (“For example, after concluding that required disclosure was neither adequate to prevent circumvention nor consistently being made, the [MSRB] amended its own rules on pay-to-play practices in the municipal securities markets to impose a complete ban on the use of third-party consultants to solicit government clients.” (citations omitted)). *See also* 3PM Letter (acknowledging that, although increased



Other commenters recommended that we rely on voluntary industry codes of conduct.<sup>292</sup> But we believe, in light of the growing body of evidence of advisers' use of third-party solicitors to engage in pay to play activities we describe above, that voluntary actions are insufficient to deter pay to play, which may yield lucrative management contracts.<sup>293</sup> As we discuss above, pay to play involves a "collective action" problem that is unlikely to be resolved by voluntary actions.<sup>294</sup> Elected officials who accept contributions from state contractors may believe they have an advantage over their opponents who foreswear the contributions, and firms that do not "pay" may fear that they will lose government business to those that do.<sup>295</sup>

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transparency by all parties involved in the investment process who might have the ability to exert influence, including advisers, third-party marketers, public officials or other trustees, etc., is necessary to minimize the adverse effects of pay to play, the issue will not be completely solved by disclosure).

<sup>292</sup> See, e.g., MVision Letter (arguing that self-regulatory initiatives such as the EVCA's Code of Conduct for Placement Agents are working and that many public pension plans' own anti-pay to play policies have been successful); EVCA Letter (describing its Code of Conduct that prohibits pay to play and is supported by various stakeholders and arguing that it, along with strong punishment of wrongdoers, should restore confidence in the process). Another commenter suggested a code of conduct enforceable by regulators. Comment Letter of Charlie Eaton on behalf of a Coalition of Professional Institutional Placement Agents (Sept. 9, 2009) (proposing an industry Code of Conduct that could be enforced by FINRA and the Commission, which should ban firms that do not adhere from doing business with all potential investors, public and private). In our view, the rule we are adopting today not only essentially serves this purpose, but more appropriately reflects prohibitions we, instead of others, have determined appropriately address our concerns.

<sup>293</sup> See Proposing Release, at sections I and II.A.3(b). See also section I of this Release.

<sup>294</sup> See *supra* note 58 and accompanying text.

<sup>295</sup> See *Blount*, 61 F.3d at 945-46 (describing the parallel dynamics applicable in municipal underwriting, "As beneficiaries of the practice, politicians vying for state or local office may be reluctant to stop it legislatively; some, of course, may seek to exploit their rivals' cozy relation with bond dealers as a campaign issue, but if they refuse to enter into similar relations, their campaigns will be financially handicapped. Bond dealers are in a still worse position to initiate reform: individual firms that decline to pay will have less chance to play, and may even be the object of explicit boycott if they do.").

Other commenters recommended that we amend our rules to require that advisers amend their codes of ethics to monitor contributions by third-party solicitors.<sup>296</sup> But advisers using third-party solicitors to circumvent pay to play restrictions are well aware of these payments, and are unlikely to be deterred by a monitoring requirement. In addition, adviser codes of ethics are unlikely to be a sufficient means to induce third-party solicitors to be transparent about their own pay to play activities.

Instead of suggesting alternative approaches, other commenters urged us to apply the rule more narrowly by exempting from the ban solicitors that are registered broker-dealers or associated persons of broker-dealers.<sup>297</sup> Some were concerned that the rule would interfere with traditional distribution arrangements of mutual funds and private funds, which are usually distributed by registered broker-dealers that may be compensated by the adviser in some form.<sup>298</sup> Many argued that registration as a broker-dealer generally differentiates placement agents that provide “legitimate” services from

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<sup>296</sup> See, e.g., ABA Letter; 3PM Letter; ICI Letter; NY City Bar Letter; Forum Letter; Jones Day Letter.

<sup>297</sup> See, e.g., Davis Polk Letter; Comment Letter of UBS Securities LLC (Oct. 2, 2009) (“UBS Letter”).

<sup>298</sup> See, e.g., SIFMA Letter; NY City Bar Letter; Monomoy Letter; IAA Letter. Mutual fund distribution fees are typically paid by the fund pursuant to a 12b-1 plan, and therefore generally would not constitute payment by the fund’s adviser. As a result, such payments would not be prohibited by rule 206(4)-5 by its terms. Where an adviser pays for the fund’s distribution out of its “legitimate profits,” however, the rule would generally be implicated. For a discussion of a mutual fund adviser’s ability to use “legitimate profits” for fund distribution, see *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73898 (Nov. 7, 1980)] (explaining, in the context of the prohibition on the indirect use of fund assets for distribution, unless pursuant to a 12b-1 plan, “[h]owever, under the rule there is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources . . . . Profits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the [Investment Company] Act.”). For private funds, third parties are often compensated by the adviser or its affiliated general partner and, therefore, those payments are subject to the rule. Structuring such a payment to come from the private fund for the purpose of evading the rule would violate the rule. See Rule 206(4)-5(d).

those that merely offer political influence.<sup>299</sup> Others expressed concern that some broker-dealer firms that rely on placement agent business could be harmed.<sup>300</sup> We recognize that services that commenters have identified as beneficial would typically require broker-dealer registration. But registration under the Exchange Act does not preclude a broker-dealer from participating in pay to play practices—MSRB rules G-37 and G-38 do not apply, for example, to broker-dealers soliciting investments on behalf of investment companies or private funds.<sup>301</sup> Thus, amending our rule to limit third parties soliciting governments to broker-dealers registered under the Exchange Act would not achieve the prophylactic purpose of this rulemaking. We believe that our approach is appropriate in light of the concerns we are seeking to address.<sup>302</sup>

Several commenters proposed that we achieve our goals by permitting advisers to engage solicitors and placement agents that are registered broker-dealers and subject to rules similar to those adopted by the MSRB.<sup>303</sup> One asserted that such rules would be “a

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<sup>299</sup> See, e.g., Bryant Law Letter; Hedgeforce Letter; Comment Letter of Girard Miller (Aug. 8, 2009); Comment Letter of Frank Schmitz (Aug. 11, 2009) (“Schmitz Letter”); Atlantic-Pacific Letter; Rubenstein Letter; Thomas Letter; Monomoy Letter; MVision Letter; Comment Letter of Lime Rock Management (Sept. 28, 2009); Benedetto Letter; Strategic Capital Letter; Comment Letter of Portfolio Advisors, LLC (Oct. 2, 2009) (“Portfolio Advisors Letter”); UBS Letter; Comment Letter of Brian Fitzgibbon (Oct. 5, 2009); Comment Letter of GenNx360 Capital Partners, L.P. (Oct. 5, 2009).

<sup>300</sup> Comment Letter of the National Association of Independent Broker-Dealers (Oct. 5, 2009).

<sup>301</sup> At least one commenter suggested that there are “inherent” safeguards in the broker-dealer regulatory regime sufficient to protect against pay to play practices. See, e.g., ABA Letter. But the broker-dealer regulatory regime does not specifically address pay to play activities, as demonstrated by the MSRB’s adoption of rules G-37 and G-38.

<sup>302</sup> We acknowledge that there are costs associated with our rule. For further analysis of these, along with the benefits, see sections I and IV of this Release.

<sup>303</sup> Skadden Letter (“The Commission and FINRA could directly impose and enforce restrictions on such broker-dealers.”); Davis Polk Letter (“Registered broker-dealers that provide legitimate placement agent services could be required by the Commission to comply with “pay-to-play” restrictions”); Credit Suisse Letter (preclude an investment

logical extension of the already-existing regulatory scheme governing broker-dealers.”<sup>304</sup>

Another agreed, arguing that such rules would be consistent with the approach the MSRB took when it adopted MSRB rule G-38, the effect of which was to sweep “all solicitors of municipal business (underwriting, sales and advisory) into the broker-dealer registration regime” where they would be subject to oversight of a registered broker-dealer and are required to conform their municipal securities activities to applicable MSRB rules, including MSRB rule G-37.<sup>305</sup> Others suggested we could similarly achieve our goals by

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adviser from using a placement agent that is not subject to pay to play restrictions analogous to rule G-37); Comment Letter of the President of M Advisory Group J. Daniel Vogelzang (Sept. 18, 2009) (“M Advisory Letter”) (treat “[a]ll placement agents, investment advisers and consultants . . . exactly the same regarding prohibited political contributions; *i.e.*, a two-year ban on doing business with any governmental agency to which a prohibited political contribution is made.”). *See also* Comment Letter of Hudson Capital Management (NY), L.P. (Oct. 5, 2009) (suggesting Commission take measures to properly license and regulate third-party solicitors); SIFMA Letter (“The pay-to-play and political activity of registered placement agents involved in soliciting government investment could . . . be directly regulated under the Exchange Act.”). We believe our rule, as adopted, which allows advisers to pay certain regulated third parties to solicit government clients on their behalf, addresses these concerns. *See infra* notes 312-26 and accompanying text.

<sup>304</sup> Davis Polk Letter.

<sup>305</sup> SIFMA Letter (“Although Rule G-38(a) specifically prohibits a municipal dealer from paying a fee to a nonaffiliated person for solicitation of municipal securities business, the policies underlying Rule G-38 were to bring solicitors within the purview of the federal securities laws — not to exclude the involvement of registered broker-dealers, including those registered broker-dealers not affiliated with advisers and private funds.”). *See also* Monument Group Letter (“We believe that MSRB Rule G-38 is not analogous to the proposed rule. Rule G-38 permits a broker-dealer that is unaffiliated with an issuer to market that issuer’s securities to a public pension plan or any other investor. Proposed Rule 206(4)-5(a)(2)(i) prevents this and seeks to entirely disintermediate the process between the issuer of a security and the ultimate investor.”); Credit Suisse Letter (“[W]e strongly believe that a more complete analogy to the MSRB Pay-to-Play Rules would not preclude regulated broker-dealers from performing placement agent services in the context of municipal investors, as the Proposed Rule would do. Notably, the MSRB Pay-to-Play Rules do not preclude SEC-registered broker-dealers from acting as placement agents to municipal issuers. Instead, the MSRB Pay-to-Play Rules subject such placement agents to “pay-to-play” restrictions and requirements and preclude them from retaining unregulated third-party finders and solicitors.”).

permitting advisers to engage as solicitors registered investment advisers that are themselves subject to pay to play restrictions under an Advisers Act rule.<sup>306</sup>

We are persuaded by these comments and have decided to revise the proposed rule to permit advisers to make payments to certain “regulated persons” to solicit government clients on their behalf.<sup>307</sup> As described in more detail below, “regulated persons” include certain broker-dealers and registered investment advisers that are themselves subject to prohibitions against participating in pay to play practices and are subject to our oversight and, in the case of broker-dealers, the oversight of a registered national securities association, such as FINRA.<sup>308</sup> As one commenter observed, “the Commission would have the direct authority to determine these restrictions as well as the oversight, control and enforcement of penalties over any violations. The restrictions could be tailored to operate with the same underlying purpose and effect on [solicitors] as the “pay-to-play” restrictions imposed on investment advisers.”<sup>309</sup> We believe that the application of such rules would provide an effective deterrent to these solicitors or placement agents from participating in pay to play arrangements because political contributions or payments would subject solicitors to similar consequences, as discussed

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<sup>306</sup> See, e.g., IAA Letter.

<sup>307</sup> See Rule 206(4)-5(a)(2)(i).

<sup>308</sup> Rule 206(4)-5(f)(9). See *supra* note 85 (noting that, in this Release, we will refer directly to FINRA, currently the only registered national securities association). As noted below, under the definition of “regulated persons” as it applies to brokers, the Commission must find, by order, that a registered national securities association’s pay to play rule applicable to such brokers imposes substantially equivalent or more stringent restrictions on them than rule 206(4)-5 imposes on investment advisers and that such rule is consistent with the objectives of rule 206(4)-5. Rule 206(4)-5(f)(9)(ii)(B).

<sup>309</sup> Davis Polk Letter.

below.<sup>310</sup> Because rule 206(4)-5 prohibits an adviser from compensating a registered adviser solicitor for solicitation activities if that adviser solicitor does not meet the definition of “regulated person,” the adviser that hired the solicitor must immediately cease compensating a solicitor that no longer meets these conditions.<sup>311</sup>

In light of our decision to permit advisers to make payments to certain “regulated persons,” described below, to solicit government clients on their behalf, we no longer believe that our proposed exception from the prohibition on advisers paying third-party solicitors for payments to related persons and employees of related person companies of the adviser is necessary.<sup>312</sup> We had proposed the exception to enable advisers to compensate these persons for government entity solicitation activities because we recognized there may be efficiencies in allowing advisers to rely on these particular types

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<sup>310</sup> Another group of commenters argued that third-party solicitors should be treated as covered associates—that is, their contributions should trigger the two-year ban for advisers that hire them. *See, e.g.*, ABA Letter; 3PM Letter; ICI Letter; NY City Bar Letter; Forum Letter; Jones Day Letter. In explaining our rejection of this approach in the Proposing Release, we noted that this approach—which we included our 1999 pay to play proposal—was criticized by commenters at that time. *See* Proposing Release, at section II.A.3(b). They primarily argued that it was unfair to impute the activities of third parties to advisers, especially given what they perceived as the harsh consequences caused by a triggering contribution—*i.e.*, a two-year time out imposed on the adviser. *See id.* They further argued that an approach in which contributions by third-party solicitors triggered a two-year time out for an adviser would create over-burdensome compliance challenges because the adviser could not meaningfully control the contribution activities of such third parties. *See id.* We continue to be sympathetic to these concerns and believe that an approach in which a contribution by a third party triggered a two-year time out for the adviser that hires the third party as a solicitor could lead to unfair consequences. *See, e.g.*, Capstone Letter; Monument Group Letter; Park Hill Letter. For example, if a solicitor gives a triggering contribution in order to assist one client, we are concerned about the harsh result that such a contribution could have on all of the solicitor’s other clients seeking business with the same prospective government entity client.

<sup>311</sup> It would be a violation of the rule for an adviser to compensate a third party for solicitation of government entity clients at any time that third party did not meet the definition of “regulated person,” regardless of whether the “regulated person” failed to meet the definition at the time it was hired or subsequently.

<sup>312</sup> *See* Proposing Release, at section II.A.3(b).

of persons to assist them in seeking clients. We requested comment regarding whether the exception would undermine the rule's efficacy by allowing advisers to compensate certain employees of related person companies whose contributions would not have triggered the two-year time out. Although we did not receive comment specifically addressing our concern,<sup>313</sup> we believe the approach we are adopting that allows advisers to pay "regulated persons" to solicit government entities on their behalf will still allow advisers to use employees of certain related companies—*i.e.*, of those related companies that qualify as "regulated persons"—as solicitors.<sup>314</sup>

### **(1) Registered Broker-Dealers**

Registered national securities association rules of similar scope and consequence as the rule we are today adopting could sufficiently satisfy the concerns that led us to propose to prohibit advisers from paying brokers to solicit potential government clients. Advisers could not easily use placement agents covered by such rules to circumvent rule 206(4)-5. Under this approach, placement agents would be deterred from engaging in pay to play directly on account of the registered national securities association's rules.

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<sup>313</sup> One commenter asked that we clarify the proposed exception for related parties (Sutherland Letter) and another recommended a case-by-case determination of whether independent contractors may be eligible for the exception, due to concern for life insurance agents who may not technically have qualified as "employees" for purposes of the exception (Skadden Letter). As noted, however, we have eliminated this exception in favor of allowing advisers to pay "regulated persons," affiliated or not, to solicit government clients on their behalf.

<sup>314</sup> We acknowledge that some advisers may have to bear certain additional costs of hiring outside parties as a result of our elimination of our proposal's "related person" exception, which would have allowed advisers to compensate related persons that are not registered broker-dealers or advisers for solicitation activities. For a discussion of costs relating to the rule, see section IV of this Release. But, we also note that the rule, as adopted, does not favor an adviser with affiliates (which our proposal would have allowed an adviser to use to solicit on its behalf) over another adviser without affiliates. Instead, our rule, as adopted, allows an adviser to pay a "regulated person" affiliated or not, to solicit on its behalf.

There would be no need for the Commission to prove in an enforcement action that a contribution by a placement agent amounted to an indirect contribution by the investment adviser because the placement agent itself could be charged with violating the registered national securities association's rules. Therefore, as adopted, rule 206(4)-5 allows an adviser to compensate "regulated persons," which includes registered brokers subject to a registered national securities association's rules, for soliciting government clients on its behalf.<sup>315</sup> An adviser may engage a registered broker to solicit government clients on its behalf so long as the broker continues to meet the definition of "regulated person" throughout its engagement as a solicitor by the adviser.

For a broker-dealer to be a "regulated person" under rule 206(4)-5, the broker-dealer must be registered with the Commission and be a member of a registered national securities association that has a rule: (i) that prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made; and (ii) that the Commission finds both to impose substantially equivalent or more stringent restrictions on broker-dealers than rule 206(4)-5 imposes on investment advisers and to

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<sup>315</sup> Rule 206(4)-5(a)(2)(i) (which prohibits advisers and their covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party other than a regulated person to solicit a government entity for investment advisory services on behalf of such investment adviser). Rule 206(4)-5 defines a "regulated person" to include a "broker," as defined in section 3(a)(4) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)(4)] or a "dealer," as defined in section 3(a)(5) of that Act [15 U.S.C. 78c(a)(5)], that is registered with the Commission, and is a member of a registered national securities association registered under section 15A of that Act [15 U.S.C. 78o-3], *provided that* (A) the rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and (B) the Commission finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers than [rule 206(4)-5] imposes on investment advisers and that such rules are consistent with the objectives of [rule 206(4)-5]. The rule's definition of "regulated person" also includes certain investment advisers. *See infra* text accompanying note 323.



be consistent with the objectives of rule 206(4)-5.<sup>316</sup> We have included the requirement that a broker-dealer, in order to qualify as a regulated person, be subject to a pay to play rule of a registered national securities association of which it is a member so that brokers seeking to act as placement agents for investment advisers are, in turn, adequately deterred from engaging in pay to play activities on behalf of those advisers by such a rule.

FINRA has informed us that it is preparing rules for consideration that would prohibit its members from soliciting advisory business from a government entity on behalf of an adviser unless they comply with requirements prohibiting pay to play activities.<sup>317</sup> FINRA has said its rule would impose regulatory requirements on member brokers<sup>318</sup> “as rigorous and as expansive” as would be imposed on investment advisers by rule 206(4)-5, and that in developing its proposal it intends to “draw closely upon all the substantive and technical elements of the SEC’s proposal as well as our regulatory expertise in examining and enforcing the MSRB rules upon which the SEC’s proposal is

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<sup>316</sup> Rule 206(4)-5(f)(9)(ii).

<sup>317</sup> See Letter from Richard G. Ketchum, Chairman & Chief Executive Officer, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (Mar. 15, 2010), *available at* <http://www.sec.gov/comments/s7-18-09/s71809-252.pdf> (“Ketchum Letter”) (“[w]e believe that a regulatory scheme targeting improper pay to play practices by broker-dealers acting on behalf of investment advisers is . . . a viable solution to a ban on certain private placement agents serving a legitimate function”). See also Letter from Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Richard G. Ketchum, Chairman & Chief Executive Officer, FINRA (Dec. 18, 2009), *available at* <http://www.sec.gov/comments/s7-18-09/s71809-252.pdf>.

<sup>318</sup> As used in this Section, “broker” means a “broker” or “dealer,” as each term is defined in section 3(a) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)].

based.”<sup>319</sup> The rules, including any recordkeeping requirements, would be enforced by FINRA, which has substantial experience enforcing MSRB rules G-37 and G-38.<sup>320</sup>

For the Commission to adopt a rule prohibiting advisers from using placement agents until FINRA adopts a rule could impose substantial hardships on a significant number of advisers and solicitors that wrote to us. It could also disrupt pension funds’ investment opportunities. Therefore, as we discuss in more detail below, we are delaying application of the prohibition on compensating third-party solicitors for one year from the effective date of this rule, in part to give FINRA time to propose such a rule.<sup>321</sup>

## (2) Registered Investment Advisers

We are also permitting advisers covered by the rule to pay solicitors for government clients that are registered investment advisers subject to similar limitations.<sup>322</sup> Under the rule, a “regulated person” includes (in addition to a registered broker subject to the conditions described above), an investment adviser that is registered with the Commission under the Advisers Act, provided that the solicitor and its covered associates have not, within two years of soliciting a government entity: (i) made a contribution to an official of that government entity (other than a *de minimis* contribution, as permitted by the rule); or (ii) coordinated, or solicited any person (including a PAC) to

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<sup>319</sup> Ketchum Letter.

<sup>320</sup> See MSRB, *About the MSRB: Enforcement of Board Rules*, available at <http://msrb.org/msrb1/whatsnew/default.asp> (“Responsibility for examination and enforcement of Board rules is delegated to the Financial Industry Regulatory Authority for all securities firms, and to the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Comptroller of the Currency, and the Office of Thrift Supervision for banks.”).

<sup>321</sup> For a discussion of transition issues, see section III of this Release.

<sup>322</sup> Rule 206(4)-5(a)(2)(i) (which prohibits advisers and their covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party other than a regulated person to solicit a government entity for investment advisory services on behalf of such investment adviser).

make, any contribution to an official of a government entity to which the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services, or payment to a political party of a state or locality where the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services to a government entity.<sup>323</sup>

We received comments urging us to permit advisers to compensate registered investment advisers for soliciting government officials, subject to rules or rule amendments the Commission could adopt under the Advisers Act.<sup>324</sup> We believe such an allowance is appropriate for similar reasons to those for permitting advisers to compensate broker-dealers subject to pay to play rules we have determined meet our objectives under rule 206(4)-5. We have direct oversight authority over investment advisers registered with us. Accordingly, we believe it is appropriate to allow them to act as third-party solicitors for other advisers. Therefore, the rule, as adopted, limits the advisers that another adviser may pay to solicit government entities on its behalf to those advisers that are registered with the Commission<sup>325</sup> and that have neither made the types of political contributions that would trigger the two-year time out nor otherwise engaged

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<sup>323</sup> Rule 206(4)-5(f)(9)(i).

<sup>324</sup> *See, e.g.*, IAA Letter.

<sup>325</sup> We are not including within the definition of “regulated person” investment advisers registered solely with state securities authorities as some commenters suggested. *See id.* We do not have regulatory authority over those advisers as we do over advisers who are registered with us (and as we do over FINRA in connection with its oversight of brokers and dealers and enforcement of its own rules). In fact, such advisers are subject neither to our oversight nor to the recordkeeping rules we are adopting today.

in activities (*e.g.*, bundling of contributions) that the adviser could not engage in under the rule.<sup>326</sup>

Advisers compensating other advisers that qualify as “regulated persons” for soliciting government entities must adopt policies and procedures reasonably designed to prevent a violation of the rule.<sup>327</sup> Such policies and procedures should include, among other things, a careful vetting of candidates and ongoing review of “regulated person” investment advisers acting as solicitors currently being used. Such review would need to determine whether the adviser (and its covered persons) acting as a solicitor has made political contributions or otherwise engaged in conduct that would disqualify it from the definition of “regulated person” and thereby preclude the hiring adviser from paying it for the solicitation activity.

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<sup>326</sup> Importantly, a person that is registered under the Exchange Act as a broker-dealer and under the Advisers Act as an investment adviser could potentially be a “regulated person” under the rule if it met the conditions for either prong of the definition. Such a regulated person should follow the rules that apply to the services it is performing, rather than complying with both investment adviser and broker-dealer pay to play requirements. The Exchange Act generally requires brokers and dealers to register with the Commission and become members of at least one self-regulatory organization. Exchange Act sections 15(a), 15(b)(8) [15 U.S.C. 78o(a), (b)(8)]. Section 3(a)(4)(A) of the Exchange Act generally defines a “broker” as any person engaged in the business of effecting transactions in securities for the account of others [15 U.S.C. 78c(a)(4)(A)]. *See, e.g., Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Exchange Act Release No. 44291, at n.124 (May 11, 2001) [66 FR 27759 (May 18, 2001)] (“Solicitation is one of the most relevant factors in determining whether a person is effecting transactions.”); *Strengthening the Commission’s Requirements Regarding Auditor Independence*, Exchange Act Release No. 47265, at n.82 (Jan. 28, 2003) [68 FR 6006 (Feb. 5, 2003)] (noting that a person may be “engaged in the business,” among other ways, by receiving compensation tied to the successful completion of a securities transaction). *See also Persons Deemed Not to Be Brokers*, Exchange Act Release No. 22172, at sec. II.A (Jun. 27, 1985) [50 FR 27940 (Jul. 9, 1985)] (noting that attorneys, accountants, insurance brokers, financial service organizations and financial consultants are engaged in the business of effecting transactions in securities for the account of others if they are retained by an issuer specifically for the purpose of selling securities to the public and receive transaction based-compensation for their services).

<sup>327</sup> *See* Advisers Act rule 206(4)-7 [17 CFR 275.206(4)-7] (requiring advisers to adopt and implement compliance policies and procedures).

(c) **Restrictions on Soliciting and Coordinating Contributions and Payments**

Rule 206(4)-5 prohibits advisers and covered persons from coordinating or soliciting<sup>328</sup> any person or PAC to make (i) any contribution<sup>329</sup> to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services,<sup>330</sup> or (ii) any payment<sup>331</sup> to a political party of a state or locality where

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<sup>328</sup> Rule 206(4)-5(f)(10)(ii) (defining “solicit,” with respect to a contribution or payment, as communicating, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.). Some commenters requested that we provide guidance regarding when an adviser would be deemed to be soliciting contributions for purposes of the rule. *See, e.g.,* Caplin & Drysdale Letter. An adviser that consents to the use of its name on fundraising literature for a candidate would be soliciting contributions for that candidate. Similarly, an adviser that sponsors a meeting or conference which features a government official as an attendee or guest speaker and which involves fundraising for the government official would be soliciting contributions for that government official. Whether a particular activity involves a solicitation or coordination of a contribution or payment for purposes of the rule will depend on the facts and circumstances, thus we have not attempted to draw a bright line. The MSRB takes a similar approach. *See MSRB, Solicitation of Contributions*, MSRB Interpretive Letter (May 21, 1999), *available at* <http://msrb.org/msrb1/rules/interp37.htm> (determination of whether activity constitutes “soliciting” under rule G-37 is a facts and circumstances analysis). *See also supra* note 255.

<sup>329</sup> In the case of the fundraising meeting or conference described as an example in note 328, expenses incurred by the adviser for hosting the event would be a contribution by the adviser, thereby triggering the two-year ban on the adviser receiving compensation for providing advisory services to the government entity over which that official has influence. *See* section II.B.2(a) of this Release. Such expenses may include, but are not limited to, the cost of the facility, the cost of refreshments, any expenses paid for administrative staff, and the payment or reimbursement of any of the government official’s expenses for the event. The *de minimis* exception under rule 206(4)-5(b)(1) would not be available with respect to these expenses because they would have been incurred by the firm, not by a natural person. *See MSRB, Supervision When Sponsoring Meetings and Conferences Involving Issuer Officials*, MSRB Rule G-37 Interpretive Notice (Mar. 26, 2007), *available at* <http://www.msrb.org/msrb1/rules/notg37.htm> (rather than addressing meetings and conferences in its rules directly, the MSRB applies a facts and circumstances test on a case-by-case basis).

<sup>330</sup> Rule 206(4)-5(a)(2)(ii). An investment adviser would be seeking to provide advisory services to a government entity when it responds to a request for proposal, communicates with a government entity regarding that entity’s formal selection process for investment advisers, or engages in some other solicitation of investment advisory business of the government entity. A violation of paragraph (a)(2)(ii) of the rule would not trigger a two-year ban on the provision of investment advisory services for compensation, but would be a violation of the rule.

the investment adviser is providing or seeking to provide investment advisory services to a government entity.<sup>332</sup> These restrictions are intended to prevent advisers from circumventing the rule's prohibition on direct contributions to certain elected officials such as by "bundling" a large number of small employee contributions to influence an election, or making contributions (or payments) indirectly through a state or local political party.<sup>333</sup>

We received only a few comments on this provision. One supporter of our proposal asserted that it "would close an important gap in which contributions might be made indirectly to government officials for the purpose of influencing their choice of investment advisers."<sup>334</sup> Most commenters that addressed the provision focused on the prohibition relating to contributions and payments to state and local political parties where the adviser is providing, or seeking to provide, advisory services. One state official suggested that this prohibition would unfairly affect states with strict limitations

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<sup>331</sup> A payment is defined as any gift, subscription, loan, advance, or deposit of money or anything of value. Rule 206(4)-5(f)(7). This definition is similar to the definition of "contribution," but broader, in the sense that it does not include limitations on the purposes for which such money is given (*e.g.*, it does not have to be made for the purpose of influencing an election). We are including the broader term "payments," as opposed to "contributions," here to deter an adviser from circumventing the rule's prohibitions by coordinating indirect contributions to government officials by making payments to political parties.

<sup>332</sup> Rule 206(4)-5(a)(2)(ii). This provision prohibits, for example, an adviser from soliciting a payment to the political party of a state if the adviser is providing or seeking to provide advisory services to the state, but would not preclude that adviser from soliciting a payment to a local political party (as long as the adviser is not also providing or seeking to provide advisory services to a government entity in that locality). In these circumstances, the rule would, however, prohibit an adviser from soliciting the payment to a local political party as a means to indirectly make payments to the state party. *See* rule 206(4)-5(d).

<sup>333</sup> We note that this provision is not limited to the bundling of employee contributions. Another example of conduct that would be prohibited by this section would be an adviser or its covered associates soliciting contributions from professional service providers.

<sup>334</sup> Cornell Law Letter.

on individual contributions to candidates as they are now more reliant on party money for campaigns.<sup>335</sup> Another state official, however, explained the importance of the provision by pointing out that it is often difficult or impossible to differentiate between individuals seeking an office and the political party, which often merely passes contributions it receives on to the candidate, and may direct successful candidates to place pension business with contributors.<sup>336</sup>

We are adopting this provision, as proposed. These restrictions on soliciting and coordinating contributions and payments close what would otherwise be a potential gap in the rule as advisers could circumvent its limitations on direct contributions through soliciting and coordinating others to make contributions to influence an election or a government official's investment adviser selection process.<sup>337</sup> We disagree that this

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<sup>335</sup> CT Treasurer Letter. In upholding restrictions targeted at a particular industry, courts have found that the loss of contributions from a small segment of the electorate "would not significantly diminish the universe of funds available to a candidate to a non-viable level." *Green Party of Conn. v. Garfield*, 590 F. Supp. 2d 288, 316 (D. Conn. 2008); see also *Preston v. Leake*, 629 F. Supp. 2d 517, 524 (E.D.N.C. 2009) (differentiating the "broad sweep of the Vermont statute" that "restricted essentially any potential campaign contribution" from a statute that "only applies to lobbyists"); *In re Earle Asphalt Co.*, 950 A.2d 918, 927 (N.J. Super. Ct. App. Div. 2008), *aff'd* 957 A.2d 1173 (N.J. 2008) (holding that a limitation on campaign contributions by government contractors and their principals did not have the same capacity to prevent candidates from amassing the resources necessary for effective campaigning as the statute in *Randall*). See *supra* note 68.

<sup>336</sup> Reilly Letter.

<sup>337</sup> We note that a direct contribution to a political party by an adviser or its covered associates would not violate the rule, unless the contribution was a means for the adviser to do indirectly what the rule would prohibit if done directly (for example, if the contribution was earmarked or known to be provided for the benefit of a particular government official). See section II.B.2(d) of this Release. The MSRB amended rule G-37 in 2005 to expand its prohibition on soliciting others to make, and on coordinating, payments to state and local political parties to close what the MSRB identified as a gap in which contributions were being made indirectly to officials through payments to political parties for the purposes of influencing their choice of municipal securities dealers. The MSRB had not previously been able to deter this misconduct, despite issuing informal guidance in both 1996 and 2003. See *Rule G-37: Request for Comments on Draft Amendments to Rule G-37(c), Relating to Prohibiting Solicitation and Coordination of*

prohibition would unfairly affect candidates in states that limit individual contributions, because the rule is non-discriminatory and would affect contributions (and payments) to all candidates equally that were being bundled or made through a gatekeeper for the benefit of an investment adviser seeking or doing business with the state or local government.

**(d) Direct and Indirect Contributions or Solicitations**

Rule 206(4)-5(d) prohibits acts done indirectly, which, if done directly, would violate the rule.<sup>338</sup> As a result, an adviser and its covered associates could not funnel payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the adviser as a means to circumvent the rule.<sup>339</sup> We emphasize, however, that contributions by these other persons would not

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*Payments to Political Parties, and Draft Question and Answer Guidance Concerning Indirect Rule Violations*, MSRB Notice 2005-11 (Feb. 15, 2005), available at <http://www.msrb.org/msrb1/archive/2005/2005-11.asp> (“Both the 1996 Q&A guidance and the 2003 Notice were intended to alert dealers and [municipal finance professionals] to the realities of political fundraising and guide them toward developing procedures that would lead to compliance with both the letter and the spirit of the rule. The MSRB continues to be concerned, however, that dealer, [municipal finance professional], and affiliated persons’ payments to political parties, including “housekeeping”, “conference” or “overhead” type accounts, and PACs give rise to at least the appearance that dealers may be circumventing the intent of Rule G-37.”); *Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Approving Proposed Rule Change Concerning Solicitation and Coordination of Payments to Political Parties and Question and Answer Guidance on Supervisory Procedures Related to Rule G-37(d) on Indirect Violations*, Exchange Act Release No. 52496 (Sept. 22, 2005) (SEC order approving change to MSRB G-37 to prohibit soliciting or coordinating payments to political parties).

<sup>338</sup> Paragraph (d) of the rule is substantially similar to section 208(d) of the Advisers Act [15 U.S.C. 80b-8(d)], which states, “It shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder.” MSRB rule G-37 contains a similar provision. See MSRB rule G-37(d).

<sup>339</sup> This provision would also cover, for example, situations in which contributions by an adviser are made, directed or funded through a third party with an expectation that, as a result of the contributions, another contribution is likely to be made by a third party to an



otherwise trigger the rule's two-year time out.<sup>340</sup> We received no comments on this aspect of the proposed rule and are adopting it as proposed.

**(e) Covered Investment Pools**

Rule 206(4)-5 includes a provision that applies each of the prohibitions of rule 206(4)-5 to an investment adviser that manages assets of a government entity through a hedge fund or other type of pooled investment vehicle ("covered investment pool").<sup>341</sup> For example, a political contribution to a government official that would, under the rule, trigger the two-year time out from providing advice for compensation to the government entity would also trigger a two-year time out from the receipt of compensation for the management of those assets through a covered investment pool. This provision extends the protection of the rule to public pension plans that increasingly access the services of

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"official of the government entity," for the benefit of the adviser. Contributions made through gatekeepers thus would be considered to be made "indirectly" for purposes of the rule. In approving MSRB rule G-37, the Commission stated: "[rule G-37(d)] is intended to prevent dealers from funneling funds or payments through other persons or entities to circumvent the [rule]'s requirements. For example, a dealer would violate the [rule] if it does business with an issuer after contributions were made to an issuer official from or by associated persons, family members of associated persons, consultants, lobbyists, attorneys, other dealer affiliates, their employees or PACs, or other persons or entities as a means to circumvent the rule. A dealer also would violate the rule by doing business with an issuer after providing money to any person or entity when the dealer knows that the money will be given to an official of an issuer who could not receive the contribution directly from the dealer without triggering the rule's prohibition on business." *Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule*, Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)].

<sup>340</sup> Like MSRB rule G-37(d), rule 206(4)-5(d) requires a showing of intent to circumvent the rule in order for such persons to trigger the time out. See *Blount*, 61 F.3d at 948 ("In short, according to the SEC, the rule restricts such gifts and contributions only when they are intended as end-runs around the direct contribution limitations.").

<sup>341</sup> See rule 206(4)-5(c). We discuss the types of pooled investment vehicles that are "covered investment pools" below at section II.B.2.(e)(1) of this release.

investment advisers through hedge funds and other types of pooled investment vehicles they sponsor or advise.

This provision will generally affect two common types of arrangements in which a government official is in a position to influence investment of funds in pooled investment vehicles. The first is the investment of public funds in a hedge fund or other type of pooled investment vehicle. The other is the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a “529 plan.”<sup>342</sup>

An adviser that makes political contributions to steer assets to a pooled investment vehicle it manages facilitates fraud by implementing a government official’s *quid pro quo* scheme.<sup>343</sup> Public pension plan beneficiaries are harmed when a government official violates the public trust, for example, by failing to disclose that the government official has directed the investment of the plan’s assets in a pooled investment vehicle not because of the vehicle’s financial merits but rather because the official has received a political contribution.<sup>344</sup> By engaging in such conduct, the adviser engages in a scheme to defraud the beneficiaries of the government plan or program.<sup>345</sup> Additionally, an investment adviser to a pooled investment vehicle that is an investment option in a government plan or program may prepare information about the pooled

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<sup>342</sup> We note that if an adviser is selected by a government entity to advise a government-sponsored plan (regardless of whether the plan selects one of the pools the adviser offers or manages as an option available under its plan), the prohibitions of the rule *directly* apply. See rule 206(4)-5(a)(1) and (a)(2).

<sup>343</sup> *SEC v. DiBella*, 587 F.3d 553, 568 (2d Cir. 2009).

<sup>344</sup> *Id.* at 566.

<sup>345</sup> See *id.* at 568–69; section 206(4) of the Advisers Act. See also Exchange Act rule 10b-5 [17 CFR 240.10b-5].

investment vehicle that may be used by plan officials to evaluate the vehicle and by pension plan beneficiaries to decide whether to allocate assets to the vehicle. Such an adviser engages in or facilitates an act, practice, or course of business which is fraudulent, deceptive, or manipulative when the adviser does not disclose that it made a contribution for the purpose of inducing an investment by the government officials and that the government officials sponsoring the plan chose the vehicle as an investment option for beneficiaries not solely on the basis of its merits, but rather as the consequence of improper *quid pro quo* payments.<sup>346</sup> The rule also operates to prevent an adviser from engaging in pay to play practices indirectly through an investment pool that it would not be permitted to do if it directly managed (or sought to directly manage) the assets of a government entity.<sup>347</sup>

Although a few commenters asserted that the rule or parts of it should not apply to pooled investment vehicles,<sup>348</sup> none made a persuasive argument that the problems the rule is designed to address are not present in the management of public pension plan and other public monies invested in pooled investment vehicles. As we discussed in the Proposing Release,<sup>349</sup> when a decision to invest public funds in a pooled investment vehicle is based on campaign contributions, the public pension plan may make inferior

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<sup>346</sup> See, e.g., *Oran v. Stafford*, 226 F.3d 275, 285-86 (3d Cir. 2000) (“a duty to disclose may arise when there is . . . an inaccurate, incomplete or misleading prior disclosure”); *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992) (“when a corporation does make a disclosure—whether it be voluntary or required—there is a duty to make it complete and accurate”) (quoting *Roeder v. Alpha Industries, Inc.*, 814 F.2d 22, 26 (1st Cir. 1987)). See also Exchange Act Rule 10b-5(b).

<sup>347</sup> See rule 206(4)-5(d). See also section 208(d) of the Act.

<sup>348</sup> See, e.g., Comment Letter of Abbott Capital Management, LLC (Oct. 6, 2009) (“Abbott Letter”); ICI Letter; NY City Bar Letter; SIFMA Letter; Skadden Letter; Sutherland Letter.

<sup>349</sup> See Proposing Release, at section II.A.3.(e)(2).

investment choices and may pay higher fees. And such pension plans may invest in pooled investment vehicles that pay substantially higher advisory fees and assume significantly greater risks than other investment alternatives.<sup>350</sup>

We find nothing in the structure of pooled investment vehicles or the variety of investment strategies they employ that suggests a reason for treating advisers to pooled investment vehicles differently from advisers to separately managed advisory accounts, except, as we discuss below, registered investment companies to which we apply a more limited version of the rule. That an investment in a pooled investment vehicle may not involve a direct advisory relationship with a government sponsored plan does not change the nature of the fraud or the harm that may be inflicted as a consequence of the adviser's pay to play activity.

Indeed, many of our recent enforcement cases alleged political contributions or kickbacks designed to induce public officials to invest public pension plan assets in pooled investment vehicles.<sup>351</sup> We are concerned that our failure to apply the rule to

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<sup>350</sup> See, e.g., Nanette Burns, *Can Retirees Afford This Much Risk?* BUSINESS WEEK (Sept. 17, 2007), available at [http://www.businessweek.com/magazine/content/07\\_38/b4050048.htm](http://www.businessweek.com/magazine/content/07_38/b4050048.htm) (asserting that public pension plan assets are increasingly being invested in higher risk alternative investments, including hedge funds); Hannah M. Terhune, *Accounts Training*, MONEY SCIENCE (Dec. 11, 2006), available at [http://www.moneyscience.com/Hedge\\_Fund\\_Tutorials/Hedge\\_Fund\\_Management\\_and\\_Performance\\_Fees.html](http://www.moneyscience.com/Hedge_Fund_Tutorials/Hedge_Fund_Management_and_Performance_Fees.html) (noting an "enormous difference in rewards for the managers of hedge funds versus those of mutual funds" because hedge fund managers are entitled to performance fees).

<sup>351</sup> See, e.g., *SEC v. Paul J. Silvester, et al.*, Litigation Release No. 16759, Civil Action No. 3:00-CV-19411 DJS (D. Conn.) (Oct. 10, 2000) (action in which investment adviser allegedly paid third-party solicitors who kicked back a portion of the money to the former Connecticut State Treasurer in order to obtain public pension fund investments in a hedge fund managed by the adviser); *SEC v. William A. DiBella, et al.*, Litigation Release No. 20498, Civil Action No. 3:04 CV 1342 (EBB) (D. Conn.) (Mar. 14, 2008) (consultant was found to have aided and abetted the former Connecticut State Treasurer in a pay to play scheme involving an investment adviser to a private equity fund who had paid third-party solicitors to obtain public pension fund investments in the fund). There are

advisers who manage assets through these vehicles would ignore an area where there has been considerable growth, both in the amount of public assets invested in such pooled investment vehicles and allegations of pay to play activity involving public pension plans.<sup>352</sup> We believe a failure to apply the rule in this area could, in some cases, even encourage the use of covered investment pools as a means of avoiding application of the rule.

Nonetheless, as described in more detail below, we have made several changes from the proposal to more narrowly tailor the applicability of the rule to pooled investment vehicles in order to achieve our regulatory purpose while reducing

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examples of pay to play activity in the context of pooled investment vehicles in other jurisdictions as well. *See, e.g., supra* note 18 (listing various actions relating to the recent pay to play allegations surrounding the New York Common Retirement Fund). *See also Guilty Plea in Fraud Case Tied to New York Pension*, ASSOCIATED PRESS (Dec. 4, 2009), available at <http://www.nytimes.com/2009/12/04/nyregion/04pension.html> (describing the guilty plea of an adviser to a venture capital fund to charges that he helped his company land a lucrative deal with New York's public pension fund by giving nearly \$1 million worth of illegal gifts to state officials).

<sup>352</sup> *See, e.g.,* Investment Company Institute, *529 Plan Program Statistics, Mar. 2009* (Feb. 5, 2010), available at [http://www.ici.org/research/stats/529s/529s\\_03-09](http://www.ici.org/research/stats/529s/529s_03-09) (indicating that 529 plan assets have increased from \$8.6 billion in 2000 to \$100.3 billion in the first quarter of 2009, and that 529 plan accounts have increased from 1.3 million in 2000 to 11.2 million in the first quarter of 2009); Investment Company Institute, *The U.S. Retirement Market, 2008*, 18 RESEARCH FUNDAMENTALS, No. 5 (June 2009), available at <http://www.ici.org/pdf/fm-v18n5.pdf> (indicating that 403(b) plan and 457 plan assets have increased from \$627 billion in 2000 to \$712 billion in the fourth quarter of 2008); SEI, *Collective Investment Trusts: The New Wave in Retirement Investing* (May 2008), available at <https://longjump.com/networking/RepositoryPublicDocDownload?id=80031025axe139509557&docname=SEI%20CIT%20White%20Paper%205.08.pdf&cid=80031025&encode=application/pdf> (citing Morningstar data indicating that collective investment trust assets nearly tripled from 2004 to 2007 and grew by more than 150 percent between 2005 and 2007 alone). *See also* Michael Marois, *CalPERS, Blackstone Clash over Placement Agent 'Jackpot' Fees*, BLOOMBERG (Apr. 7, 2010), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acPNrTn1q7pw> (noting that placement agents working for private equity, hedge funds, venture capital and real estate firms typically earn the equivalent of 0.5 percent to 3 percent of the money they place under the management of their client, quoting California State Treasurer Bill Lockyer, a member of the CalPERS board, "[t]he contingency fees are too much of a jackpot for the placement agents . . . [they] invite corrupt practices").

compliance burdens that commenters brought to our attention. In addition, we have made certain clarifying changes to the rule, as described below.

**(1) Definition of “Covered Investment Pool”**

Under the rule, a “covered investment pool”<sup>353</sup> includes: (i) any investment company registered under the Investment Company Act of 1940 that is an investment option of a plan or program of a government entity; or (ii) any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act.<sup>354</sup> Accordingly, it includes such unregistered pooled investment vehicles as hedge funds, private equity funds, venture capital funds and collective investment trusts.<sup>355</sup> It also

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<sup>353</sup> Rule 206(4)-5(f)(3).

<sup>354</sup> 15 U.S.C. 80a-3(c)(1), (7) or (11). We note that a bank maintaining a collective investment trust would not be subject to the rule if the bank falls within the exclusion from the definition of “investment adviser” in section 202(a)(11)(A) of the Advisers Act [15 U.S.C. 80b-2(a)(11)(A)]. A non-bank adviser that provides advisory services with respect to a collective investment trust in which a government entity invests, however, would be subject to the rule’s prohibitions with respect to all of its government entity clients, including the collective investment trust in which a government entity invests, unless another exemption is available.

<sup>355</sup> One commenter questioned the Commission’s authority to apply the rule in the context of covered investment pools in light of the opinion of the Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). Sutherland Letter. That case created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act in certain cases where investors in a pool are defrauded by an investment adviser to that pool. *See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)], (adopting rule 206(4)-8 [17 CFR 275.206(4)-8]). In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of “client” as used in that section, the Court of Appeals expressed the view that, for purposes of sections 206(1) and (2), the “client” of an investment adviser managing a pool is the pool itself, not an investor in the pool. In its opinion, the Court of Appeals distinguished sections 206(1) and (2) from section 206(4) of the Advisers Act, which applies to persons other than clients. *Id.* at n.6. *See also United States v. Elliott*, 62 F.3d 1304, 1311 (11th Cir. 1995). Section 206(4) permits us to adopt rules proscribing fraudulent conduct that is potentially harmful to investors in pooled investment vehicles. We are adopting rule 206(4)-5 under this authority.

includes registered pooled investment vehicles, such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.<sup>356</sup> These plans or programs may include college savings plans like “529 plans”<sup>357</sup> and retirement plans like “403(b) plans”<sup>358</sup> and “457 plans”<sup>359</sup> that typically allow participants to select among pre-established investment “options,” or particular investment pools (often invested in registered investment companies or funds of funds, such as target date funds), that a government official has directly or indirectly selected to include as investment choices for participants.<sup>360</sup>

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<sup>356</sup> Rule 206(4)-5(f)(8).

<sup>357</sup> A 529 plan is a “qualified tuition plan” established under section 529 of the Internal Revenue Code of 1986 [26 U.S.C. 529]. States generally establish 529 plans as state trusts which are considered instrumentalities of states for federal securities law purposes. As a result, the plans themselves are generally not regulated under the federal securities laws and many of the protections of the federal securities laws do not apply to investors in them. *See* section 2(b) of the Investment Company Act [15 U.S.C. 80a-2(b) and section 202(b) of the Advisers Act [15 U.S.C. 80b-2(b) (exempting state-owned entities from those statutes). However, the federal securities laws do generally apply to, and the Commission does generally regulate, the brokers, dealers, and municipal securities dealers that effect transactions in interests in 529 plans. *See generally* sections 15(a)(1) and 15B of the Exchange Act [15 U.S.C. 78a-15(a)(1) and 15B]. A bank effecting transactions in 529 plan interests may be exempt from the definition of “broker” or “municipal securities dealer” under the Exchange Act if it can rely on an exception from the definition of broker in the Exchange Act. In addition, state sponsors of 529 plans may hire third-party investment advisers either to manage 529 plan assets on their behalf or to act as investment consultants to the agency responsible for managing plan assets. These investment advisers, unless they qualify for a specific exemption from registration under the Advisers Act, are generally required to be registered with the Commission as investment advisers and would therefore be subject to our rule.

<sup>358</sup> A 403(b) plan is a tax-deferred employee benefit retirement plan established under section 403(b) of the Internal Revenue Code of 1986 [26 U.S.C. 403(b)].

<sup>359</sup> A 457 plan is a tax-deferred employee benefit retirement plan established under section 457 of the Internal Revenue Code of 1986 [26 U.S.C. 457].

<sup>360</sup> We would consider a registered investment company to be an investment option of a plan or program of a government entity where the participant selects a model fund or portfolio (such as an age-based investment option of a 529 plan) and the government entity selects the specific underlying registered investment company or companies in which the portfolio’s assets are invested.

We proposed to include in the definition of “covered investment pool” the types of pooled investment vehicles that are likely to be used as funding vehicles for, or investments of, government-sponsored savings and retirement plans. We explained that we included registered investment companies because of the significant growth in government-sponsored savings plans in recent years, which increasingly use these funds as investment options,<sup>361</sup> and the increased competition among advisers for selection of their fund as an investment option for these plans.<sup>362</sup> We were concerned that advisers to pooled investment vehicles, including registered investment companies, may make political contributions to influence the decision by government officials to include their funds as options in such plans.

We recognized in our proposal, however, that an adviser to a registered investment company might have difficulty in identifying when or if a government investor was a fund shareholder for purposes of preventing the adviser (or its covered associates) from making contributions that would trigger a two-year time out.<sup>363</sup> Therefore, we proposed to only include publicly offered registered investment companies

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<sup>361</sup> See *supra* note 352 and accompanying text.

<sup>362</sup> See, e.g., Charles Paikert, *TIAA-CREF Stages Comeback in College Savings Plans*, CRAIN’S NEW YORK BUS., Apr. 23, 2007 (depicting TIAA-CREF’s struggle to remain a major player in managing State 529 plans because of increasing competition from the industry’s heavyweights); Beth Healy, *Investment Giants Battle for Share of Exploding College-Savings Market*, BOSTON GLOBE, Oct. 29, 2000, at F1 (describing the increasing competition between investment firms for state 529 plans and increasing competition to market their plans nationally). See also AnnaMaria Andriotis, *529 Plan Fees are Dropping*, SMARTMONEY, Dec. 16, 2009, available at <http://www.smartmoney.com/personal-finance/college-planning/529-plan-fees-are-dropping-but-for-how-long/?hpadref=1> (“Costs on these plans are falling for a few reasons, and the biggest one has little to do with the state of the economy: the nature of their contracts creates competition. When a contract for a state 529 plan expires, program managers compete against each other and may lower their fees to try to secure the new contract.”).

<sup>363</sup> See Proposing Release, at nn. 185-87 and accompanying text.



in the definition of covered investment pool for purposes of the two-year time out provision to the extent they were investments or investment options of a plan or program of a government entity.<sup>364</sup>

Several commenters asserted that an adviser to a publicly offered investment company would have similar difficulties in identifying government investors in registered investment companies for purposes of complying with other provisions of the rule.<sup>365</sup>

One opposed application of the rule to registered investment companies “even if the [company] is not included in a plan or program of a government entity,”<sup>366</sup> although

several generally urged us to exclude registered investment companies from the rule altogether.<sup>367</sup> Another commenter urged us to apply the rule’s recordkeeping

requirements (discussed below) prospectively and after a period of time that would be

adequate to enable funds to redesign their processes and systems to capture information

about whether an investor is a “government entity,” which would be necessary to comply

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<sup>364</sup> See proposed rule 206(4)-5(f)(3) (“Covered investment pool means any investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) . . . except that for purposes of paragraph (a)(1) of this section, an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), the shares of which are registered under the Securities Act of 1933 (15 U.S.C. 77a), shall be a covered investment pool only if it is an investment or an investment option of a plan or program of a government entity.”).

<sup>365</sup> See Davis Polk Letter; Fidelity Letter; ICI Letter; NSCP Letter; Comment Letter of Standard & Poor’s Investment Advisory Services LLC and Standard & Poor’s Securities Evaluations, Inc. (Oct. 5, 2009) (“S&P Letter”); SIFMA Letter; T. Rowe Price Letter.

<sup>366</sup> T. Rowe Price Letter.

<sup>367</sup> Fidelity Letter; ICI Letter; NSCP Letter; SIFMA Letter. We disagree that registered investment companies should be excluded from our rule. Pay to play activity is fraudulent, regardless of whether it occurs in the context of a pooled investment vehicle or a separately managed account. One commenter asserted that the existence of a regulatory regime applicable to investment companies precludes the need for pay to play prohibitions with respect to these pools. See ICI Letter. However, existing laws and regulations applicable to investment companies do not specifically address pay to play practices.

with the rule and our proposed amendment to the Act's recordkeeping rule.<sup>368</sup> Some noted that identifying government investors would be particularly challenging when shares were held through an intermediary.<sup>369</sup>

We continue to believe for the reasons discussed above<sup>370</sup> and in the Proposing Release, that advisers to registered investment companies should be subject to the rule. In response to comments, we have modified our proposal to include a registered investment company in the definition of covered investment pool, for purposes of all three of the rule's pay to play prohibitions, but *only* if it is an investment option of a plan or program of a government entity.<sup>371</sup> We believe this approach strikes the right balance between applying the rule in those contexts, discussed in the Proposing Release,<sup>372</sup> in which advisers to registered investment companies may be more likely to engage in pay to play conduct, while recognizing the compliance challenges relating to identifying government investors in registered investment companies<sup>373</sup> that may result from a

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<sup>368</sup> ICI Letter. *See also* section II.D of this Release.

<sup>369</sup> *See* T. Rowe Price Letter; ICI Letter, Fidelity Letter.

<sup>370</sup> *See supra* notes 361-362 and accompanying text.

<sup>371</sup> Rule 206(4)-5(f)(3).

<sup>372</sup> Proposing Release, at nn.185-87 and accompanying text. *See also supra* notes 352 and 362 and accompanying text (describing the growth in government-sponsored savings plans in recent years and the increased competition for an adviser's fund to be selected as an investment option of such a plan).

<sup>373</sup> Identifying government investors in other types of covered investment pools does not generally present similar compliance challenges. *See, e.g.,* rule 2(a)(51) under the Investment Company Act [17 CFR 270.2(a)(51)] (defining "qualified purchaser," as that term is used in section 3(c)(7) of that Act); Rule 501(a) of Regulation D under the Securities Act of 1933 ("Securities Act") [17 CFR 230.501(a)] (defining "accredited investor" for purposes of limited offerings without registration under the Securities Act of 1933); and Advisers Act rule 205-3 (creating an exception from the prohibition against an adviser receiving performance-based compensation from clients that are not "qualified clients," and which is relied on by many advisers to funds that are exempt from Investment Company Act registration under section 3(c)(1) of that Act).

broader application of the rule. When an adviser's investment company is an investment option in a participant-directed government plan or program, we believe it is reasonable to expect the adviser will know (or can reasonably be expected to acquire information about) the identity of the government plan.<sup>374</sup> We recognize that when shares are held through an intermediary, an adviser may have to take additional steps to identify a government entity.<sup>375</sup> Therefore, we have provided advisers to registered investment companies with additional time to modify current systems and processes.<sup>376</sup>

We have also made several minor changes from our proposal intended to clarify and simplify application of the rule. First, at the suggestion of commenters,<sup>377</sup> we are clarifying that an adviser to a registered investment company is only subject to the rule—*i.e.*, the investment company is only considered a covered investment pool—if the investment company is an investment option of a plan or program of a government entity that is *participant-directed*.<sup>378</sup> This change reflects our intent, as demonstrated by the

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<sup>374</sup> With respect to a 529 plan, for example, an adviser would know that its investment company is an investment option of the plan and will know the identity of the government entity investor because a 529 plan can only be established by a state, which generally establishes a trust to serve as the direct investor in the investment company, while plan participants invest in various options offered by the 529 trust. The rule does not require an adviser to identify plan participants, only the government plan or program. *See* rule 206(4)-5(f)(5)(iii) (defining a “government entity” to include a plan or program of a government entity. The definition does *not* include the participants in those plans or programs).

<sup>375</sup> For example, while 403(b) plans and 457 plans are generally associated with retirement plans for government employees, they are not used exclusively for this purpose. For instance, certain non-profit or tax-exempt entities can establish these types of plans. We also understand that it is not uncommon for contributions of 403(b) and 457 plans to be commingled into an omnibus position that is forwarded to the fund, making it more challenging for an adviser to distinguish government entity investors from others.

<sup>376</sup> *See* section III.D of this Release. We received several letters addressing this concern. ICI Letter; T. Rowe Price Letter; Fidelity Letter.

<sup>377</sup> *See, e.g.*, ICI Letter; Davis Polk Letter; SIFMA Letter.

<sup>378</sup> Rule 206(4)-5(f)(8).

examples we give in the definition (*i.e.*, 529 plans, 403(b) plans, and 457 plans) that the definition is intended to encompass those covered investment pools that have been pre-selected by the government sponsoring or establishing the plan or program as part of a limited menu of investment options from which participants in the plan or program may allocate their account. We have also added, as additional examples to the definition of “government entity,” a defined benefit plan and a state general fund to better distinguish these pools of assets from a plan or program of a government entity.<sup>379</sup> We have also made minor organizational changes within the definition of government entity from our proposal to make clear that such pools are not “plans or programs of a government entity.”

Finally, we have simplified the definition of “covered investment pool” as it applies to registered investment companies. The definition as adopted includes investment companies registered under the Investment Company Act that are an option of a plan or program of a government entity, regardless of whether, as proposed, their shares are registered under the Securities Act of 1933 (“1933 Act”). As discussed above, under the rule as adopted an adviser to a registered investment company is only subject to the rule if the company is an investment option of a plan or program. As a result, we believe it is unnecessary to distinguish between registered investment companies based on whether their shares are registered under the 1933 Act, although we understand that those shares will typically be registered where the fund is an option in a plan or program of a government entity.

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<sup>379</sup> Rule 206(4)-5(f)(5).

## (2) Application of the Rule

Under rule 206(4)-5 (and as proposed) an investment adviser is subject to the two-year time out if it manages a covered investment pool in which the assets of a government entity are invested.<sup>380</sup> The rule does not require a government entity's withdrawal of its investment or cancellation of any commitment it has made. Indeed, the rule prohibits advisers not from *providing advice* subsequent to a triggering political contribution, but rather from *receiving compensation* for providing advice. If a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year "time out" is made, the adviser must forgo any compensation related to the assets invested or committed by that government entity.<sup>381</sup>

Application of the two-year time out may present different issues for covered investment pools than for separately managed accounts due to various structural and legal differences. Having made a contribution triggering the two-year time out, the adviser may have multiple options available to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. For instance, in the case of a private pool, the adviser could seek to cause the pool to redeem the investment of the

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<sup>380</sup> Rule 206(4)-5(c).

<sup>381</sup> As we noted above and in the Proposing Release, the phrase "for compensation" includes both profits and the recouping of costs, so an adviser is not permitted to continue to manage assets at cost after a disqualifying contribution is made. Proposing Release, at n.191. *See also supra* note 137 and accompanying text. As we discussed above in section II.B.2(a)(1) of this Release, we are not persuaded by commenters who suggested permitting the adviser to be compensated at cost following payment of a triggering contribution or payment. *See, e.g.*, Dechert Letter; NY City Bar Letter. In our judgment, the potential loss of profits from the government client alone may be insufficient to deter pay to play activities. However, costs specifically attributable to the covered investment pool and not normally incurred in connection with a separately managed account, such as costs attributable to an annual audit of the pool's assets and delivery of its audited financial statements, would not be considered compensation to the adviser for these purposes.

government entity.<sup>382</sup> Such redemptions may be relatively simple matters in the case of, for example, a highly liquid private pool.<sup>383</sup> Commenters pointed out to us that, for some private pools, such as venture capital and private equity funds, a government entity's withdrawal of its capital or cancellation of its commitment may have adverse implications for other investors in the fund.<sup>384</sup> In such cases, the adviser could instead comply with the rule by waiving or rebating the portion of its fees or any performance allocation or carried interest attributable to assets of the government client.<sup>385</sup>

For registered investment companies, the options for restricting compensation involving government investors are more limited, due to both Investment Company Act

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<sup>382</sup> To the extent the adviser may seek to cause the private pool to redeem the investment of a government entity investor under these circumstances, it should consider disclosing this as an investment risk in a private placement memorandum, prospectus or other disclosure document to current and prospective investors in such a fund. *See, e.g.*, Rule 502 of Regulation D under the Securities Act [17 CFR 230.502] (addressing disclosure obligations for non-accredited investors who purchase securities in a limited offering pursuant to rules 505 or 506 of Regulation D under the Securities Act [17 CFR 230.505 or 17 CFR 230.506]).

<sup>383</sup> We understand that other types of pooled investment vehicles, including private equity and venture capital funds, already have special withdrawal and transfer provisions related to the regulatory and tax considerations applicable to certain types of investors, such as those regulated by the Employee Retirement Income Security Act of 1974 ("ERISA") [29 U.S.C. 18]. *See generally* JAMES M. SCHELL, PRIVATE EQUITY FUNDS – BUSINESS STRUCTURE AND OPERATIONS (Law Journal Press 2000) (2010).

<sup>384</sup> *See* Abbott Letter; ICI Letter; NY City Bar Letter.

<sup>385</sup> As we noted in the Proposing Release, some commenters to our 1999 Proposal asserted that a performance fee waiver raises various calculation issues. *See* Proposing Release, at n.192. An adviser making a disqualifying contribution could comply with rule 206(4)-5 by waiving a performance fee or carried interest determined on the same basis as the fee or carried interest is normally calculated—*e.g.*, on a mark-to-market basis. For arrangements like those typically found in private equity and venture capital funds where the fee or carry is calculated based on realized gains and losses and mark-to-market calculations are not feasible, advisers could use a straight-line method of calculation which assumes that the realized gains and losses were earned over the life of the investment.

provisions and potential tax consequences.<sup>386</sup> In our proposal, we suggested one approach that would meet the requirements of the rule—an adviser of a registered investment company could waive its advisory fee for the fund as a whole in an amount approximately equal to fees attributable to the government entity.<sup>387</sup> One commenter agreed with our approach,<sup>388</sup> while another commenter suggested we could, alternatively, permit the government entity to continue to pay its portion of the advisory fee, but require the adviser to rebate that portion of the fee to the fund as a whole.<sup>389</sup> We believe either approach would meet the requirements of the rule we are adopting today.

### (3) Subadvisory Arrangements

A number of commenters urged that we exclude from the rule subadvisers to covered investment pools because, being in a subordinate role to the adviser, they may have no involvement in the adviser's solicitation activities including no ability to identify government entities being solicited, and therefore should not be held accountable for the adviser's actions.<sup>390</sup> None of these commenters, however, indicated that a subadviser could not obtain from the adviser the information necessary to comply with the rule. Additionally, no commenter provided us with a basis to distinguish advisers from subadvisers that would be adequate to avoid undermining the prophylactic nature of our

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<sup>386</sup> See Proposing Release, at n.193 and accompanying text. See, e.g., rule 18f-3 under the Investment Company Act [17 CFR 270.18f-3]. Moreover, other regulatory considerations, such as those under ERISA, may impact these arrangements with respect to collective investment trusts.

<sup>387</sup> This may also be done at the class level or series level for private funds organized as corporations.

<sup>388</sup> ICI Letter.

<sup>389</sup> NY City Bar Letter.

<sup>390</sup> See, e.g., IAA Letter; S&P Letter; Skadden Letter; Davis Polk Letter.

rule. “Subadviser” is not defined under the Act,<sup>391</sup> and significant variation exists in subadvisory relationships.<sup>392</sup> There is no readily available way to draw meaningful distinctions between advisers and subadvisers by, for example, looking at who controls marketing and solicitation activities,<sup>393</sup> who has an advisory contract directly with the government client,<sup>394</sup> or other factors. In addition, subadvisers generally have the same economic incentives as advisers to obtain new business and increase assets under management. We are concerned that under the approaches suggested by commenters, an adviser that sought to avoid compliance with the prophylactic provisions of our rule and engage in pay to play could organize itself to operate as a subadviser in such an arrangement. We therefore believe it is not appropriate to exclude subadvisers from the rule.

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<sup>391</sup> “Subadviser” also is not defined under the Investment Company Act, which requires that both advisory and subadvisory contracts (“which contract, whether with such registered company or with an investment adviser of such registered company . . .”) be approved by a vote of a majority of the outstanding voting securities of the registered investment company. *See* section 15(a) of the Investment Company Act [15 U.S.C. 80a-15(a)].

<sup>392</sup> *See, e.g.*, Investment Company Institute, *Board Oversight of Subadvisers* (Jan. 2010), available at [http://www.ici.org/pdf/idc\\_10\\_subadvisers.pdf](http://www.ici.org/pdf/idc_10_subadvisers.pdf) (providing guidance to mutual fund boards of directors with respect to overseeing subadvisory arrangements and recognizing that “there is no one ‘correct’ approach to effective subadvisory oversight by fund boards” because there are a wide variety of potential subadvisory arrangements).

<sup>393</sup> *See, e.g.*, Davis Polk Letter (suggesting that we limit the application of the prohibitions to a subadviser to a covered investment pool that has the ability to control the soliciting, marketing or acceptance of government clients); S&P Letter (suggesting that we limit the application of the prohibitions to a subadviser to a covered investment pool that: (1) has the ability to control the soliciting, marketing or acceptance of government clients; and (2) is not a related person of the investment adviser or distributor or other investment pool).

<sup>394</sup> *See, e.g.*, IAA Letter; Skadden Letter. *See also* sections 2(a)(20) and 15(a) of the Investment Company Act (treating a subadviser as an adviser to a registered investment company even in the absence of a direct contractual relationship with the investment company).



We are, however, providing some guidance that may assist advisers in subadvisory and fund of funds arrangements in complying with the rule.<sup>395</sup> First, by the terms of the rule, if an adviser or subadviser makes a contribution that triggers the two-year time out from receiving compensation, the subadviser or adviser, as applicable, that did not make the triggering contribution could continue to receive compensation from the government entity,<sup>396</sup> unless the arrangement were a means to do indirectly what the adviser or subadviser could not do directly under the rule.<sup>397</sup> Second, advisers to underlying funds in a fund of funds arrangement are not required to look through the investing fund to determine whether a government entity is an investor in the investing fund unless the investment were made in that manner as a means for the adviser to do indirectly what it could not do directly under the rule.<sup>398</sup>

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<sup>395</sup> See, e.g., IAA Letter (requesting clarification as to how the rule would apply when an adviser becomes subject to the compensation ban after hiring a subadviser or vice versa). See also Fidelity Letter; MFA Letter; SIFMA Letter (each expressing concern about how the rule would apply in the fund of funds context).

<sup>396</sup> We understand that, under some advisory arrangements, the government entity has a contract only with the adviser and not the subadviser. Under those circumstances, it would be consistent with the rule for an adviser that has triggered the two-year time out to pass through to the subadviser that portion of the fee to which the subadviser is entitled, as long as the adviser retains no compensation from the government entity and the subadviser (and its own covered associates) has not triggered a time out as well.

<sup>397</sup> See Rule 206(4)-5(d). For instance, an adviser that hires an affiliated subadviser to manage a covered investment pool in which a government entity invests so that the adviser could make contributions to that government entity would be doing indirectly what it would be prohibited from doing directly under the rule. A subadviser would be providing “investment advisory services for compensation to a government entity” regardless of whether the subadviser is paid directly by the government entity or by the adviser.

<sup>398</sup> See rule 206(4)-5(d).

**(f) Exemptions**

An adviser may apply to the Commission for an order exempting it from the two-year compensation ban.<sup>399</sup> Under this provision, which we are adopting as proposed, we can exempt advisers from the rule's time out requirement where the adviser discovers contributions that trigger the compensation ban only after they have been made, and when imposition of the prohibition is unnecessary to achieve the rule's intended purpose. This provision will provide advisers with an additional avenue by which to seek to cure the consequences of an inadvertent violation by the adviser that falls outside the limits of the rule's *de minimis* exception and exception for returned contributions,<sup>400</sup> such as when a disgruntled employee makes a greater than \$350 contribution as he or she exits the firm. In determining whether to grant an exemption, we will take into account the varying facts and circumstances that each application presents. Among other factors, we 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) whether the investment adviser, (A) before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of rule 206(4)-5; (B) prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and (C) after learning of the contribution, (1) has taken all available steps to cause the contributor involved in making the contribution which

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<sup>399</sup> Rules 0-4, 0-5, and 0-6 under the Advisers Act [17 CFR 275.0-4, 0-5, and 0-6] provide procedures for filing applications under the Act, including applications under the rule 206(4)-5.

<sup>400</sup> See sections II.B.2(a)(6) and (7) of this Release, describing exceptions to the two-year time out prohibition of the rule.

resulted in such prohibition to obtain a return of the contribution; and (2) has taken such other remedial or preventive measures as may be appropriate under the circumstances; (iii) whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment; (iv) the timing and amount of the contribution which resulted in the prohibition; (v) the nature of the election (*e.g.*, federal, state or local); and (vi) the contributor's apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.<sup>401</sup> We intend to apply these factors with sufficient flexibility to avoid consequences disproportionate to the violation, while effecting the policies underlying the rule.

We received limited comment on this provision. A few commenters suggested that the operation of the rule should toll until a decision is made about an applicant's request.<sup>402</sup> We are concerned that such an approach could encourage frivolous applications and encourage applicants to delay the disposition of their applications. As we explained in the Proposing Release, an adviser seeking an exemption could place into an escrow account any advisory fees earned between the date of the contribution triggering the prohibition and the date on which we determine whether to grant an exemption.<sup>403</sup> Some commenters recommended the rule build in a specified length of

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<sup>401</sup> See Rule 206(4)-5(e). These factors are similar to those considered by FINRA and the appropriate bank regulators in determining whether to grant an exemption under MSRB rule G-37(i).

<sup>402</sup> ICI Letter; Skadden Letter.

<sup>403</sup> See Proposing Release, at n.199. The escrow account would be payable to the adviser if the Commission grants the exemption. If the Commission does not grant the exemption, the fees contained in the account would be returned to the government entity client. In contrast, MSRB rule G-37, on which rule 206(4)-5 is based, does not permit a municipal

time for the Commission to respond to requests for relief.<sup>404</sup> We recognize that applications for an exemptive order will be time-sensitive and will consider such applications expeditiously. We note that the escrow arrangements discussed above may lessen the hardship on advisers.

#### **D. Recordkeeping**

We are adopting amendments to rule 204-2 to require registered investment advisers that have government clients, or that provide investment advisory services to a covered investment pool in which a government entity investor invests, to make and keep certain records that will allow us to examine for compliance with new rule 206(4)-5.<sup>405</sup> The rule amendments reflect several changes from our proposal, which are discussed below. These requirements are similar to the MSRB recordkeeping requirements for brokers, dealers and municipal securities dealers.<sup>406</sup>

Amended rule 204-2 requires registered advisers that provide investment advisory services to a government entity, or to a covered investment pool in which a government

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securities dealer to continue to engage in municipal securities business with an issuer while an application is pending. *See* MSRB Rule G-37 Q&A, Question V.1.

<sup>404</sup> IAA Letter; ICI Letter; NASP Letter (each suggesting all applications be granted if they are not acted upon in 30 days); Skadden Letter (suggesting a 45-day deadline).

<sup>405</sup> Rule 204-2(a)(18) and (h)(1). An adviser is required to make and keep these records only if it provides investment advisory services to a government entity or if a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services. Advisers that solicit government clients on behalf of other advisers are also subject to the amended recordkeeping requirements. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act, however, are not subject to the recordkeeping requirements under amended 204-2 unless they do register with us, although as discussed earlier, *supra* note 92 and accompanying text, they are subject to rule 206(4)-5. Advisers keeping substantially the same records under rules adopted by the MSRB are not required to keep duplicate records. Rule 204-2(h)(1).

<sup>406</sup> MSRB rule G-8(a)(xvi). The MSRB also requires certain records to be made and kept in accordance with disclosure requirements that our rule does not contain.

entity is an investor, to make and keep records of contributions made by the adviser and covered associates to government officials (including candidates), and of payments to state or local political parties and PACs.<sup>407</sup> The adviser's records of contributions and payments must be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment and whether a contribution was subject to rule 206(4)-5's exception for certain returned contributions.<sup>408</sup> The rule also requires an adviser that has government clients to make and keep a list of its covered associates,<sup>409</sup> and the government entities to which the adviser has provided advisory services in the past five years.<sup>410</sup> Similarly, advisers to covered investment pools must make and keep a list of government entities that invest, or have invested in the past five years, in a covered investment pool, including any government entity that selects a covered investment pool to be an option of a plan or program of a government entity, such as a 529, 457 or 403(b) plan.<sup>411</sup> An investment adviser, regardless of whether it currently has a government client, must also keep a list of the names and business addresses of each regulated person to whom the adviser provides or agrees to provide,

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<sup>407</sup> Contributions and payments by PACs controlled by the adviser or a covered associate would also have to be recorded as these PACs are "covered associates" under the rule. Rule 206(4)-5(f)(2)(iii). *See* section II.B.2(a)(4) of this Release.

<sup>408</sup> Rule 204-2(a)(18)(ii).

<sup>409</sup> The adviser must record the name, title(s), and business and residence addresses of each covered associate. Rule 204-2(a)(18)(i)(A).

<sup>410</sup> Advisers do not have to maintain a record of government entities that were clients before the effective date. For additional information regarding the implementation of rule 206(4)-5, see section III of this Release.

<sup>411</sup> Amended rule 204-2 does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. *See supra* note 374. Consistent with changes we have made to the definition of covered investment pool, we note that an adviser's recordkeeping obligations with respect to a registered investment company apply only if such an investment company is an option of a plan or program of a government entity. *See* section II.B.2(e) of this Release.

directly or indirectly, payment to solicit a government entity on its behalf.<sup>412</sup> The amended rule reflects several changes from our proposal, which we describe below.

First, in response to comments,<sup>413</sup> we have limited the rule to provide that only records of contributions,<sup>414</sup> not payments,<sup>415</sup> to government officials and candidates are required to be kept under the rule.<sup>416</sup> We have made this change because, unlike contributions, which are one type of payment, all payments do not trigger the two-year time out. As a result of this change, the recordkeeping obligations better reflect the activities of an adviser or a covered associate that could result in the adviser being subject to the two-year time out. Commenters also argued that we should not require, as proposed, advisers to maintain records of payments to PACs.<sup>417</sup> Although those payments do not trigger application of the two-year time out, payments to PACs can be a means for an adviser or covered associate to funnel contributions to a government official without directly contributing. We are, therefore, adopting the amendment to require advisers to keep records of payments to PACs as these records will allow our staff to identify situations that might suggest an intent to circumvent the rule.<sup>418</sup>

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<sup>412</sup> Rule 204-2(a)(18)(i)(D).

<sup>413</sup> Fidelity Letter; IAA Letter; SIFMA Letter.

<sup>414</sup> See *supra* note 153 and accompanying text (defining “contribution”)

<sup>415</sup> See *supra* note 331 (defining “payment”).

<sup>416</sup> Rule 204-2(a)(18)(i)(C).

<sup>417</sup> See, e.g., IAA Letter; SIFMA Letter.

<sup>418</sup> Accordingly, as part of a strong compliance program, an adviser or covered associate that receives a general solicitation to make a contribution to a PAC should consider inquiring about how the collected funds would be used to determine whether the PAC is closely associated with a government official to whom a direct contribution would subject the adviser to the two-year time out. See section II.B.2(d) of this Release and rule 206(4)-5(d). The MSRB takes a similar approach regarding whether a payment to a PAC is an indirect contribution to a government official. See MSRB Rule G-37 Q&A, Questions III.4 and III.5.

Second, an investment adviser to a registered investment company must maintain records identifying government entity investors only if the investments are made as part of a plan or program of a government entity or provide participants in the plan or program with the option of investing in the fund.<sup>419</sup> This change would narrow the records required to those necessary to support the rule as modified from our proposal, and we believe addresses commenters' concerns regarding the ability of advisers to registered investment companies to identify government entity investors.<sup>420</sup> As discussed above, we believe it is reasonable to expect advisers to know the identity of the government entity when a registered fund they advise is part of a plan or program. In addition, as commenters suggested, we are providing a substantial transition period for advisers to registered investment companies that should allow these advisers to make the necessary changes to account documents and systems to allow them to identify government entities that provide one or more of the investment companies they advise as an investment option.<sup>421</sup>

Third, the amended rule requires an adviser to maintain a list of only those government entities to which it provides, or has provided in the past five years,

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<sup>419</sup> Rule 204-2(a)(18)(i)(B). Amended rule 204-2 does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. For a discussion of the application of the rule to a covered investment pool that is an option of a government plan or program, see *supra* note 371 and accompanying text. Consistent with changes we have made to the definition of covered investment pool, we note that an adviser's recordkeeping obligations with respect to a registered investment company apply only if such an investment company is an option of a plan or program of a government entity. See section II.B.2(e) of this Release.

<sup>420</sup> Advisers to covered investment pools that are relying on Investment Company Act exclusions in sections 3(c)(1), 3(c)(7) and 3(c)(11) must identify government entity investors regardless of whether they are an investment option of a plan or program of a government entity. Rule 204-2(a)(18)(i)(B).

<sup>421</sup> See section III of this Release.

investment advisory services.<sup>422</sup> We are not requiring, as proposed, a list of government entities the adviser solicited for advisory business.<sup>423</sup> Some commenters expressed concerns about the potential scope of this requirement and noted that solicitation does not trigger rule 206(4)-5's two-year time out, rather it is providing advice for compensation that does so.<sup>424</sup> In light of these concerns, and the record before us today, we are not requiring advisers to maintain lists of government entities solicited that do not become clients.

Fourth, as discussed above, rule 206(4)-5 permits an adviser to use certain third parties to solicit on its behalf. We are, therefore, requiring that advisers that provide or agree to provide, directly or indirectly, payment to advisers or broker-dealers registered with the Commission that act as regulated persons under rule 206(4)-5 to maintain a list of the names and business addresses of each such regulated person.<sup>425</sup> These records will enable the Commission's staff to review and compare the regulated person's records to those of the adviser that hired the regulated person.

Finally, the amendments require advisers to make and keep records of their covered associates, and their own and their covered associates' contributions, *only if* they provide advisory services to a government client.<sup>426</sup> Commenters had expressed concerns that requiring advisers with no government business to make and keep these records

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<sup>422</sup> See rule 204-2(a)(18)(i)(B).

<sup>423</sup> See proposed rule 204-2(a)(18)(i)(B).

<sup>424</sup> Dechert Letter; SIFMA Letter; Skadden Letter.

<sup>425</sup> Rule 204-2(a)(18)(i)(D). If an adviser does not specify which types of clients the regulated person should solicit on its behalf (*e.g.*, that it should *only* solicit government entities), the adviser could satisfy this requirement by maintaining a list of all of its regulated person solicitors. *Supra* note 412.

<sup>426</sup> Rule 204-2(a)(18)(iii).



could be unnecessarily intrusive to employees and burdensome on advisers.<sup>427</sup> In light of those concerns, and the record before us today, we are not requiring advisers with no government business to make and keep these records.<sup>428</sup> As a consequence, an adviser with no government clients would not have to require employees to report their political contributions.

**E. Amendment to Cash Solicitation Rule**

We are adopting, as proposed, a technical amendment to rule 206(4)-3 under the Advisers Act, the “cash solicitation rule.” That rule makes it unlawful, except under specified circumstances and subject to certain conditions, for an investment adviser to make a cash payment to a person who directly or indirectly solicits any client for, or refers any client to, an investment adviser.<sup>429</sup>

Paragraph (iii) of the cash solicitation rule contains general restrictions on third-party solicitors that cover solicitation activities directed at *any* client, regardless of whether it is a government entity client. New paragraph (e) to rule 206(4)-3 alerts

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<sup>427</sup> IAA Letter; Dechert Letter; SIFMA Letter.

<sup>428</sup> Although advisers that do not have government entity clients are not required to maintain records under the amendments, the look-back requirements of rule 206(4)-5 continue to apply. As a result, an adviser that has not maintained records of the firm’s and its covered associates’ contributions would have to determine whether any contributions by the adviser, its covered associates, and any former covered associates would subject the firm to the two-year time out prior to accepting compensation from a new government entity client. The same applies to newly-formed advisers. The records an adviser develops during this determination process, would fall under the adviser’s obligation to maintain records of all direct or indirect contributions made by the investment adviser or its covered associates to an official of a government entity, or payments to a political party of a state or political subdivision thereof, or to a political action committee. Rule 204-2(a)(18)(i)(C).

<sup>429</sup> 17 CFR 275.206(4)-3.

advisers and others that special prohibitions apply to solicitation activities involving government entity clients under rule 206(4)-5.<sup>430</sup>

### **III. EFFECTIVE AND COMPLIANCE DATES**

Rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3 are effective on September 13, 2010. Investment advisers subject to rule 206(4)-5 must be in compliance with the rule on March 14, 2011. Investment advisers may no longer use third parties to solicit government business except in compliance with the rule on September 13, 2011.<sup>431</sup>

Advisers to registered investment companies that are covered investment pools must comply with the rule by September 13, 2011.<sup>432</sup> Advisers subject to rule 204-2 must comply with amended rule 204-2 on March 14, 2011. However, if they advise registered investment companies that are covered investment pools, they have until September 13, 2011 to comply with the amended recordkeeping rule with respect to those registered investment companies.

#### **A. Two-Year Time Out and Prohibition on Soliciting or Coordinating Contributions**

We are providing advisers with a six month transition period to give them time to identify their covered associates and current government entity clients and to modify their compliance programs to address new compliance obligations under the rule.<sup>433</sup>

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<sup>430</sup> Rule 206(4)-3(e). We received no comments on this proposed amendment.

<sup>431</sup> Rule 206(4)-5(a)(2).

<sup>432</sup> Rule 206(4)-5(f)(3).

<sup>433</sup> Section III.D of this Release addresses when advisers to “covered investment pools” that are registered investment companies must comply with the rule; section III.E of this Release addresses transition considerations specific to certain other pooled investment vehicles.

Accordingly, rule 206(4)-5's prohibition on providing advisory services for compensation within two years of a contribution will not apply to, and the rule's prohibition on soliciting or coordinating contributions will not be triggered by contributions made before March 14, 2011.<sup>434</sup> We believe that the length of the transition period should address commenters' concerns that advisers have sufficient time to implement policies and procedures regarding contributions to avoid violations of the rule and that the rule not affect the 2010 elections for which some advisory personnel may already have committed to make political contributions.<sup>435</sup>

**B. Prohibition on Using Third Parties to Solicit Government Business and Cash Solicitation Rule Amendment**

Advisers must comply with the new rule's prohibition on making payments to third parties to solicit government entities for investment advisory services on September 13, 2011.<sup>436</sup> Before this compliance date, advisers are not

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<sup>434</sup> Likewise, these prohibitions do not apply to contributions made before March 14, 2011 by new covered associates to which the look back applies. See section II.B.2(a)(5) of this Release for a discussion of the rule's look-back provision. For example, if an individual who becomes a covered associate of an adviser on or after March 14, 2011 made a contribution before March 14, 2011, that new covered associate's contribution would not trigger the two-year time out for the adviser. On the other hand, if an individual who later becomes a covered associate made the contribution on or after March 14, 2011, the contribution would trigger the two-year time out for the adviser if it were made less than, as applicable, six months or two years before the individual became a covered associate.

<sup>435</sup> Commenters recommended that we provide advisers with six months to one year as a transition for rule 206(4)-5. See Davis Polk Letter; MFA Letter; ICI Letter; IAA Letter; NASP Letter; Skadden Letter.

<sup>436</sup> Rule 206(4)-5(a)(2).

prohibited by the rule from making payments to third-party solicitors regardless of whether they are registered as broker-dealers or investment advisers.<sup>437</sup>

We have provided an extended transition period to provide advisers and third-party solicitors with sufficient time to conform their business practices to the new rule, and to revise their compliance policies and procedures to prevent violation of the new rule. In addition, the transition period will provide an opportunity for a registered national securities association to propose a rule that would meet the requirements of rule 206(4)-5(f)(9)(ii)(B) and for the Commission to consider such a rule. If, after one year, a registered national securities association has not adopted such rules, advisers would be prohibited from making payments to broker-dealers for distribution or solicitation activities with respect to government entities, but would be permitted to make payments to registered investment advisers that meet the definition of “regulated person” under the rule.<sup>438</sup> We understand from our staff, however, that FINRA plans to act within the timeframe; if they do not, we will consider whether we should take further action.

Finally, the compliance date for the technical amendment to the cash solicitation rule, rule 206(4)-3, which is intended to alert advisers that rule 206(4)-5 is applicable to solicitations of a government entity, is one year from the effective date, as the amendment to the cash solicitation rule need only be operative when rule 206(4)-5’s third-party solicitor provisions are in effect.

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<sup>437</sup> We note, however, that the antifraud provisions of the federal securities laws continue to apply during the transition period.

<sup>438</sup> See rule 206(4)-5(f)(9)(i).

### **C. Recordkeeping**

As discussed above, the amendments to rule 204-2 apply only to investment advisers with clients who are government entities. Such advisers must comply with the amended rule on March 14, 2011 except as noted below. By March 14, 2011, these advisers must begin to maintain records of all persons who are covered associates under the rule and keep records of political contributions they make on and after that date. Advisers must also make and keep a record of all government entities that they provide advisory services to on and after March 14, 2011. Advisers are not, however, required to look back for the five years prior to the effective date to identify former government clients. Advisers that pay regulated persons to solicit government entities for advisory services on their behalf must make and keep a list of those persons beginning on and after September 13, 2011.<sup>439</sup>

### **D. Registered Investment Companies**

Advisers to registered investment companies that are “covered investment pools” under the rule<sup>440</sup> must comply with rule 205(4)-5 with respect to those covered pools September 13, 2011. During the transition period, contributions by the adviser or its employees to government entity clients that have selected an adviser’s

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<sup>439</sup> Rule 204-2(a)(18)(i)(D).

<sup>440</sup> A registered investment company is only a covered investment pool if it is an investment option of a plan or program of a government entity, such as a 529 plan, 403(b) plan or 457 plan. *See* rule 206(4)-5(f)(3).

registered investment company as an investment option of a plan or program will not trigger the prohibitions of rule 206(4)-5.<sup>441</sup>

We have provided for an extended compliance date to respond to concerns expressed by commenters that an adviser to a registered investment company may require additional time to identify government entities that have selected that registered investment company as an investment option when shares of the fund are held through omnibus arrangements such that the identity of the fund investor is not readily available to the adviser.<sup>442</sup> The changes we have made to the proposed rule that limit the application of the two-year time out with respect to registered investment companies to those that are options in a plan or program of a government entity,<sup>443</sup> together with this extended compliance date should provide advisers to registered investment companies sufficient time to put into place those system enhancements or business arrangements, such as those with intermediaries, that may be necessary to identify those government plans or programs in which the funds serve as investment options.<sup>444</sup>

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<sup>441</sup> Advisers to covered investment pools other than registered investment companies—*i.e.*, companies that would be investment companies under section 3(a) of the Investment Company Act but for the exclusion provided from that definition by either section 3(c)(1), section 3(c)(7) or section 3(c)(11)—are subject to the six-month transition period. We believe advisers to these types of funds, because the interests in them are typically held in the name of the investor, should be able to identify government entities without significant difficulty.

<sup>442</sup> See ICI Letter; T. Rowe Price Letter.

<sup>443</sup> See section II.B.2(a) of this Release.

<sup>444</sup> A few commenters recommended that the rule apply only to new government investors in registered investment companies after the effective date of the rule. See ICI Letter; T. Rowe Price Letter. We do not believe this would be appropriate because pay to play can be just as troubling in the context of an adviser renewing an advisory contract (or including a registered investment company as an investment option in a plan or program) as one that is endeavoring to obtain business for the first time.

As noted above, we are providing for an extended compliance date for advisers that manage registered investment companies that are covered investment pools under the rule, which we are applying, for the same reasons, to recordkeeping obligations that arise as a result of those covered investment pools. Thus, advisers to these covered investment pools must make and keep a record of all government entity investors on and after September 13, 2011.<sup>445</sup>

#### **IV. COST-BENEFIT ANALYSIS**

We are sensitive to the costs and benefits imposed by our rules, and understand that there will be costs associated with compliance with rule 206(4)-5 and the amendments to rule 204-2.<sup>446</sup> We recognize that the rule and amendments will place burdens on advisers that provide or seek to provide advisory services to government entities, and that advisers may in turn choose to limit the ability of certain persons associated with an adviser to make contributions to candidates for certain offices and to solicit contributions for certain candidates and payments to political parties. We believe there are practical, cost-effective means to comply with the rule without an adviser imposing a blanket ban on political contributions by its covered associates. We have closely drawn the rule, and modified it based on comments received, to achieve our goal of addressing adviser participation in pay to play practices, while seeking to limit the burdens imposed by the rule.

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<sup>445</sup> Amended rule 204-2 does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. *See supra* note 411.

<sup>446</sup> As proposed, we are also making a conforming technical amendment to rule 206(4)-3 to address potential areas of conflict with proposed rule 206(4)-5. We do not believe that this technical amendment affects the costs associated with the rulemaking. It will benefit advisers because it provides clarity about the application of our rules when they potentially overlap.

The rule and rule amendments are designed to address pay to play practices by investment advisers that provide advisory services to government entity clients and to certain covered investment pools in which a government entity invests. The rule prohibits an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. The rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party that is not a “regulated person” for a solicitation of advisory business from any government entity, or for a solicitation of a government entity to invest in certain covered investment pools, on behalf of such adviser. Additionally, the rule prevents an adviser from coordinating or soliciting from others contributions to certain elected officials or candidates or payments to certain political parties. The rule applies both to advisers registered with us (or required to be registered) and those that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)). Our amendment to rule 204-2 requires a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees, as well as records of the regulated persons the adviser pays or agrees to pay to solicit government entities on the adviser’s behalf.

In the Proposing Release, we requested comment on the effects of the proposed rule and rule amendments on pension plan beneficiaries, participants in government plans or programs, investors in pooled investment vehicles, investment advisers, the advisory profession as a whole, government entities, third party solicitors, and political action



committees.<sup>447</sup> We requested that commenters provide analysis and empirical data to support their views on the costs and benefits associated with the proposal. For example, we requested comment on the costs of establishing compliance procedures to comply with the proposed rule, both on an initial and ongoing basis and on the costs of using compliance procedures of an affiliated broker-dealer that the broker-dealer established as a result of MSRB rules G-37 and G-38. In addition, we requested data regarding our assumptions about the number of unregistered advisers that would be subject to the proposed rule, and the number of covered associates of these exempt advisers. Finally, in the context of the objectives of this rulemaking, we sought comments that address whether these rules will promote efficiency, competition and capital formation, and what effect the rule would have on the market for investment advisory services and third-party solicitation services.

We received approximately 250 comment letters on the proposal. Almost all of the commenters agreed that pay to play is a serious issue that should be addressed. One commenter stated that “the benefits derived from the application of pay to play limitations to public sector advisory services will far outweigh any temporary dislocations that may occur as private and public sector professionals make the necessary adjustments to their activities to transition to the Commission's new standards.”<sup>448</sup> Many, however, expressed concern about costs,<sup>449</sup> particularly those related to the proposed ban on payments to third parties. Some suggested that the Commission underestimated the

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<sup>447</sup> Proposing Release, at section III.C.

<sup>448</sup> MSRB Letter. *See also* Thompson Letter; Common Cause Letter; Fund Democracy/Consumer Federation Letter (each identifying benefits of the rule).

<sup>449</sup> *See, e.g.*, Davis Polk Letter (generally commenting that any benefits of the proposed rule were outweighed by its likely costs). *See also* ICI Letter; Monument Group Letter.

costs of compliance with the rule and rule amendments.<sup>450</sup> As discussed below, many of the commenters that did comment specifically on the costs and benefits of the proposal did not provide empirical data to support their views.

#### **A. Benefits**

As we discuss extensively throughout this Release, we expect that rule 206(4)-5 will yield several important direct and indirect benefits. Overall, the rule is intended to address pay to play relationships that interfere with the legitimate process by which advisers are chosen based on the merits rather than on their contributions to political officials. The potential for fraud to invade the various, intertwined relationships created by pay to play arrangements is without question. We believe that rule 206(4)-5 will reduce the occurrence of fraudulent conduct resulting from pay to play and thus will achieve its goals of protecting public pension plans, beneficiaries, and other investors from the resulting harms. One commenter who agreed with us commended the proposed rule as a “strong start in controlling corruption, balancing the rights of the advisors and

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<sup>450</sup> See, e.g., SIFMA Letter (“While SIFMA believes that addressing practices that potentially undermine the merit-based selection of investment advisers is an important and laudable effort, the SEC appears to have underestimated the compliance costs the Proposed Rule will impose on covered parties.”); ICI Letter ([I]n relying on the estimates for compliance with the MSRB rules, the Commission significantly underestimates the compliance and recordkeeping burdens associated with the proposed rule.”); Davis Polk Letter (“We believe that the Commission may have substantially underestimated the number of investment advisers that will be affected by the Proposed Rule and its costs and market effects in concluding that many of the aspects of the Rule would impose only minimal additional costs and burdens on investors and investment advisers.”). The commenters who addressed our estimates, however, did so in general terms and did not provide specific suggestions as to how they should be modified. See the discussion below regarding changes from the proposed rule that we believe mitigate some of the costs.

their executives with the very real detriment to the public which the numerous cases of pay-to-play involving public pension funds and other public entities have caused.”<sup>451</sup>

Addressing pay to play practices will help protect public pension plans and investments of the public in government-sponsored savings and retirement plans and programs by addressing situations in which a more qualified adviser may not be selected, potentially leading to inferior management, diminished returns or greater losses. One commenter who agreed, observed, “[w]hen lucrative investment contracts are awarded to those who pay to play, public pension funds may end up receiving substandard services and higher fees, resulting in lower earnings.”<sup>452</sup> One public official commenter detailed the role of pay to play arrangements in the selection of public pension fund managers and the harm it can inflict on the affected plans,<sup>453</sup> while other officials wrote to us explicitly expressing support for a Commission rule.<sup>454</sup> By addressing pay to play practices, we will help level the playing field so that the advisers selected to manage retirement funds and other investments for the public are more likely to be selected based on the quality of their advisory services. These benefits, although difficult to quantify, could result in substantial savings and better performance for the public pension plans, their

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<sup>451</sup> Common Cause Letter.

<sup>452</sup> Bloomberg Letter.

<sup>453</sup> Weber Letter (“I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen.”). *See also* Pohndorf Letter (noting that when the sole trustee of a major pension fund changed several years ago, a firm managing some of the fund’s assets “began to receive invitations to fundraising events for the new trustee with suggested donation amounts”); Tobe Letter (suggesting the negative effects of pay to play activities on the Kentucky Retirement System’s investment performance).

<sup>454</sup> *See, e.g.*, DiNapoli Letter; Bloomberg Letter.

beneficiaries, and participants.<sup>455</sup> Two commenters noted that the rule would promote the interests of plan beneficiaries.<sup>456</sup>

By leveling the playing field among advisers competing for state and local government business, the rule will help minimize or eliminate manipulation of the market for advisory services provided to state and local governments.<sup>457</sup> For example, direct political contributions or payments made to third-party solicitors as part of pay to play practices create artificial barriers to competition for firms that cannot, or will not, make those contributions or payments.<sup>458</sup> They also increase costs for firms that may feel they have no alternative but to pay to play. The rule addresses a collective action problem created by this dynamic analogous to the one identified in the *Blount* opinion.<sup>459</sup> One commenter emphasized the importance of restoring public confidence in the investment

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<sup>455</sup> According to the most recently available US census data, as of 2008, there are 2,550 state and local government employee retirement systems. <http://www.census.gov/govs/retire/>. See also Fund Democracy/Consumer Federation Letter (“These practices adversely affect the economic interests of millions of America’s public servants.”).

<sup>456</sup> Comment Letter of John C. Emmel (Sept. 18, 2009) (“one more step to foster a level playing field for investors . . . where advisors’ priorities trump those of the investing public”); Comment Letter of George E. Kozel (Aug. 31, 2009) (“Kozel Letter”) (“Their interests lie in obtaining the highest fees not in producing benefits for the pensioners . . .”).

<sup>457</sup> See DiNapoli Letter (advocating for a “level playing field for investors and investment advisers that protects the integrity of the decision-making process [for hiring an investment adviser]”); Bloomberg Letter (“Pay to play practices clearly undermine the open competitive process by which government contracts are to be awarded.”).

<sup>458</sup> See *supra* note 453.

<sup>459</sup> See *Blount*, 61 F.3d at 945-46 (discussing the harms of pay to play: “Moreover, there appears to be a collective action problem tending to make the misallocation of resources persist.”). See also text accompanying notes 291-294 of this release. Collective action problems are a class of market failures calling for a regulatory response, and exist, for example, where participants may prefer to abstain from an unsavory practice (such as pay to play), but nonetheless participate out of concern that, even if they abstain, their competitors will continue to engage in the practice profitably and without adverse consequences.

activities of all public pension funds.<sup>460</sup> Indeed, at its core, the rulemaking addresses practices that undermine the integrity of the market for advisory services, as underscored by another commenter.<sup>461</sup>

Allocative efficiency is enhanced when government clients award advisory business to advisers that compete based on price, performance and service and not the influence of pay to play, which in turn enables advisory firms, particularly smaller advisory firms, to compete on merit, rather than their ability or willingness to make contributions.<sup>462</sup> In addition, taking into account the effects of analogous practices in the underwriting of municipal securities prior to MSRB rule G-37,<sup>463</sup> we believe a merit-based competitive process may result in the allocation of public pension monies to different advisers who may well deliver better investment performance and lower advisory fees than those advisers whose selection was influenced by pay to play.

As adopted, the rule contains a prohibition against advisers directly or indirectly compensating a third party to solicit government entities on its behalf, unless the third-party solicitor is a “regulated person” subject to pay to play restrictions. This exception

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<sup>460</sup> Thompson Letter. *See also* Bloomberg Letter.

<sup>461</sup> Common Cause Letter (“Pay-to-play has not only the potential to compromise an investment adviser’s ethical and legal duties under the Investment Advisers Act of 1940, but in several high profile cases across the nation, has already done so, negatively impacting the public perception of government decision making and, in some cases, costing the taxpayer millions of dollars and placing billions of dollars in pension funds at risk.”). *See also* Dempsey Letter (noting applause for efforts “to stop the ‘pay-to-play’ practice which only serves to undermine public trust in investment advisors and regulators”).

<sup>462</sup> *See* Comment Letter of Budge Collins (Sept. 30, 2009) (the rule would “level the playing field for the rest of us who have never made contributions to elected officials who sit on investment management committees”).

<sup>463</sup> One commenter cited a study containing evidence that before rule G-37 was adopted, underwriters’ pay to play practices distorted underwriting fees as well as which firms were hired by government issuers. *See* Butler Letter.

enables advisers and pension plans (and their beneficiaries) to continue to benefit from the services of third-party solicitors, such as the placement of interests in private funds, while at the same time benefitting from a Commission rule that prohibits pay to play practices.<sup>464</sup>

Our rule may also benefit pension plans by preventing harms that can result when an adviser is not negotiating at arm's length with a government official. For example, as a result of pay to play, an adviser may obtain greater ancillary benefits, such as "soft dollars," from the advisory relationship, which may be directed for the benefit of the adviser, potentially at the expense of the pension plan, thereby using a pension plan asset for the adviser's own purposes.<sup>465</sup> Additionally, taxpayers may benefit from our rule because they might otherwise bear the financial burden of bailing out a government pension fund that has ended up with a shortfall due to poor performance or excessive fees that might result from pay to play.<sup>466</sup>

In addition to the general benefits of addressing pay to play practices by investment advisers noted above, we believe the specific provisions of the rule, including the two-year time out, the ban on using third parties to solicit government business, and

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<sup>464</sup> Commenters, both on the Proposing Release and our 1999 proposal, argued that treating third-party solicitors as covered associates would create significant compliance challenges because these solicitors were not controlled by advisers. *See supra* note 264 and accompanying text.

<sup>465</sup> *See supra* note 55 and accompanying text.

<sup>466</sup> *See* Kozel Letter (supporting the Commission's proposal and asserting that the persons who engage in pay to play practices know that any shortfalls would be covered by taxpayers); Bloomberg Letter ("Because the City is legally obligated to make up any short fall in the pension system assets to ensure full payment of pension benefits, pay to play practices can potentially harm all New Yorkers."). *See also* Common Cause Letter; 1997 SURVEY, *supra* note 8 ("[t]he investment of plan assets is an issue of immense consequence to plan participants, taxpayers, and to the economy as a whole" as a low rate of return will require additional funding from the sponsoring government, which "can place an additional strain on the sponsoring government and may require tax increases").

the restrictions on soliciting and coordinating contributions and payments will likely result in similar benefits to those that have resulted from MSRB rules G-37 and G-38, on which our rule is closely modeled. The MSRB rules have prohibited municipal securities dealers from participating in pay to play practices since 1994.<sup>467</sup> As we have stated previously, we believe these rules have significantly curbed pay to play practices in the municipal securities market, and are likely to be similarly effective in deterring pay to play activities by investment advisers.<sup>468</sup>

Applying the rule to government entity investments in certain pooled investment vehicles or where a pooled investment vehicle is an investment option in a government-sponsored plan or program will extend the same benefits regardless of whether an adviser subject to the rule is providing advice directly to the government entity or is managing assets for the government entity indirectly through a pooled investment vehicle. By addressing distortions in the process by which investment decisions are made regarding public investments, we are providing important protections to public pension plans and their beneficiaries, as well as participants in other important plans or programs sponsored by government entities. Other investors in a pooled investment vehicle also will be better protected from, among other things, the effects of fraud that may result from an adviser's participation in pay to play activities, such as higher advisory fees.

Finally, the amendments to rule 204-2 will benefit the public plans and their beneficiaries and participants in state plans or programs as well as investment advisers that keep the required records. The public pension plans, beneficiaries, and participants

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<sup>467</sup> MSRB rule G-37 was approved by the Commission and adopted by the MSRB in 1994. *See supra* note 66.

<sup>468</sup> *See supra* notes 101–107 and accompanying text.

will benefit from these amendments because the records required to be kept will provide Commission staff with information to review an adviser's compliance with rule 206(4)-5 and thereby may promote improved compliance. Advisers will benefit from the amendments to the recordkeeping rule as these records will assist the Commission in enforcing the rule against, for example, a competitor whose pay to play activities, if not uncovered, could adversely affect the competitive position of a compliant adviser.

## **B. Costs**

We acknowledge that the rule and rule amendments will impose costs on advisers that provide or seek to provide advisory services to government clients directly, or indirectly through pooled investment vehicles. We discuss these costs below, along with a number of modifications we have made to the proposed rule and proposed amendments that will reduce costs.

### **1. Compliance Costs Related to Rule 206(4)-5**

Rule 206(4)-5 requires an adviser with government clients to incur costs to monitor contributions made by the adviser and its covered associates and to establish procedures to comply with the rule. The initial and ongoing compliance costs imposed by the rule will vary significantly among firms, depending on a number of factors. Our estimated compliance costs, discussed below, take into account different ways a firm might comply with the rule. These factors include the number of covered associates of the adviser, the degree to which compliance procedures are automated (including policies and procedures that could require pre-clearance), the extent to which an adviser has a pre-existing policy under its code of ethics or compliance program,<sup>469</sup> and whether the

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One commenter stated that many investment advisers already have pay to play policies and procedures in place within the framework of their codes of ethics. *See* IAA Letter



adviser is affiliated with a broker-dealer firm that is subject to MSRB rules G-37 and G-38. A smaller adviser, for example, will likely have a small number of covered associates, and thus expend less resources to comply with the rule and rule amendments than a larger adviser.

Although a larger adviser is likely to spend more resources to comply with the rule, based on staff observations, a larger adviser is more likely to have an affiliated broker-dealer that is required to comply with MSRB rules G-37 and G-38.<sup>470</sup> As we learned from a broker-dealer with an investment adviser affiliate that commented on our 1999 proposal, “the more the Rule mirrors G-37, the more firms can borrow from or build upon compliance procedures already in place. . . .”<sup>471</sup> Accordingly, we believe

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(advocating for regulation that would address pay to play practices through an adviser’s code of ethics, as an alternative to the approach taken in proposed rule 206(4)-5).

<sup>470</sup> According to registration information available from Investment Adviser Registration Depository (“IARD”) as of April 1, 2010, there are 1,332 SEC-registered investment advisers (or 11.48% of the total 11,607 registered advisers) that indicate in Item 5.D.(9) of Form ADV that they have state or municipal government clients. Of those 1,332 advisers, 113 (or 85.0%) of the largest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. 204 of the largest 20% (or 76.7%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. Conversely, only 40 (or 30.1%) of the smallest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer; and only 67 of the smallest 20% (or 25.2%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. With respect to broker-dealer affiliates, however, we note that our IARD data does not indicate whether the affiliated broker-dealer is a municipal securities dealer subject to MSRB rules G-37 and G-38. Also, as one commenter asserted, private fund managers may be among the larger advisers, based on assets under management, but they are unlikely to have an affiliated broker-dealer that has already adopted similar procedures to comply with MSRB rules G-37 and G-38 because most private fund managers are not involved in municipal underwriting. MFA Letter. We acknowledge that a private fund manager generally would be less likely to have an affiliated broker-dealer from which it can borrow or build upon compliance procedures; however, we also expect that a private fund manager would use less resources than other large registered advisers to comply with the rule because a private fund manager is not subject to rule 206(4)-7, the Advisers Act compliance rule, and would likely have fewer employees and covered associates than a larger organization.

<sup>471</sup> Comment Letter of US Bancorp Piper Jaffray Inc. (now, “Piper Jaffray & Co.”) (Nov. 15, 1999).

some advisers with broker-dealer affiliates may spend fewer resources to comply with the rule and rule amendments. We recognize, as some commenters pointed out, that MSRB rules G-37 and G-38 compliance systems may not be easily extensible in all cases, and we acknowledge that the range of efficiencies created in these circumstances will vary.<sup>472</sup> A prominent concern of these commenters related to a proposed recordkeeping amendment which would have required advisers to keep records of solicitations—something that is not required under MSRB recordkeeping rule G-8. As previously discussed, we are not adopting that proposed amendment, which may address the concern noted by commenters.

We anticipate that advisory firms subject to rule 206(4)-5 will develop compliance procedures to monitor the political contributions made by the adviser and its covered associates.<sup>473</sup> We estimate that the costs imposed by the rule will be higher initially, as firms establish and implement procedures and systems to comply with the rule and rule amendments. We expect that compliance expenses would then decline to a relatively constant amount in future years, and annual expenses are likely to be lower for small advisers as the systems and processes should be less complex than for a large adviser.

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<sup>472</sup> SIFMA Letter. *See also* ICI Letter.

<sup>473</sup> Investment advisers registered with the Commission are required to adopt and implement policies and procedures reasonably designed to prevent violation by the adviser or its supervised persons of the Advisers Act and the rules the Commission has adopted thereunder. *See* rule 206(4)-7.

We estimate that approximately 1,697 investment advisers registered with the Commission may be affected by the rule and rule amendments.<sup>474</sup> Of the 1,697 advisers, we estimate that approximately 1,271 advisers have fewer than five covered associates that would be subject to the rule (each, a “smaller firm”); approximately 304 advisers have between five and 15 covered associates (each, a “medium firm”); and approximately 122 advisers have more than 15 covered associates that would be subject to the prohibitions of the rule (each, a “larger firm”).<sup>475</sup>

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<sup>474</sup> This estimate is based on registration information from IARD as of April 1, 2010, applying the same methodology as in the Proposing Release. As previously noted, according to responses to Item 5.D(9) of Part 1 of Form ADV, 1,332 advisers have clients that are state or municipal government entities, which represents 11.48% of all advisers registered with us. 10,275 advisers have not responded that they have clients that are state or municipal government entities. Of those, however, responses to Item 5.D(6) of Part 1 of Form ADV indicate that 2,486 advisers have some clients that are other pooled investment vehicles. Estimating that the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*, 11.48%.  $2,486 \times 11.48\% = 285$ . 285 of these advisers would be subject to the rule. Out of the 10,275 that have not responded that they have clients that are state or municipal government entities, after backing out the 2,486 which have clients that are other pooled investment vehicles, responses to Item 5.D(4) of Part 1 of Form ADV indicate that 699 advisers have some clients that are registered investment companies. Estimating that roughly the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*, 11.48%.  $699 \times 11.48\% = 80$ . 80 of these advisers would be subject to the rule. Although we limited the application of rule 206(4)-5 with respect to registered investment companies to those that are investment options of a plan or program of a government entity, we continue to estimate that 80 advisers would have to comply with the recordkeeping provisions because of the difficulty in further delineating this estimated number. Therefore, we estimate that the total number of advisers subject to the rule would be: 1,332 advisers with state or municipal clients + 285 advisers with other pooled investment vehicle clients + 80 advisers with registered investment company clients = 1,697 advisers subject to rule. We expect certain additional advisers may incur compliance costs associated with rule 206(4)-5. We anticipate some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers. Additionally, some advisers that do not currently have government clients may seek to obtain them in the future. In doing so, they likely would conduct due diligence to confirm they would not be prohibited from receiving compensation for providing investment advisory services to the government client.

<sup>475</sup> This estimate is based on registration information from IARD as of April 1, 2010. These estimates are based on IARD data, specifically the responses to Item 5.B.(1) of Form ADV, that 997 (or 74.9%) of the 1,332 registered investment advisers that have

One commenter disagreed with us basing our cost estimates on an assumption that most registered advisers would have fewer than five covered associates because the commenter expects most advisers to require all or most of their employees to receive approval prior to making any political contributions in order to avoid inadvertently triggering the rule.<sup>476</sup> Although the rule does not require this approach and the changes we have made to the rule (*e.g.*, modified definition of covered associate) should help address the concerns of this commenter that led to the assertion, we recognize that some advisers may voluntarily restrict all of their employees' political contributions in such a manner. This type of pre-screening process could be perceived by the individuals subject to them as costs imposed on their ability to express their support for certain candidates for elected office and government officials. We also received a comment that our estimates should take into account turnover of personnel.<sup>477</sup> Our cost estimate assumes a certain level of turnover; although these categories are based on an adviser's number of covered associates, we have not calculated per-covered associate costs associated with this rulemaking. The categories of smaller, medium and larger advisers are based on an estimated number of covered associates, but are not intended to represent a static population of covered associates within each category. For instance, in estimating the ongoing burdens on advisers to comply with the rule, we implicitly incorporated a greater

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government clients have fewer than five employees who perform investment advisory functions, 239 (or 17.9%) have five to 15 such employees, and 96 (or 7.2%) have more than 15 such employees. We then applied those percentages to the 1,697 advisers we believe will be subject to the proposed rule for a total of 1,271 smaller, 304 medium and 122 larger firms.

<sup>476</sup> See MFA Letter.

<sup>477</sup> ICI Letter.

degree of turnover at larger advisers in estimating that they would incur 1,000 hours annually as compared to the estimated 10 hours for a small adviser.

Advisers that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act [15 U.S.C. 80b-3(b)(3)] would be subject to rule 206(4)-5.<sup>478</sup> Based on our review of registration information on IARD and outside sources and reports, we estimate that there are approximately 2,000 advisers that are unregistered in reliance on section 203(b)(3).<sup>479</sup> Applying the same principles we used with respect to registered investment advisers, we estimate that 230 of those advisers manage pooled investment vehicles in which government client assets are invested and would therefore be subject to the rule.<sup>480</sup> For purposes of this analysis, it is assumed that each unregistered advisory firm that would be subject to the rule would either be a smaller firm or a medium firm in terms of number of covered associates because it is unlikely that an adviser that operates outside of public view and is limited to fewer than 15 clients<sup>481</sup> would have a large number of advisory personnel that would be covered associates. One commenter agreed that most of these unregistered advisers would be small, although the commenter based its assessment on assets under management, not on the adviser's likely number of covered associates.<sup>482</sup>

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<sup>478</sup> The amendments to rules 204-2 and 206(4)-3, however, only apply to advisers that are registered, or required to be registered, with the Commission.

<sup>479</sup> This number is based on our review of registration information on IARD as of April 1, 2010, IARD data from the peak of hedge fund adviser registration in 2005, and a distillation of numerous third-party sources including news organizations and industry trade groups.

<sup>480</sup> 11.48% of 2000 is 230. *See supra* note 474.

<sup>481</sup> *See* section 203(b)(3) of the Advisers Act [15 U.S.C. 80b-3(b)(3)] (advisers who rely on this exception from registration must have fewer than 15 clients in a 12-month period) .

<sup>482</sup> 3PM Letter.

Some commenters asserted that our estimated number of advisers subject to the proposed rule was too low.<sup>483</sup> One claimed that the number of advisory firms exempted from registration in reliance on Section 203(b)(3) may be “over two times our estimate,” but provided statistics about the number of unregistered pooled investment vehicles, not the number of advisers to those pools.<sup>484</sup> Other commenters did not provide empirical data or suggest alternative formulas by which to recalculate our estimate. Additionally, another seemed to misunderstand our estimates.<sup>485</sup>

As we stated in the Proposing Release,<sup>486</sup> although the time needed to comply with the rule will vary significantly from adviser to adviser, as discussed in detail below, the Commission staff estimates that firms with government clients will spend between 8 hours and 250 hours to establish policies and procedures to comply with the rule. Commission staff further estimates that ongoing compliance with the rule will require between 10 and 1,000 hours annually. In addition, advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the rule. These costs would vary widely among firms. Small advisers may not incur any system costs if they determine a system is unnecessary due to the limited number of employees they have or the limited number of government entity clients they have. Large firms likely already have devoted significant resources into automating compliance and reporting and the new rule could result in enhancements to these existing systems. We

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<sup>483</sup> See Davis Polk Letter; MFA Letter; 3PM Letter.

<sup>484</sup> 3PM Letter. See also Davis Polk Letter (citing to 3PM Letter on this proposition).

<sup>485</sup> Davis Polk Letter (suggesting that we failed to take into account the costs likely to be borne by unregistered investment advisers). See *supra* notes 479 and 480 and accompanying text; Proposing Release, nn.219-20 and accompanying text (providing an estimate of the number of unregistered advisers we expect to be subject to this rule, and that must develop compliance systems).

<sup>486</sup> See Proposing Release, at section III.B.

believe such system costs could range from the tens of thousands of dollars for simple reporting systems, to hundreds of thousands of dollars for complex systems used by the large advisers.

Initial compliance procedures would likely be designed, and ongoing administration of them performed, by compliance managers and compliance clerks. We estimate that the hourly wage rate for compliance managers is \$294, including benefits, and for compliance clerks, \$59 per hour, including benefits.<sup>487</sup> To establish and implement adequate compliance procedures, we estimate that the rule would impose initial compliance costs of approximately \$2,352 per smaller firm,<sup>488</sup> approximately \$29,407 per medium firm,<sup>489</sup> and approximately \$58,813 per larger firm.<sup>490</sup> It is

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<sup>487</sup> Our hourly wage rate estimate for a compliance manager and compliance clerk is based on data from the *Securities Industry Financial Markets Association's Management & Professional Earnings in the Securities Industry 2009*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 (in the case of compliance managers) or 2.93 (in the case of compliance clerks) to account for bonuses, firm size, employee benefits and overhead. The calculations discussed in this release are updated from those included in the Proposing Release to incorporate data from the most recently updated version of this publication.

<sup>488</sup> The per firm cost estimate is based on our estimate that development of initial compliance procedures for smaller firms would take 8 hours of compliance manager time (at \$294 per hour). Accordingly, the per firm cost estimate is \$2,352 (8 x \$294).

<sup>489</sup> With respect to our estimated range of 8-250 hours, we assume a medium firm would take 125 hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he or she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for medium firms would take 93.75 hours of compliance manager time, at \$294 per hour (or \$27,563), and 31.25 hours of clerical time, at \$59 per hour (or \$1,844), for a total estimated cost of \$29,407.

<sup>490</sup> With respect to our estimated range of 8-250 hours, we assume a larger firm would take 250 hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he/she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for larger firms would take 187.50 hours of compliance

estimated that the rule would impose annual, ongoing compliance expenses of approximately \$2,940 per smaller firm,<sup>491</sup> \$117,625 per medium firm,<sup>492</sup> and \$235,250 per larger firm.<sup>493</sup>

In establishing these estimates, which are calculated in the same manner as those we included in the Proposing Release, we took into consideration comments in 1999 that suggested our cost estimates were too low.<sup>494</sup> Our staff, in developing the estimates contained in the Proposing Release, also engaged in conversations with industry professionals regarding broker-dealer compliance with rules G-37 and G-38 and representatives of investment advisers that have pay to play policies in place.<sup>495</sup> We significantly increased our cost estimates from the 1999 proposal as a result. Some commenters on the proposed rule asserted that our projected costs are too low, but did not provide empirical data or formulas for us to review.<sup>496</sup> One commenter indicated that, “as a practical matter, although there may be significant differences in the number of hours dedicated to ongoing annual compliance between firms of different sizes, the

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manager time, at \$294 per hour (or \$55,125), and 62.5 hours of clerical time, at \$59 per hour (or \$3,688), for a total estimated cost of \$58,813.

<sup>491</sup> The per firm cost estimate is based on our estimate that ongoing compliance procedures for smaller firms would take 10 hours of compliance manager time, at \$294 per hour, for a total estimated cost of \$2,940 per year.

<sup>492</sup> The per firm cost estimate is based on our estimate that ongoing compliance procedures for medium firms would take 375 hours of compliance manager time, at \$294 per hour (or \$110,250), and 125 hours of clerical time, at \$59 per hour (or \$7,375), for a total estimated cost of \$117,625 per year.

<sup>493</sup> The per firm cost estimate is based on our estimate that ongoing compliance procedures for larger firms would take 750 hours of compliance manager time, at \$294 per hour (or \$220,500) and 250 hours of clerical time, at \$59 per hour (or \$14,750), for a total cost of \$235,250 per year.

<sup>494</sup> See Proposing Release, at n.226 and accompanying text.

<sup>495</sup> *Id.* at section III.B.

<sup>496</sup> See, e.g., ICI Letter; MFA Letter; SIFMA Letter.



estimated number of hours needed to develop initial compliance procedures will be similar for all firms, regardless of size. The initial effort of designing and implementing new policies and procedures and educating personnel will require similar effort and upfront fixed costs.”<sup>497</sup> We disagree. Although there are some aspects of implementing a compliance program that would be similar among all firms regardless of their number of covered associates, we expect most costs will vary significantly among firms of different sizes as they engage in such activities as developing and monitoring reporting mechanisms to track covered associate contributions, revising their codes of ethics, training their employees, and performing routine quality control tests.

In the Proposing Release, we estimated that 75% of larger advisory firms, 50% of medium firms, and 25% of smaller firms that are subject to the rule may also engage outside legal services to assist in drafting policies and procedures, based on staff observations. In addition, we also estimated the cost associated with such an engagement would include fees for approximately three hours of outside legal review for a smaller firm, 10 hours for a medium firm, and 30 hours for a larger firm. One commenter suggested that we had underestimated both the percentage of advisers that would engage outside counsel and the number of hours that outside counsel would spend lending their assistance, but did not provide alternative estimates.<sup>498</sup> Based on our staff’s experience administering the compliance program rule, we continue to believe that our estimates for the number of firms that will retain outside counsel for review of policies and procedures are appropriate. Based on this comment, however, we have revisited the number of hours we estimated outside counsel would spend reviewing policies and procedures and have

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<sup>497</sup> See Davis Polk Letter.

<sup>498</sup> *Id.*

increased these estimates. We now estimate the cost associated with such an engagement would include fees for approximately eight hours of outside legal review for a smaller firm, 16 hours for a medium firm, and 40 hours for a larger firm, at a rate of \$400 per hour.<sup>499</sup> Consequently, for a smaller firm we estimate a total of \$3,200 in outside legal fees for each of the estimated 318 advisers that would seek assistance, for a medium firm we estimate a total of \$6,400 for the estimated 152 advisers that would seek assistance, and for each of the 92 larger firms we estimate a total of \$16,000. Thus, we estimate that approximately 562 investment advisers will incur these additional costs, for a total cost of \$3,462,400<sup>500</sup> among advisers affected by the rule amendments.<sup>501</sup>

One commenter suggested that, due to the complexity of, and variation among, state and local laws, it might be more difficult than we had accounted for in the proposal for an adviser to determine with certainty who could be a covered official, and as a result, a greater number of advisers would seek the help of outside counsel to make this determination than we estimated.<sup>502</sup> Although the commenter did not provide an estimate of how many firms might seek such assistance, we believe that the additional guidance we have provided in the discussion of officials will address this commenter's concerns and result in fewer consultations with outside counsel than anticipated. In addition, it is our understanding from discussions with those involved in advising on compliance with

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<sup>499</sup> In the Proposing Release we estimated the hourly cost of outside counsel to be \$400 based on our consultation with advisers and law firms who regularly assist them in compliance matters. We did not receive comment on this estimate and continue to believe that it is an accurate estimate.

<sup>500</sup>  $(318 \times \$3,200 = \$1,017,600) + (152 \times \$6,400 = \$972,800) + (92 \times \$16,000 = \$1,472,000) = \$3,462,400$ .

<sup>501</sup> One commenter asserted that a greater number of firms would seek assistance of counsel, regardless of size, but did not provide data to support its assertion. Davis Polk Letter.

<sup>502</sup> Caplin & Drysdale Letter. *See also* IAA Letter; MFA Letter.

MSRB rules G-37 and G-38 that a small percentage of persons subject to the rule seek legal assistance to make these determinations. Our rule uses substantially similar definitions of “official” of a “government entity” to those used in the MSRB rules; therefore we expect that the percentage of advisory firms that would retain legal counsel to make these determinations would be similarly small. Moreover, we anticipate that the advisers that are most likely to need assistance identifying officials of government entities are larger advisers, whose businesses tend to be national in scope and whose clients are located throughout the country. If all 122 of the larger advisory firms we estimate are subject to the rule retain legal counsel at a rate of \$400 per hour, for approximately 20 hours per year, those advisers would incur an estimated total of \$976,000 in legal fees.<sup>503</sup>

In the Proposing Release, we estimated that approximately five advisers annually would apply to the Commission for an exemption from the rule, based on staff discussions with the FINRA staff responsible for reviewing exemptive applications submitted under MSRB rule G-37, and that outside counsel would spend 16 hours preparing and submitting an application. We received criticism that these approximations were too low.<sup>504</sup> Given that the advisory industry is much larger than the municipal securities industry, and in light of the number of comment letters we received that expressed concern about inadvertent violations of the rule that would not qualify for the exception for returned contributions, our staff estimates that approximately seven advisers annually would apply to the Commission for an exemption from the rule.

Although we may initially receive more than seven applications a year for an exemption,

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<sup>503</sup> \$400 x 20 = \$8,000, and \$8,000 x 122 = \$976,000.

<sup>504</sup> See Davis Polk Letter; ICI Letter.

over time, we expect the number of applications we receive will significantly decline to an average of approximately seven annually. We continue to believe that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, but based on commenters concerns have raised the number of hours counsel will spend preparing and submitting an application from 16 hours to 32 hours, at a rate of \$400 per hour.<sup>505</sup> As a result, each application will cost approximately \$12,800, and the total estimated cost for seven applications annually will be \$89,600.

## **2. Other Costs Related to Rule 206(4)-5**

The prohibitions of the rule may also impose other costs on advisers, covered associates, third-party solicitors, and political officials.

### **(a) Two-Year Time Out**

An adviser that becomes subject to the prohibitions of the rule would no longer be eligible to receive advisory fees from its government client. This would result in a direct loss to the adviser of revenues and profits relating to that government client, although another adviser that the government client subsequently chose to retain would see an increase in revenues and profits. The two-year time out could also limit the number of advisers able to provide services to potential government entity clients. An adviser that triggers the two-year time out may be obligated to provide (uncompensated) advisory services for a reasonable period of time until the government client finds a successor to ensure its withdrawal did not harm the client, or the contractual arrangement between the adviser and the government client might obligate the adviser to continue to perform under the contract at no fee. An adviser that provides uncompensated advisory services to a

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<sup>505</sup> The hourly cost estimate of \$400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

government client would, at a minimum, incur the direct cost of providing uncompensated services, and may incur opportunity costs if the adviser is unable to pursue other business opportunities for a period of time.

Advisers to government clients, as well as covered associates of the adviser, also may be less likely to make contributions to government officials, including candidates, potentially resulting in less funding for these officials. Under the rule, advisers and covered associates will be subject to new limitations on the amounts and to whom they can contribute without triggering the rule's time out provision. In addition, these same persons will be prohibited from soliciting others to contribute or from coordinating contributions to government officials, including candidates, or payments to political parties in certain circumstances. These limitations and prohibitions, including if a firm chooses to adopt policies or procedures that are more restrictive than the rule, could be perceived by the individuals subject to them as costs imposed on their ability to express their support for certain candidates for elected office and government officials.<sup>506</sup> In addition to these costs, the rule's impact on advisers' and employees' contributions will introduce some inefficiency into the allocation of contributions to candidates and officials as the rule impacts contributions regardless of whether they are being made for the purpose of engaging in pay to play.

We have made several modifications to the rule from the proposal that will reduce these costs or burdens. We are creating a new exception to the two-year time out for

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<sup>506</sup> One commenter suggested that the proposed rule would inhibit individuals who work for an investment adviser from running for office because, if they were successful, it may cost their former employer business. Caplin & Drysdale Letter. We have addressed this comment by making it clear that an individual can contribute to his or her own campaign without triggering the rule. *See supra* note 139.

contributions made by a natural person more than six months prior to becoming a covered associate unless he or she, after becoming a covered associate, solicits clients on behalf of the investment adviser.<sup>507</sup> This modification will decrease the burdens on both employees and employers in terms of tracking and limiting employee contributions prior to becoming employed or promoted by an investment adviser. In terms of narrowing the scope of “covered investment pools,” we included a registered investment company in the definition of covered investment pool, for purposes of all three of the rule’s pay to play prohibitions, only if it is an investment option of a plan or program of a government entity.<sup>508</sup> As noted above, we believe this approach strikes the right balance between applying the rule in those contexts in which advisers to registered investment companies are more likely to engage in pay to play conduct while recognizing the compliance challenges and costs that may result from a broader application of the rule. We are also broadening the exception to the rule’s time out provision in several respects that should further decrease the compliance costs associated with the two-year time out and will lower any perceived costs on covered associates’ ability to express their support for candidates. We are increasing the aggregate contribution amount eligible for the exception for certain returned contributions from \$250 to \$350 to any one official per election,<sup>509</sup> and we are increasing the number of times an adviser is permitted to rely on the returned contributions exception from two to three per calendar year for advisers with more than 50 employees.<sup>510</sup> Furthermore, we are making the same adjustment from \$250

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<sup>507</sup> Rule 206(4)-5(b)(2).

<sup>508</sup> Rule 206(4)-5(f)(3) and (f)(8).

<sup>509</sup> Rule 206(4)-5(b)(3).

<sup>510</sup> *Id.*

to \$350 for contributions eligible for the *de minimis* exception,<sup>511</sup> and we are adopting a *de minimis* exception for contributions not exceeding \$150 made by individuals who are not entitled to vote for the candidate.<sup>512</sup>

Several commenters highlighted the costs of the two-year time out to the adviser and government entity client, as well as pension fund beneficiaries, stating that the time out could force termination of long-standing relationships and may result in a permanent termination of the advisory relationship.<sup>513</sup> We acknowledge that advisers subject to the time out may lose a government client's business beyond the two-year period and are sensitive to the concerns of commenters regarding the operation of the rule on public pension funds, including the burdens they may face in replacing managers and the possibility that some managers may no longer seek to manage public plan assets as a result of the rule. We believe that these costs are necessary to accomplish our goal of addressing pay to play and are justified by the benefits of rule 206(4)-5. As discussed above, rule 206(4)-5 is modeled on the pay to play rules adopted by the MSRB, which have significantly curbed pay to play practices in the municipal securities market. We believe that adopting a two-year time out similar to the time out applicable under the MSRB rules is appropriate, and that the fiduciary relationship advisers have with public

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<sup>511</sup> Rule 206(4)-5(b)(1).

<sup>512</sup> *See id.*

<sup>513</sup> *See, e.g.,* ICI Letter (“[E]xisting state and local government clients may be harmed by the forced termination of a mutually beneficial business relationship, despite receiving free services for a period of time, because the government client is subject to the costs associated with selecting a new adviser, and plan beneficiaries are subject to the costs associated with portfolio commissions and other restructuring costs. Consequently, our members believe that the two-year ban will operate as a permanent ban because a government entity will be unlikely to go through the process of identifying and hiring a replacement adviser, and then return to the original adviser after the ban ends.”). *See also* IAA Letter; NASP Letter; SIFMA Letter.

pension plans argues for a strong prophylactic rule. Finally, while we have designed the rule to reduce its impact,<sup>514</sup> investment advisers are best positioned to protect government clients by developing and enforcing robust compliance programs designed to prevent contributions from triggering the two-year time out.

Commenters also noted, particularly, the potential harm of the two-year time out to government clients and to other investors in a fund that holds illiquid securities when a government investor redeems its interests in the fund as a result of the fund adviser's triggering contribution.<sup>515</sup> As we note above, however, our rule does not require an adviser that has triggered the time out to redeem the interests of a government investor or cancel its commitment. The adviser may have multiple options available from which to select to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. The adviser could instead comply with the rule by waiving or rebating the portion of its fees or any performance allocation or carried interest attributable to the government client.<sup>516</sup>

Most of the comments we received about the costs of this aspect of the proposed rule, however, focused on the costs of an inadvertent violation.<sup>517</sup> We understand that there will be costs, sometimes quite significant, as a result of inadvertent violations. However, with these potential costs in mind, we have taken additional steps to decrease

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<sup>514</sup> See, e.g., section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to the two-year time out); section II.B.2(f) of this Release (discussing the rule's exemptive provision).

<sup>515</sup> CT Treasurer Letter; NY City Bar Letter.

<sup>516</sup> See *supra* note 385 and accompanying text.

<sup>517</sup> See, e.g., IAA Letter ("We are concerned that the Commission has not considered the significance of the sanctions imposed as a result of an adviser's inadvertent violation of the rule.").



the likelihood of inadvertent violations of the rule. First, as discussed above, we shortened the look back with respect to most covered associates. We expect this new exception will provide an additional mechanism for advisers to avoid the cost of a time out as a result of an inadvertent violation and will largely address commenters' concerns about the screening burdens for new or promoted employees that this aspect of the proposal would have imposed on advisers.<sup>518</sup> Second, as discussed above, we are increasing to \$350 the amount eligible for an exception for certain returned contributions from what we had proposed, we are increasing the number of times an adviser is permitted to rely on the returned contributions exception, and we are also adopting an additional *de minimis* exception for certain contributions not exceeding \$150. Last, we note that an adviser's implementation of a strong compliance program will reduce the likelihood, and therefore costs, of inadvertent violations.

One commenter asserted that the proposed rule would put advisers at a competitive disadvantage to other providers of advisory services to government plans that would not be subject to it, such as banks and insurance companies.<sup>519</sup> As we stated earlier, we believe that the concerns that we are trying to address with the rule justify its adoption, notwithstanding the potential competitive effects that advisers may face as a

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<sup>518</sup> IAA Letter (“Under the Proposal, investment advisers would be required to screen for and eliminate potential employment candidates based upon contributions made for a period of up to twenty-four months before the person would begin employment with the adviser. This requirement . . . would be extremely costly and burdensome to implement.”); Wells Fargo Letter (“The “look back” provision is too draconian. . . . [A] compliance system [will be] costly to develop and arduous to implement . . . [and] it would also impose severe limitations on the career opportunities of those newly entering the investment advisory world who are weighed down by political contributions that were completely innocuous when made.”).

<sup>519</sup> NY City Bar Letter.

result of the limits on our jurisdiction. We also do not view competition by means of engaging in practices such as pay to play as an interest that we need to protect.

**(b) Third-Party Solicitor Ban**

Under our proposal, advisers would have been prohibited from compensating any third party to solicit government entities for advisory services, other than “related persons.”<sup>520</sup> As a result, advisers that rely on third-party solicitors to obtain government clients would have had to bear the expense of hiring and training in-house staff in order to continue their solicitation activities,<sup>521</sup> a result that commenters said would be particularly costly for small and new investment advisers.<sup>522</sup> In addition, third-party solicitors might also have experienced substantial negative consequences under the

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<sup>520</sup> Proposed rule 206(4)-5(a)(2)(i)(a).

<sup>521</sup> *See, e.g.*, Comment Letter of Greenhill & Co., LLC (Oct. 2, 2009) (“The elimination of placement agents would add a significant administrative and cost burden to fund sponsors seeking investors.”). *See also* Alta Letter; Atlantic-Pacific Letter; Braxton Letter; Benedetto Letter; CA Assoc. of County Retirement Letter; Capstone Letter; EVCA Letter; GA Firefighters Letter; Glovista Letter; IL Fund Association Letter; MN Board Letter; Myers Letter; NCPERS Letter; NYC Teachers Letter; PA Public School Retirement Letter; Reed Letter; Myers Letter; TX Public Retirement Letter; WI Board Letter; Credit Suisse Letter (“Moreover, by performing these functions, placement agents enable investment advisers to focus on their core expertise, investment management, and to avoid the necessity of developing the costly in-house resources necessary to raise capital directly.”).

<sup>522</sup> *See, e.g.*, MFA Letter (“[M]anagers that engage placement agents, particularly small and offshore managers, would lose the ability to market their services to government clients or incur significantly higher costs to hire internal marketing personnel; and managers that hire internal personnel could spend substantial amounts to register as a broker-dealer.”). *See also* SIFMA Letter; IAA Letter; Seward & Kissel Letter; Sadis & Goldberg Letter; WI Board Letter; GA Firefighters Letter; MN Board Letter; IL Fund Association Letter; NYC Teachers Letter; TX Public Retirement Letter; PA Public School Retirement Letter; Ehrmann Letter; Finn Letter; Savanna Letter; Atlantic-Pacific Letter; Peterson Letter; Devon Letter; Chaldon Letter; Meridian Letter; Benedetto Letter; Capstone Letter; Braxton Letter; Littlejohn Letter; Alta Letter; Charles River Letter; Reed Letter; Glovista Letter; Blackstone Letter; Park Hill Letter.

proposed rule.<sup>523</sup> We heard from many commenters on this issue, offering various perspectives on how the costs would outweigh the benefits of the proposed prohibition.<sup>524</sup> A few commenters asserted that this proposal would have a significant adverse effect on efficient capital formation in that it would make it more difficult for private equity and venture capital managers to obtain funding that they in turn can invest in portfolio companies.<sup>525</sup> As other commenters pointed out, this aspect of our proposed rule might also have placed a significant burden on public pension plans,<sup>526</sup> particularly smaller

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<sup>523</sup> Proposing Release, at 89. *See also* Thomas Letter (“The ban would very likely cripple many legitimate placement agents – most of whom are currently regulated by the SEC and FINRA – as the public pension plans are the largest source of capital for alternative investments.”); Comment Letter of the Managing Partner of Bridge 1 Advisors, LLC Robert G. McGroarty (Sept. 24, 2009) (“Bridge 1 Letter”); SIFMA Letter.

<sup>524</sup> *See, e.g.*, Davis Polk Letter (“While we strongly support the underlying purpose of the Proposed Rule, we believe that this ban on all third-party solicitors is overly expansive and the costs inflicted on both investment advisers and government clients from lack of access to the valuable services provided by most third-party solicitors outweigh any expected benefits to be gained from its adoption.”); Capstone Letter (suggesting that many placement agent firms are small businesses helping investment managers that are, themselves, minority- or women-owned small businesses, and that, together, they are creating jobs and helping other businesses by efficiently directing capital); Monument Letter (making a similar comment regarding the minority and female ownership of placement agents); Glantz Letter; Comment Letter of Indian Harbor Partner Robert W. Stone (Aug. 13, 2009) (“Indian Harbor Letter”); Kurmanaliyeva Letter; M Advisory Letter (adding that the investment management industry as a whole will incur “dramatic job losses”); Parenteau Letter.

<sup>525</sup> Alta Letter; Benedetto Letter; Comment Letter of Berkshire Property Advisors, LLC (Sept. 29, 2009) (“Berkshire Letter”); Bridge 1 Letter; Comment Letter of Hampshire Real Estate Companies (Sept. 29, 2009); Comment Letter of Thomas J. Mizo on behalf of HFF Securities L.P. (Sept. 24, 2009); M Advisory Letter; Monument Group Letter; Comment Letter of Psilos Group Managers, LLC (Sept. 28, 2009).

<sup>526</sup> *See, e.g.*, Park Hill Letter (“The Commission has commented that if the Placement Agent Ban is adopted, Public Pension Investors can seek to engage placement agents themselves in order to continue to have access to their services in helping to find the best Fund Sponsors. However, that would impose costs on Public Pension Investors that they do not currently incur. Moreover, as the Commission has acknowledged in its cost-benefit analysis, if the Placement Agent Ban were adopted, Fund Sponsors who do not have in-house marketing staffs would be disproportionately disadvantaged relative to larger firms that have those internal resources in the competition for obtaining access to Public Pension Investors and other institutional investors.”); Thomas Letter (“A ban on placement agents would have significant unintended consequences for public pension

plans because third-party solicitors provide services that plans may value, including serving as placement agent for alternative investments and serving a screening function with respect to those investments presented to the pension plan.<sup>527</sup>

Others argued, for similar reasons as those expressed above, that it would also harm public pension plans to ban payments to third parties because it would decrease

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plans. . . . [For instance, the] incremental effort by investment staffs to perform due diligence on promising but possibly ill-prepared investment managers will raise the cost and lessen the overall pension fund portfolio performance.”); Comment Letter of Austin F. Whitman (Sept. 21, 2009) (“Without access to placement agents, government pensions would be significantly disadvantaged relative to their private sector peers, with limited access (and benefit from) the services described above.”); ABA Letter. *But see* Fund Democracy/Consumer Federation Letter (“The proposed ban would simply replace the indirect cost of placement agents incurred by pension plan sponsors with the direct cost of hiring their own placement agents – without the conflict of interest and potential for abuse that relying on advisers’ placement agents creates.”).

<sup>527</sup> *See, e.g.*, Ogburn Letter; Schmitz Letter (highlighting the valuable “pre-vetting” function of placement agents, especially in light of pension funds’ budgetary pressures and lean staffs); Savanna Letter (discussing the “pre-screening” effect that reputable placement agent client selection provides for pension professionals); Atlantic-Pacific Letter; Indian Harbor Letter; Peterson Letter; Rubenstein Letter; Comment Letter of Réal Desrochers (Aug. 20, 2009) (noting that from the perspective of a former pension fund investment officer, “[t]he skill sets of certain placement agents streamlined what they brought to our attention and made our internal process much more efficient.”); Devon Letter; Thomas Letter; Myers Letter; PRIM Board Letter (“[T]he Commission should strongly resist the politically expedient suggestion that an outright ban on the use of placement agents is somehow good for plan sponsors; nothing could be further than the truth.”); Meridian Letter; Comment Letter of Norman G. Benedict (Sept. 30, 2009) (indicating that, from the perspective of a retired public pension chief investment officer, placement agents provide an essential and invaluable service, particularly with providing access to private equity fund investments, which often yielded higher returns than more traditional, publicly traded securities); Berkshire Letter; Comment Letter of The British Private Equity and Venture Capital Association (Sept. 18, 2009) (“BVCA Letter”) (“Placement agents are not just a crude middleman in the fundraising process”); CT Treasurer Letter; Credit Suisse Letter (describing four key functions its placement agent group performs); Portfolio Advisors Letter (noting that among the valuable services provided are: “(1) helping new fund sponsors to become more established among the institutional investor community; (ii) helping sponsors to complete RFPs, provide information and respond to questions, which, in turn, gives the public pension plans and other investors a broader pool of investment options; and (iii) serving as intermediaries in uniting capital with fund sponsors who can put the money to work by investing in businesses and creating value”); George Letter; Comment Letter of Rahul Mehta (Sept. 11, 2009); Touchstone Letter; SIFMA Letter.

competition by reducing the number of advisers competing for government business<sup>528</sup> and limit the universe of investment opportunities presented to public pension funds.<sup>529</sup>

We believe our decision to modify the proposed rule to permit advisers to make payments to certain “regulated persons” to solicit government clients on their behalf,<sup>530</sup> as described in more detail above, should alleviate many of these concerns, including those from private equity and venture capital managers on capital formation.<sup>531</sup> In particular, we believe the concerns expressed by private equity and venture capital managers regarding the effects of the rule on capital formation have been substantially addressed by the modification for payments to “regulated persons.” We expect advisers that engage the services of regulated person solicitors will incur limited costs to initially confirm and subsequently monitor the solicitor’s eligibility to be a “regulated person.” Nevertheless, we expect this exception to the third-party solicitor ban will substantially reduce the costs commenters associated with this aspect of the proposal.

We acknowledge, however, that the third-party solicitor ban will nonetheless have a substantial negative impact on persons who provide third-party solicitation services that

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<sup>528</sup> See, e.g., Seward & Kissel Letter; Meridian Letter; SIFMA Letter; Comment Letter of Oakpoint Advisors (Aug. 26, 2009); Comment Letter of SeaCrest Investment Management, LLC (Sept. 25, 2009).

<sup>529</sup> See, e.g., Braxton Letter (stressing not only the increased costs that public pension funds will likely face, but also the likely reduction in creative investment strategies and opportunities available as a result of smaller and emerging funds being forced out of the market); BVCA Letter; CT Treasurer Letter; SIFMA Letter; IAA Letter; Strategic Capital Letter; Alta Letter; Benedetto Letter; Glantz Letter; Kurmanaliyeva Letter; Park Hill Letter.

<sup>530</sup> See Rule 206(4)-5(a)(2)(i).

<sup>531</sup> Our decision not to adopt the “related person” exception contained in the proposed rule does not diminish our belief. As we noted above, we believe our modification of the ban to allow advisers to pay “regulated persons” to solicit government entities on their behalf will still allow advisers to use employees of certain related companies—*i.e.*, of those related companies that qualify as “regulated persons”—as solicitors.

are not regulated persons, including state-registered advisers.<sup>532</sup> If their businesses consist solely of soliciting government entities on behalf of investment advisers, the rule could result in these persons instead being employed directly by regulated persons, shifting the focus of their solicitation activities, seeking to change their business model to shift their source of payment from investment advisers to pension plans, or going out of business.<sup>533</sup> In addition, we acknowledge that the third-party solicitor ban may adversely affect both competition and allocative efficiency in the market for advisory services where third-party solicitors that are not regulated persons participate. We have carefully considered these effects. As discussed above, however, we do not have regulatory authority to oversee the activities of state-registered advisers through examination and our recordkeeping rules. Nor do we have authority over the states to oversee their enforcement of their rules, as we do with FINRA. As a result, we have not included state-registered advisers in the definition of regulated person.<sup>534</sup>

In addition, some commenters suggested that the third-party prohibition could have a negative impact on the efficient allocation of capital for government plans, particularly small ones, and advisers that seek to manage these assets directly (not through a covered investment pool).<sup>535</sup> These small government plans may, as a result of the rule's ban on payments to third parties, have fewer managers to select from to the extent that larger advisers choose not to participate in this market. In addition, both government plans and advisers that seek these government clients may have to hire

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<sup>532</sup> As we note above, state-registered advisers are subject neither to our oversight nor to the recordkeeping rules we are adopting today.

<sup>533</sup> See *supra* note 523.

<sup>534</sup> See *supra* note 325 and accompanying text.

<sup>535</sup> See, e.g., 3PM Letter; Bryant Law Letter.

internal staff, respectively, to identify potential advisers and potential government clients to the extent these functions are not internalized. However, these commenters did not discuss the potentially significant costs that exist today of hiring third-party solicitors, and that eliminating the cost of pay to play may, in fact, provide greater access to pension plans by those advisers that are currently unable to afford the costs of direct or indirect political contributions or third-party solicitor fees.<sup>536</sup> We expect that prohibiting pay to play will reduce the costs to plans and their beneficiaries that may result when adviser selection is based on political contributions rather than investment considerations.<sup>537</sup>

### 3. Costs Related to the Amendments to Rule 204-2

The amendments to rule 204-2 require SEC-registered advisers with government clients to maintain certain records of campaign contributions by certain advisory personnel and records of the regulated persons the adviser pays or agrees to pay to solicit government entities on its behalf.<sup>538</sup> Records are a critical complement to rule 206(4)-5. In particular, such records are necessary for examiners to inspect advisers for compliance with the terms of the rule.

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<sup>536</sup> At least one commenter agreed. *See* Butler Letter (“[W]e find some evidence that the pay to play practices by underwriters [before rule G-37 was adopted] distorted not only the fees, but which firms were allocated business. The current proposal mentions that pay to play practices may create an uneven playing field among investment advisers by hurting smaller advisers that cannot afford to make political contributions. We find evidence that is consistent with this view [in our research on pay to play by municipal underwriters]. During the pay to play era, municipal bonds were underwritten by investment banks with larger underwriting market shares compared to afterward. One interpretation of this result is that smaller underwriters were passed over in favor of larger underwriters (who presumably had deeper pockets for political contributions).”).

<sup>537</sup> *See supra* notes 452 & 453 and accompanying text (describing commenters’ observations about some of the pay to play costs to plans and their beneficiaries).

<sup>538</sup> Unregistered advisers that would be subject to rule 206(4)-5 would not be subject to the amendments to rule 204-2.

As described below, for purposes of the Paperwork Reduction Act of 1995 (“PRA”),<sup>539</sup> we have estimated that Commission-registered advisers would incur approximately 3,394 additional hours annually to comply with the amendments to rule 204-2.<sup>540</sup> Based on this estimate, we anticipate that advisers would incur an aggregate cost of approximately \$200,246 per year for the total hours advisory personnel would spend in complying with the recordkeeping requirements.<sup>541</sup> In addition, we expect advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the amendments to rule 204-2. For purposes of the PRA, we have estimated that some small and medium firms will incur start-up costs, on average, of \$10,000, and larger firms will incur, on average, \$100,000. As a result, the amendments to rule 204-2 are estimated to increase the PRA non-labor cost burden by \$20,080,000.<sup>542</sup>

We received a number of specific comments on this aspect of the proposal, many of which included assertions about cost burdens associated with maintaining records related to unsuccessful solicitations, and urged us to reconsider the benefits to be gained from such a requirement in light of the costs.<sup>543</sup> We were persuaded by these

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<sup>539</sup> 44 U.S.C. 3501.

<sup>540</sup> See *infra* note 559 and accompanying text.

<sup>541</sup> We expect that the function of recording and maintaining records of political contributions would be performed by a compliance clerk at a cost of \$59 per hour. See *supra* note 487. Therefore, the total costs would be \$200,246 (3,394 hours x \$59 per/hour).

<sup>542</sup>  $(\$10,000 \times 788) + (\$100,000 \times 122) = \$7,880,000 + \$12,200,000 = \$20,080,000$ .

<sup>543</sup> MassMutual Letter (“[T]he requirement to maintain records of each governmental entity being solicited would require a diverse financial services company like MassMutual to undertake significant legacy software system modifications or build an entirely new system to track each instance of a “solicitation,” which could include phone calls, meetings, or responses to governmental requests. This system would then need to aggregate data across multiple business lines, many with existing systems that may not have the ability to share this data in a useful format. All of these are costly and time consuming activities to meet a requirement that appears to add little value to the



commenters to eliminate provisions of the proposed amendments to the recordkeeping rule that would have required advisers to maintain a list of government entities that the adviser solicits.<sup>544</sup> Instead, an adviser must only retain records of existing government entity clients and investors as well as records of regulated persons that the adviser pays or agrees to pay to solicit government entities on its behalf for a five-year period.

Additionally, we have narrowed the scope of the amended rule to apply only to advisers with government entity clients; an adviser is only required to make and keep these records if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services.<sup>545</sup> We have also limited the rule to provide that only records of contributions, not payments, to government officials and candidates are required to be kept under the rule. Additionally, because rule 206(4)-5 applies to an adviser to a registered investment company only if it is an investment option of a participant-directed plan or program of a government entity,<sup>546</sup> such investment advisers will only have to identify government entities that provide plan or program participants the option of investing in the fund, which addresses many commenters' concerns about recordkeeping burdens that would have been imposed on advisers to registered investment companies under the proposed rule.<sup>547</sup>

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Commission's efforts to ensure compliance with the Proposed Rule." See also Davis Polk Letter; Dechert Letter; Holl Letter; SIFMA Letter; Skadden Letter.

<sup>544</sup> See proposed rule 204-2(a)(18)(i)(B).

<sup>545</sup> Rule 204-2(a)(18)(iii). See NASP Letter ("Many advisers do not have governmental clients but will still have to collect the information or attestations which would increase compliance costs while providing no public benefit at all.")

<sup>546</sup> See *supra* note 353 and accompanying text.

<sup>547</sup> See, e.g., ICI Letter.

We anticipate that commenters' general concerns that we may have underestimated the burdens we presented in our proposal will be offset by what we believe will be a reduction in burdens as a result of the various modifications from our proposal described above. In addition, we have revised the rule to require advisers to maintain a list of regulated persons that solicit on an adviser's behalf, but expect advisers to already have this information in the normal course of business, including in some instances, to comply with existing requirements of rule 206(4)-3.

## **V. PAPERWORK REDUCTION ACT**

### **A. Rule 204-2**

The amendment to rule 204-2 contains a "collection of information" requirement within the meaning of the PRA. In the Proposing Release, the Commission solicited comment on the proposed amendment to the collection of information requirement.<sup>548</sup> The Commission also submitted the proposed amendment's collection of information requirement to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under control number 3235-0278. The title for the collection of information is "Rule 204-2 under the Investment Advisers Act of 1940." Rule 204-2 contains a currently approved collection of information number under OMB control number 3235-0278. An agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 204 of the Advisers Act provides that investment advisers registered or required to be registered with the Commission must make and keep certain records for

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<sup>548</sup> See Proposing Release, at section IV.

prescribed periods, and make and disseminate certain reports. Rule 204-2 sets forth the requirements for maintaining and preserving specified books and records. This collection of information is mandatory. The collection of information under rule 204-2 is necessary for the Commission staff to use in its examination and oversight program, and the information generally is kept confidential.<sup>549</sup> The respondents are investment advisers registered or required to be registered with us.

Today's amendments to rule 204-2 require every investment adviser registered or required to be registered that provides advisory services to (or pays or agrees to pay regulated persons to solicit) government entities to maintain certain records of contributions made by the adviser or any of its covered associates and regarding regulated persons the adviser pays or agrees to pay for soliciting government entities on its behalf. The amendments require such an adviser to make and keep the following records: (i) the names, titles, and business and residence addresses of all covered associates of the investment adviser; (ii) all government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years, but not prior to the effective date of the rule; (iii) all direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or payments to a political party of a state or political subdivision thereof, or to a political action committee; and (iv) the name and business address of each regulated person to whom the investment adviser provides or agrees to provide, directly or indirectly,

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<sup>549</sup> See section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

payment to solicit a government entity for investment advisory services on its behalf, in accordance with rule 206(4)-5(a)(2)(i).

The adviser's records of contributions and payments are required to be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment, and whether such contribution or payment was subject to the exception for certain returned contributions pursuant to rule 206(4)-5(b)(2). An investment adviser is only required to make and keep current the records referred to in (i) and (iii) above if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the adviser provides investment advisory services. The records required by amended rule 204-2 are required to be maintained in the same manner, and for the same period of time, as other books and records under rule 204-2(a). This collection of information will be found at 17 CFR 275.204-2. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act are not subject to the recordkeeping requirements.

The amendments to rule 204-2 that we are adopting today differ from our proposed amendments in several respects. We have tailored certain of the requirements from our proposal. First, we have limited the rule to provide that only records of contributions, not payments, to government officials, including candidates, are required to be kept under the rule. Second, investment advisers to registered investment companies only have to identify—and keep records regarding—government entities that invest in a fund as part of a plan or program of a government entity, including any government entity that selects the fund as an investment option for participants in the plan or

program.<sup>550</sup> Third, we are not adopting provisions of the proposed amendments to the recordkeeping rule that would have required advisers to maintain a list of all government entities that they have solicited. In addition, we have revised the rule so that only those advisers that have government entity clients must make and keep certain required records, unlike the proposal, which would have required all registered advisers to maintain records of contributions and covered associates. We are also adopting a requirement that advisers maintain records of regulated persons they pay to solicit government entities on their behalf, to reflect that rule 206(4)-5 permits advisers to compensate these solicitors.

As noted above, we requested comment on the PRA analysis contained in the Proposing Release. Although a few commenters expressed general concerns that the paperwork burdens associated with our proposed amendments to rule 204-2 might be understated, commenters representing advisers to registered investment companies suggested that the proposal significantly underestimated the burden attributed to these covered investment pools.<sup>551</sup> With respect to registered investment companies, commenters noted that the proposed recordkeeping requirements required advisers to identify government investors in registered investment companies regardless of whether the fund was part of a plan or program of a government entity, and as a result the

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<sup>550</sup> Under our proposal, investment advisers to registered investment companies would have had to identify and keep records regarding government entities that invest in the funds regardless of whether they were part of a plan or program of a government entity. For a discussion of this modification, see section II.B. of this Release.

<sup>551</sup> See ICI Letter (“[I]n relying on the estimates for compliance with the MSRB rules, the Commission significantly underestimates the compliance and recordkeeping burdens associated with the proposed rule.”).

proposed amendments to the recordkeeping rule would have been difficult to comply with as fund shareholder records do not necessarily identify government investors.

As a result of these comments, we recognize that we may have underestimated the recordkeeping burden for advisers to registered investment companies that would have been subject to proposed rule 206(4)-5. However, we believe that our change to the definition of “covered investment pool” from the proposal to only include those registered investment companies that are an investment option of a plan or program of a government entity addresses the recordkeeping concerns commenters expressed regarding these covered investment pools and lowers recordkeeping burdens by limiting the records relating to registered investment companies that an investment adviser must keep under the rule.<sup>552</sup> In addition, the other changes we highlight above—other than the requirement to keep records regarding regulated persons—would lessen the recordkeeping requirements relative to our proposal and thereby diminish our burden estimates. We anticipate that commenters’ general concerns that we may have underestimated the burdens we presented in our proposal, as well as the burden associated with the additional requirement to maintain a list of regulated persons that solicit on an adviser’s behalf, will be offset by what we believe will be a reduction in burdens as a result of the various modifications from proposed amendments to the recordkeeping rule, as described above. Moreover, notwithstanding the fact that the amendments we are adopting reduce advisers’ recordkeeping obligations relative to our proposal, we are increasing our estimates to address the additional investment advisers who have registered with us since our proposal was issued.

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<sup>552</sup> See Rule 204-2(a)(18)(i)(B).

Prior to today's amendments, the approved collection of information for rule 204-2, set to expire on March 31, 2011, was based on an average of 181.15 burden hours each year, per Commission-registered adviser, for a total of 1,954,109 burden hours. In addition, the currently-approved collection of information for Rule 204-2 includes a non-labor cost estimate of \$13,551,390. The total burden is based on an estimate of 10,787 registered advisers.

Commission records indicate that currently there are approximately 11,607 registered investment advisers subject to the collection of information imposed by rule 204-2.<sup>553</sup> As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 148,543 hours.<sup>554</sup> In addition, the total non-labor cost burden has increased to \$14,581,509 as a result of this increase in the number of registered advisers.<sup>555</sup>

In our Proposing Release, we estimated that approximately 1,764 Commission-registered advisers provide, or seek to provide, advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.<sup>556</sup> One commenter argued that this estimate was too low because it underestimates the number of investment advisers unregistered in reliance on Section 203(b)(3) of the Advisers Act and estimated to be subject to the

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<sup>553</sup> This figure is based on registration information from IARD as of April 1, 2010. The figures we relied on in our Proposing Release were based on registration information from IARD as of July 1, 2009. *See* Proposing Release, at section IV.

<sup>554</sup>  $11,607 - 10,787 = 820$ .  $820$  additional advisers x  $181.15$  hours =  $148,543$  hours.

<sup>555</sup> We estimate that non-labor costs attributed to rule 204-2 will increase in the same proportion as the increase in the estimated hour burden for the rule.  $(2,102,652 \text{ hours} / 1,954,109 \text{ hours}) \times \$13,551,390$  currently approved non-labor cost estimate =  $\$14,581,509$ .

<sup>556</sup> *See* Proposing Release, at section IV.

Proposed Rule.<sup>557</sup> Unregistered advisers are not subject to rule 204-2's recordkeeping requirements. As a result, they are not included in our estimates for purposes of this analysis. We continue to believe our estimates are appropriate, although we have revised this number for purposes of both our cost-benefit analysis above and our PRA analysis to reflect both an increase in the number of registered advisers since the proposal and the modification from our proposal to not require records of unsuccessful solicitations. We now estimate that approximately 1,697 registered advisers provide advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.<sup>558</sup>

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<sup>557</sup> Davis Polk Letter (“The cost benefit analysis is based solely on an estimated 1,764 registered investment advisers and does not account for the costs and burdens of compliance attributable to investment advisers exempt from registration. The estimated number of investment advisers unregistered in reliance on section 203(b)(3) of the Advisers Act (2,000) and estimated to be subject to the Proposed Rule (231), appears to be low. In its comment letter, the Third Party Marketers Association notes that the number of advisory firms exempted from registration may be ‘over two times the estimate of the Commission. . . .’” (citations omitted)). The Davis Polk Letter does not offer any of its own estimates for the number of unregistered advisers, and the 3PM Letter references statistics regarding the number of funds, not the number of advisers.

<sup>558</sup> This estimate is based on registration information from IARD as of April 1, 2010, applying the same methodology as in the Proposing Release. As previously noted, according to responses to Item 5.D(9) of Part 1 of Form ADV, 1,332 advisers have clients that are state or municipal government entities, which represents 11.48% of all advisers registered with us. 10,275 advisers have not responded that they have clients that are state or municipal government entities. Of those, however, responses to Item 5.D(6) of Part 1 of Form ADV indicate that 2,486 advisers have some clients that are other pooled investment vehicles. Estimating that the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*, 11.48%. 285 of these advisers would be subject to the rule (2,486 x 11.48 % = 285). Out of the 10,275 that have not responded that they have clients that are state or municipal government entities, after backing out the 2,486 which have clients that are other pooled investment vehicles, responses to Item 5.D(4) of Part 1 of Form ADV indicate that 699 advisers have some clients that are registered investment companies. Estimating that roughly the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—*i.e.*, 11.48%. 80 of these advisers would be subject to the rule (699 x 11.48% = 80). Although we limited the application of rule 206(4)-5 with respect to registered investment companies to those that are investment options of a plan or program of a government entity, we continue to estimate that 80 advisers would have to comply with



Under the amendments, each respondent is required to retain the records in the same manner and for the same period of time as currently required under rule 204-2. The amendments to rule 204-2 are estimated to increase the burden by approximately 2 hours per Commission-registered adviser with government clients annually for a total increase of 3,394 hours.<sup>559</sup> The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 204-2 thus would be 2,106,046 hours.<sup>560</sup> The revised average burden per Commission-registered adviser would be 181.45 hours.<sup>561</sup>

Additionally, as we noted in the Proposing Release and reiterate above, we expect advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the amendments to rule 204-2. These costs would vary widely among firms. Small advisers may not incur any system costs if they determine a system is unnecessary due to the limited number of employees they have or the limited number of government entity clients they have. Large firms likely already have devoted

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the recordkeeping provisions because of the difficulty in further delineating this estimated number. Therefore, we estimate that the total number of advisers subject to the rule would be: 1,332 advisers with state or municipal clients + 285 advisers with other pooled investment vehicle clients + 80 advisers with registered investment company clients = 1,697 advisers subject to rule. We expect certain additional advisers may incur compliance costs associated with rule 206(4)-5. We anticipate some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers. In the Proposing Release, our estimates included an estimated burden attributable to advisers that do not currently have government clients but that may begin to seek them. The revision to the recordkeeping rule that eliminated the requirement to maintain records of government entities that an adviser solicits has eliminated the need for this additional burden estimate.

<sup>559</sup>  $2 \times 1,697 = 3,394$ .

<sup>560</sup>  $1,954,109$  (current approved burden) +  $148,543$  (burden for additional registrants) +  $3,394$  (burden for proposed amendments) =  $2,106,046$  hours.

<sup>561</sup>  $2,106,046$  (revised annual aggregate burden) divided by  $11,607$  (total number of registrants) =  $181.45$ .

significant resources into automating compliance and reporting and the new rule could result in enhancements to these existing systems.

As a result of these one-time costs, we estimate that there will be an increase to the total non-labor cost burden. We estimated above that the non-labor cost burden has increased to \$14,581,509 as a result of the increase in the number of registered advisers since the collection was last approved.<sup>562</sup> We believe the one-time costs could vary substantially among smaller, medium, and larger firms as smaller and medium firms may be able to use non-specialized software, such as a spreadsheet, or off-the-shelf compliance software to keep track of the information required by the rule while larger firms are more likely to have proprietary systems. Based on IARD data we estimate that there are approximately 1,271 smaller firms, 304 medium firms, and 122 larger firms.<sup>563</sup> We estimate that one half of the smaller and medium firms will not incur these one-time start up costs because they will use existing tools for compliance. We expect the other half of smaller and medium firms will incur one-time start up costs on average of \$10,000, in the event they have a greater number of employees and government clients, and larger firms, that likely have the most employees and government clients, will incur one-time start up costs on average of \$100,000. As a result, the amendments to rule 204-

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<sup>562</sup> See *supra* note 555.

<sup>563</sup> This estimate is based on registration information from IARD as of April 1, 2010. These estimates are based on IARD data, specifically the responses to Item 5.B.(1) of Form ADV, that 997 (or 74.9%) of the 1,332 registered investment advisers that have government clients have fewer than five employees who perform investment advisory functions, 239 (or 17.9%) have five to 15 such employees, and 96 (or 7.2%) have more than 15 such employees. We then applied those percentages to the 1,697 advisers we believe will be subject to the proposed rule for a total of 1,271 smaller, 304 medium and 122 larger firms.

2 are estimated to increase the non-labor cost burden by \$20,080,000.<sup>564</sup> Due to this increase, we now estimate the revised total non-labor cost burden for rule 204-2 to be \$34,661,509.

**B. Rule 206(4)-3**

The amendment to rule 206(4)-3 contains a revised collection of information requirement within the meaning of the PRA. In the Proposing Release, the Commission published notice soliciting comment on the collection of information requirement.<sup>565</sup> The Commission submitted the revised collection of information requirement to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. Rule 206(4)-3 contains a currently approved collection of information under OMB control number 3235-0242. The title for the collection of information is “Rule 206(4)-3 – Cash Payments for Client Solicitations.” As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 206(4) of the Advisers Act provides that it shall be unlawful for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)-3 generally prohibits investment advisers from paying cash fees to solicitors for client referrals unless certain conditions are met. The rule requires that an adviser pay all solicitors’ fees pursuant to a written agreement that the adviser is required to retain. This collection of information is

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<sup>564</sup>  $[\$10,000 \times 788] + [\$100,000 \times 122] = \$7,880,000 + \$12,200,000 = \$20,080,000.$

<sup>565</sup> See Proposing Release, at section IV.

mandatory. The Commission staff uses this collection of information in its examination and oversight program, and the information generally is kept confidential.<sup>566</sup>

The Commission is adopting amendments to rule 206(4)-3 under the Advisers Act. The amendments to rule 206(4)-3, which are identical to our proposed amendments, require every investment adviser that relies on the rule and that provides or seeks to provide advisory services to government entities to also abide by the limitations provided in rule 206(4)-5. This collection of information is found at 17 CFR 275.206(4)-3. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act would not be subject to rule 206(4)-3.

We requested comment on the PRA analysis contained in Proposing Release. We received no comment on this portion of our analysis. In addition, we have not modified our amendments to rule 206(4)-3 relative to our proposal.

The current approved collection of information for rule 206(4)-3, set to expire on March 31, 2011, is based on an estimate that 20 percent of the 10,817 Commission-registered advisers (or 2,163 advisers) rely on the rule, at an average of 7.04 burden hours each year, per respondent, for a total of 15,228 burden hours (7.04 x 2,163).

Commission records indicate that currently there are approximately 11,607 registered investment advisers,<sup>567</sup> 20 percent of which (or 2,321) are likely subject to the collection of information imposed by rule 206(4)-3. As a result of the increase in the number of advisers registered with the Commission since the current total burden was

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<sup>566</sup> Section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

<sup>567</sup> This figure is based on registration information from IARD as of April 1, 2010. The figures we relied on in our Proposing Release were based on registration information from IARD as of July 1, 2009.

approved, the total burden has increased by 1,112.32 hours (158 additional advisers<sup>568</sup> x 7.04 hours). We estimate that approximately 20 percent of the Commission-registered advisers that use rule 206(4)-3 (or 464 advisers)<sup>569</sup> provide, or seek to provide, advisory services to government clients.<sup>570</sup> Under the amendments, each respondent would be prohibited from certain solicitation activities, subject to the exception for “regulated persons,” with respect to government clients, activities that otherwise would have been covered by rule 206(4)-3.<sup>571</sup> Thus, they would not need to enter into and retain the written agreement required under rule 206(4)-3 with respect to those third parties they are prohibited from paying to solicit government entities.

In the Proposing Release, we estimated a decrease to the burden due to the prohibition on paying third party solicitors to be 20% of the annual burden. As a result of the revised ban on using third parties, we now estimate that the amendments to rule 206(4)-3 will only decrease the burden by 15 percent,<sup>572</sup> or approximately 1.06 hour,<sup>573</sup> per Commission-registered adviser that uses the rule and has or is seeking government

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<sup>568</sup> 2,321 (20% of current registered investment advisers) – 2,163 (20% of registered investment advisers when burden estimate was last approved by OMB) = 158.

<sup>569</sup> 2,321 x 20 percent = 464.

<sup>570</sup> In light of the 11.48% of registered investment advisers that indicate they have state or municipal government clients, we conservatively estimate that 20% of the advisers who rely on rule 206(4)-3 are soliciting government entities to be advisory clients or to invest in covered investment pools those advisers manage. *See supra* note 558.

<sup>571</sup> Rule 206(4)-3(a).

<sup>572</sup> In our proposal, which would have banned the use of third-party solicitors altogether, we estimated a 20 percent decrease in the burden under rule 206(4)-3. But, to account for the regulated persons exception to the third-party solicitor ban in adopted rule 206(4)-5, we have modified our estimate to only a 15 percent decrease. That is because our staff estimates that one quarter (or 5 percent) of the proposal’s estimated burden reduction relating to entering into and retaining the written agreement required under rule 206(4)-3 will be retained as investment advisers engage third parties that are regulated persons to solicit on their behalf.

<sup>573</sup> 7.04 x 15 percent = 1.06.

clients annually, for a total decrease of 491.84 hours.<sup>574</sup> The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 206(4)-3 thus would be 15,848.48 hours.<sup>575</sup> The revised average burden per Commission-registered adviser would be 6.83 hours.<sup>576</sup>

**C. Rule 206(4)-7**

As a result of the adoption of rule 206(4)-5, rule 206(4)-7 contains a revised collection of information requirement within the meaning of the PRA. In the Proposing Release, the Commission estimated that registered advisers would spend between 8 hours and 250 hours to establish policies and procedures to comply with rule 206(4)-5.<sup>577</sup> Rule 206(4)-7 contains a currently approved collection of information under OMB control number 3235-0585. The title for the collection of information is “Investment Advisers Act Rule 206(4)-7, Compliance procedures and practices.” As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 206(4) of the Advisers Act provides that it shall be unlawful for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)-7, in part, requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. This collection of

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<sup>574</sup>  $464 \times 1.06 = 491.84$ .

<sup>575</sup>  $15,228$  (current approved burden) +  $1,112.32$  (burden for additional registrants) -  $491.84$  (reduction in burden for amendments) =  $15,848.48$  hours.

<sup>576</sup>  $15,848.48$  (revised annual aggregate burden) divided by  $2,321$  (total number of registrants who rely on rule) =  $6.83$ .

<sup>577</sup> See Proposing Release, at section III.B.

information is mandatory. The purpose of the information collection requirement is to ensure that registered advisers maintain comprehensive, written internal compliance programs. It also assists the Commission's staff in its examination and oversight program. Information obtained in our examination and oversight program generally is kept confidential.<sup>578</sup>

As we previously noted, we expect that registered investment advisers subject to rule 206(4)-5 will modify their compliance programs to address new obligations under that rule. The current approved collection of information for rule 206(4)-7, set to expire on March 31, 2011, is based on 10,817 registered advisers that were subject to the rule at an average burden of 80 hours each year per respondent for a total of 865,360 burden hours.

Commission records indicate that currently there are approximately 11,607 registered investment advisers.<sup>579</sup> As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 63,200 hours (790 x 80 hours). In addition, although the time needed to comply with rule 206(4)-5 will vary significantly from adviser to adviser, as discussed in detail below, the Commission staff estimates that firms with government clients will spend between 8 hours and 250 hours to implement policies and procedures to comply with the rule, depending on the firm's number of covered associates.<sup>580</sup> Of the

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<sup>578</sup> Section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

<sup>579</sup> This figure is based on registration information from IARD as of April 1, 2010.

<sup>580</sup> See section IV.B.1. of this Release (describing the cost estimates associated with compliance with rule 206(4)-5).

1,697 registered advisers that we estimate may be affected by rule 206(4)-5,<sup>581</sup> we estimate that approximately 1,271 are smaller firms, 304 are medium firms, and 122 are larger firms.<sup>582</sup> We anticipate that smaller firms will spend 8 hours, medium firms will spend 125 hours, and larger firms will spend 250 hours,<sup>583</sup> for a total of 78,668 hours,<sup>584</sup> to implement policies and procedures. Our estimates take into account our staff's observation that some registered advisers have established policies regarding political contributions, which can be revised to reflect the new requirements. The revised annual aggregate burden for all respondents to comply with rule 206(4)-7 thus would be 1,007,228 hours.<sup>585</sup>

**D. Rule 0-4**

Rule 0-4 under the Advisers Act,<sup>586</sup> entitled "General Requirements of Papers and Applications," prescribes general instructions for filing an application seeking exemptive relief with the Commission. The requirements of rule 0-4 are designed to provide the Commission with the necessary information to assess whether granting the orders of exemption are necessary and appropriate, in the public interest and consistent with the protection of investors and the intended purposes of the Act. In light of the adoption of rule 206(4)-5, which contains a provision for seeking an exemptive order from the

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<sup>581</sup> See *supra* note 558. Advisers that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act [15 U.S.C. 80b-3(b)(3)] are not subject to rule 206(4)-7 and, therefore, are not reflected in this burden estimates pursuant to the PRA.

<sup>582</sup> See *supra* note 475.

<sup>583</sup> See *supra* notes 489-491.

<sup>584</sup>  $(1,271 \times 8 = 10,168) + (304 \times 125 = 38,000) + (122 \times 250 = 30,500) = 78,668$ .

<sup>585</sup>  $865,360$  (current approved burden) +  $63,200$  (burden for additional registrants) +  $78,668$  (burden attributable to rule 206(4)-5) =  $1,007,228$  hours.

<sup>586</sup> 17 CFR 275.0-4.



Commission, we are revising the collection of information requirement for rule 0-4. Rule 0-4 contains a currently approved collection of information under OMB control number 3235-0633. As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The current approved collection of information contains an estimated total annual hour burden of one hour for administrative purposes because most of the work of preparing an application is performed by outside counsel and, therefore, imposes minimal, if any, hourly burden on respondents. Because we expect that all, or substantially all, of the work of preparing an application for an exemptive order under rule 206(4)-5 will also be performed by outside counsel, we continue to believe that the current estimate of one hour, in the unlikely event the adviser does perform an administrative role, is sufficient. As a result, we are not increasing our estimated hourly burden in connection with the adoption of rule 206(4)-5.

The current approved collection of information also contains an estimated total annual cost burden of \$355,000, which is attributed to outside counsel legal fees. In the Proposing Release, we estimated that approximately five advisers annually would apply to the Commission for an exemption from rule 206(4)-5.<sup>587</sup> We also estimated that an advisory firm that applies for an exemption would hire outside counsel to prepare their exemptive requests, and that counsel would spend 16 hours preparing and submitting an application for review at a rate of \$400 per hour, for a per application cost of \$6,400 and a total estimated cost for five applications annually of \$32,000.

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<sup>587</sup> See Proposing Release, at Section III.B.

The Commission requested public comment on these estimates in the Proposing Release, and we received comments indicating that our estimate of five exemptive application submissions per year is too low.<sup>588</sup> We did not receive comments on our cost estimates. Given that the advisory industry is much larger than the municipal securities industry, and in light of the number of comment letters we received that expressed concern about inadvertent violations of the rule that would not qualify for the exception for returned contributions, our staff estimates that approximately seven advisers annually would apply to the Commission for an exemption from the rule. Although we may initially receive more than seven applications a year for an exemption, over time, we expect the number of applications we receive will significantly decline to an average of approximately seven annually. We continue to believe that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, but based on commenters concerns have raised the number of hours counsel will spend preparing and submitting an application from 16 hours to 32 hours, at a rate of \$400 per hour.<sup>589</sup> As a result, each application will cost approximately \$12,800, and the total estimated cost for seven applications annually will be \$89,600. The total estimated annual cost burden to applicants of filing all applications has therefore increased to \$444,600.<sup>590</sup>

## **VI. FINAL REGULATORY FLEXIBILITY ANALYSIS**

The Commission has prepared the following Final Regulatory Flexibility Analysis regarding rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3 in accordance

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<sup>588</sup> See Davis Polk Letter; ICI Letter.

<sup>589</sup> The hourly cost estimate of \$400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

<sup>590</sup> \$355,000 + \$89,600 = \$444,600.

with section 3(a) of the Regulatory Flexibility Act.<sup>591</sup> We prepared an Initial Regulatory Flexibility Analysis (“IRFA”) in conjunction with the Proposing Release in August 2009.<sup>592</sup> The Proposing Release included, and solicited comment, on the IRFA.

**A. Need for the Rule**

Investment advisers that seek to influence the award of advisory contracts by government entities, by making or soliciting political contributions to those officials who are in a position to influence the awards, violate their fiduciary obligations. These practices—known as “pay to play”—distort the process by which investment advisers are selected and, as discussed in greater detail above, can harm advisers’ public pension plan clients, and thereby beneficiaries of those plans, which may receive inferior advisory services and pay higher fees.<sup>593</sup> In addition, the most qualified adviser may not be selected, potentially leading to inferior management, diminished returns, or greater losses for the public pension plan. Pay to play is a significant problem in the management of public funds by investment advisers. Moreover, we believe that advisers’ participation in pay to play is inconsistent with the high standards of ethical conduct required of them under the Advisers Act. The rule and rule amendments we are adopting today are designed to prevent fraud, deception, and manipulation by reducing or eliminating adviser participation in pay to play practices.

Rule 206(4)-5, the “pay to play” rule, prohibits an investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act, from providing

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<sup>591</sup> 5 U.S.C. 604(b).

<sup>592</sup> See Proposing Release, at section V.

<sup>593</sup> See section I of this Release, for more information about the need for the Commission to take action to prevent pay to play practices.

advisory services for compensation to a government client for two years after the adviser, or any of its covered associates, makes a contribution to public officials (and candidates) such as state treasurers, comptrollers, or other elected executives or administrators who can influence the selection of the adviser.<sup>594</sup> In addition, the rule we are adopting prohibits an adviser and its covered associates from soliciting contributions for an elected official or candidate or payments to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity,<sup>595</sup> and from providing or agreeing to provide, directly or indirectly, payment to any third party, other than a “regulated person,” engaged to solicit advisory business from any government entity on behalf of the adviser.<sup>596</sup> Further, the prohibitions in the rule also apply to advisers to certain investment pools in which a government entity invests or that are investment options of a plan or program of a government entity.<sup>597</sup> The amendment we are adopting to rule 204-2 is designed to provide Commission staff with records to review compliance with rule 206(4)-5, and the amendment to rule 206(4)-3 clarifies the application of the cash solicitation rule as a result of the adoption of rule 206(4)-5.<sup>598</sup>

## **B. Significant Issues Raised by Public Comment**

In the Proposing Release, we requested comment on the IRFA, in particular, on the number of small entities, particularly small advisers, to which the rule and rule amendments would apply and the effect on those entities, including whether the effects

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<sup>594</sup> Rule 206(4)-5(a)(1).

<sup>595</sup> Rule 206(4)-5(a)(2)(ii).

<sup>596</sup> Rule 206(4)-5(a)(2)(i). “Regulated person” is defined in rule 206(4)-5(f)(9).

<sup>597</sup> Rule 206(4)-5(c).

<sup>598</sup> For a more detailed discussion of the prohibitions contained in rule 206(4)-5, see section II.B.2 of this Release. For a more detailed discussion of the amendments to rules 204-2 and 206(4)-3, see sections II.D and II.E, respectively, of this Release.

would be economically significant; and how to quantify the number of small advisers, including those that are unregistered, that would be subject to the proposed rule and rule amendments. We received a number of comments related to the impact of our proposal on small advisers. The commenters argued that the proposed rule, particularly the provision that would have prohibited advisers from directly or indirectly compensating any third party to solicit government business on its behalf, would be disproportionately expensive for, and would impose an undue regulatory burden on, smaller firms.<sup>599</sup>

### **C. Small Entities Subject to Rule**

Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than \$25 million; (ii) did not have total assets of \$5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had \$5 million or more on the last day of its most recent fiscal year.<sup>600</sup>

The Commission estimates that as of April 2010 there are approximately 708 small SEC-registered investment advisers.<sup>601</sup> Of these 708 advisers, 61 indicate on Form ADV that they have state or local government clients, and would, therefore, be affected

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<sup>599</sup> See *supra* note 522.

<sup>600</sup> 17 CFR 275.0-7(a).

<sup>601</sup> This estimate is based on registration information from IARD as of April 1, 2010. We have estimated the number of small advisers by reference to advisers' responses to Item 12.A, B and C of Part 1 of Form ADV.

by the rule.<sup>602</sup> The rule also applies to those advisers that are exempt from registration with the Commission in reliance on section 203(b)(3) of the Advisers Act. As noted above, based on our review of registration information on IARD and outside sources and reports, we estimate that there are approximately 2,000 advisers that are unregistered in reliance on section 203(b)(3).<sup>603</sup> Applying the same principles we used with respect to registered investment advisers, we estimate that 230 of those advisers manage pooled investment vehicles in which government client assets are invested and would therefore be subject to the rule.<sup>604</sup> Based on the current number of registered advisers subject to the rule that are small entities, we estimate that approximately 4 percent of unregistered advisers,<sup>605</sup> or nine, would be subject to the rule are small entities.<sup>606</sup>

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<sup>602</sup> This estimate is based on registration information from IARD as of April 1, 2010. We have estimated the number of small advisers with state or local government clients by reference to advisers' responses to Item 5.D(9) of Part 1 of Form ADV.

<sup>603</sup> This number is based on our review of registration information on IARD as of April 1, 2010, IARD data from the peak of hedge fund adviser registration in 2005, and a distillation of numerous third-party sources including news organizations and industry trade groups.

<sup>604</sup> 11.48% of 2000 is 230. *See supra* note 474.

<sup>605</sup> 61 registered small entities subject to the rule/1,697 registered advisers subject to the rule = 3.6%.

<sup>606</sup>  $230 \times 4\% = 9.2$ . Because these advisers are not registered with us, we do not have more precise data about them, and we are not aware of any databases that compile information regarding how many advisers that are exempt from registration with the Commission in reliance on section 203(b)(3) of the Advisers Act have state or local government clients, and how many of these advisers would be small entities for purposes of this analysis. We sought comments on this issue, but none of the comments we received provided any estimates or empirical data. However, we address above commenters who generally questioned our estimates. *See supra* notes 482-484 and accompanying text. We expect certain additional advisers may incur compliance costs associated with rule 206(4)-5. Some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers.

**D. Projected Reporting, Recordkeeping, and Other Compliance Requirements**

The rule imposes certain reporting, recordkeeping and compliance requirements on advisers, including small advisers. The rule imposes a new compliance requirement by: (i) prohibiting an adviser from providing investment advisory services for compensation to government clients for two years after the adviser or any of its covered associates makes a contribution to certain elected officials or candidates; (ii) prohibiting an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party, other than a “regulated person,” engaged to solicit advisory business from any government entity on behalf of the adviser; and (iii) prohibiting an adviser or any of its covered associates from soliciting contributions for an elected official or candidate or payments to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity.

The rule amendments impose new recordkeeping requirements by requiring an adviser to maintain certain records about its covered associates, its advisory clients, government entities invested in certain pooled investment vehicles managed by the adviser, its solicitors, and its political contributions, as well as the political contributions of its covered associates.<sup>607</sup> An investment adviser that does not provide or seek to provide advisory services to a government entity, or to a covered investment pool in which a government entity invests, is not subject to rule 206(4)-5 and certain recordkeeping requirements under amended rule 204-2.

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<sup>607</sup> See *supra* notes 559-564 and accompanying text (providing the revised estimated hour burden and non-labor cost burden to comply with amended rule 204-2, for purposes of the PRA).

As noted above, we believe that a limited number of small advisers<sup>608</sup> will have to comply with rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3. To the extent small advisers tend to have fewer clients and fewer employees that would be covered associates for purposes of the rule, the rule should impose lower costs on small advisers as compared to large advisers because variable costs, such as the requirement to make and keep records relating to contributions, should be lower due to the likelihood that there would be fewer records to make and keep.<sup>609</sup> Moreover, as discussed above, the rule and amendments were modified from what we had proposed in several ways that we expect will substantially minimize compliance burdens on small advisers.

**E. Agency Action to Minimize Effect on Small Entities**

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant impact on small entities.<sup>610</sup> In considering whether to adopt rule 206(4)-5 and the amendments to rules 204-2 and 206(4)-3, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule and rule amendments for such small entities; (iii) the use of performance

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<sup>608</sup> See section VI.C of this Release.

<sup>609</sup> However, as noted above, many larger advisers with broker-dealer affiliates may spend fewer resources to comply with the proposed rule and rule amendments because they may be able to rely on compliance procedures and systems that the broker-dealer already has in place to comply with MSRB rules G-37 and G-38. See *supra* section IV.B.

<sup>610</sup> As noted above, we considered two alternatives to certain aspects of proposed rule 206(4)-5: a disclosure obligation and a two-year time out for third-party solicitors. We do not believe either alternative would accomplish our stated objective of curtailing pay to play activities and thereby address potential harms from those activities. See Proposing Release, at section II.A.2, including nn.133 and 134 and accompanying text.



rather than design standards; and (iv) an exemption from coverage of the rule and rule amendments, or any part thereof, for such small entities.

Regarding the first alternative, the Commission is not adopting different compliance or reporting requirements for small advisers as it may be inappropriate to do so under the circumstances. The proposal is designed to reduce or eliminate adviser participation in pay to play, a practice that can distort the process by which investment advisers are selected to manage public pension plans that can harm public pension plan clients and cause advisers to violate their fiduciary obligations. To establish different requirements for small advisers could diminish the protections the rule and rule amendments would provide to public pension plan clients and their beneficiaries.

Regarding the second alternative, we considered whether further clarification, consolidation, or simplification of the compliance requirements would be feasible or necessary, and would reduce compliance requirements. As a result, we have simplified the compliance requirements by limiting the recordkeeping obligations to better reflect the activities of an adviser or a covered associate that could result in the adviser being subject to the two-year time out, including not requiring advisers to maintain records of unsuccessful solicitations of government entities and payments (as opposed to contributions) by advisers or covered associates to government officials.<sup>611</sup> Moreover, we are amending rule 206(4)-3, the cash solicitation rule, to clarify that the requirements of new rule 206(4)-5 apply to solicitation activities involving government clients.<sup>612</sup>

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<sup>611</sup> See *supra* note 423 and accompanying text.

<sup>612</sup> See section II.D. of this Release.

Regarding the third alternative, we considered using performance rather than design standards with respect to pay to play practices of investment advisers to be neither consistent with the objectives for this rulemaking nor sufficient to protect investors in accordance with our statutory mandate of investor protection. Design standards, which we have employed, provide a base line for advisory conduct as it relates to contributions and other pay to play activities, which is consistent with a rule designed to prohibit pay to play. The use of design standards also is important to ensure consistent application of the rule among investment advisers to which the rule and rule amendments will apply.

Regarding the fourth alternative, exempting small entities could compromise the overall effectiveness of the rule and related rule amendments. Banning pay to play practices benefits clients of both small and large advisers, and it would be inconsistent to specify different requirements for small advisers.

As discussed above, several commenters suggested alternative approaches to our rule.<sup>613</sup> Such alternatives include, for example: (i) that we require advisers to disclose their contributions to state and local officials; (ii) that we require advisers to include in their codes of ethics a policy that prohibits contributions made for the purpose of influencing the selection of the adviser; (iii) that we require advisers to adopt policies and procedures reasonably designed to prevent and detect contributions designed to influence the selection of an adviser; (iv) that we mandate preclearance of employee contributions; and (v) that we allow an adviser to customize sanctions based on the severity of the violation.<sup>614</sup> While it may be true that some of these approaches could diminish the

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<sup>613</sup> See generally section II.B.2(a) of this Release.

<sup>614</sup> See *id.*

compliance burdens on advisers, including small advisers, as we explain above, we considered these alternative approaches and do not believe they would appropriately address the kind of conduct at which our rule is directed.<sup>615</sup>

We are sensitive to the burdens our rule amendments will have on small advisers. We believe that the rule we are adopting today contains a number of modifications from what we had proposed that will alleviate many of the commenters' concerns regarding small advisers. Most notably, as described above, we have created an exception to the third-party solicitor ban for "regulated persons," which will, for instance, allow advisers to continue to use third party placement agents to sell interests in covered investment pools they manage instead of incurring additional costs to hire internal marketing staff, a result that could have disproportionately affected small advisers.<sup>616</sup> Moreover, as discussed above, we have modified the exceptions to the rule's two-year time out provisions in certain respects to reduce the likelihood of an inadvertent or minor violation of the rule, including a shortened look back of six months for certain new covered associates whose contributions are less likely to involve pay to play and a new *de minimis* exception for contributions to officials for whom a covered associate is not entitled to vote.<sup>617</sup> We have also limited certain recordkeeping requirements we had proposed in order to achieve our goals in a way that balances the costs and benefits of the rule, including not requiring records of unsuccessful solicitations or payments (that are not contributions) by advisers or covered associates to government officials.<sup>618</sup>

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<sup>615</sup> See *id.*

<sup>616</sup> See section II.B.2(b) of this Release.

<sup>617</sup> See sections II.B.2(a)(5) and (6) of this Release.

<sup>618</sup> See sections II.D and III.B.3. of this Release.

## **VII. EFFECTS ON COMPETITION, EFFICIENCY AND CAPITAL FORMATION**

We are adopting amendments to rule 204-2 pursuant to our authority under sections 204 and 211. Section 204 requires the Commission, when engaging in rulemaking pursuant to that authority, to consider whether the rule is “necessary or appropriate in the public interest or for the protection of investors.”<sup>619</sup> Section 202(c) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>620</sup>

In the Proposing Release, we solicited comment on whether, if adopted, the proposed amendments to rule 204-2 would promote efficiency, competition and capital formation. We further encouraged commenters to provide empirical data to support their views on any burdens on efficiency, competition or capital formation that might result from adoption of the proposed amendments. We did not receive any empirical data in this regard concerning the proposed amendments. We received some general comments, addressed below, asserting that the proposed amendments to require registered advisers to maintain books and records relating to investment advisory services they provide to government entities would have an adverse impact on competition.

We are amending rule 204-2 to require a registered adviser to make and keep a list of its covered associates, the government entities to which the adviser directly or

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<sup>619</sup> 15 U.S.C. 80b-4.

<sup>620</sup> 15 U.S.C. 80b-2(c). In contrast, we are adopting rule 206(4)-5 and amendments to rule 206(4)-3 pursuant to our authority set forth in sections 206(4) and 211. For a discussion of the effects of these amendments on competition, efficiency and capital formation, see sections IV, V, and VI of this Release.

indirectly provides advisory services, the “regulated person” solicitors the adviser retains, and the contributions made by the firm and its covered associates, as applicable, to government officials and candidates.<sup>621</sup> The amendments are designed to provide our examiners important information about the adviser and its covered associates’ contributions to government officials, the government entities to which the adviser directly or indirectly provides advisory services, and the solicitors it retains. These amendments may also benefit advisers as records required under the amended rule will assist the Commission in enforcing the rule against, for example, an adviser whose pay to play activities, if not uncovered, could adversely affect the competitive position of a compliant adviser.

Although we believe that the amendments to the Advisers Act recordkeeping rule will require advisers to incur both one-time costs to establish and enhance current systems to assist in their compliance with the amendments and ongoing costs to maintain records, these costs will be borne by all registered advisers that have government entity clients or that pay regulated entities to solicit government clients on their behalf. As the amendments to the recordkeeping rule do not disproportionately affect any particular group of advisers with government entity clients and do not materially increase the compliance burden on advisers under rule 204-2, we do not believe that they will affect competition across registered investment advisers. Some commenters asserted that certain asset managers that provide advice to government entities but are not subject to the Advisers Act recordkeeping rule, such as banks and advisers that are exempt from registration under the Act, may be at a competitive advantage to registered advisers that

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<sup>621</sup> Rule 204-2(a)(18)(i).

must incur the costs of keeping records under the rule.<sup>622</sup> While we acknowledge these entities could potentially obtain a competitive advantage for this reason, we do not believe the costs attributable to the amendments to rule 204-2 will have a significant impact on registered advisers such that the advantage gained by asset managers not subject to the Advisers Act recordkeeping rule will be substantial.<sup>623</sup> Moreover, exempt advisers or persons that do not meet the definition of investment adviser are not subject to rule 204-2.<sup>624</sup> Finally, we also note that banks may be subject to laws and rules that do not apply to registered advisers.

We believe that the amendments to rule 204-2 may, to a limited extent, affect efficiency and capital formation with respect to the allocation of public pension plan assets. The amendments to rule 204-2 will allow our staff to examine for compliance with rule 206(4)-5. Authority to examine records may improve registered investment advisers' compliance with rule 206(4)-5, which may reduce the adverse effects of political contributions on the selection of investment advisers. While the amendments to the rule will not affect the aggregate amount of pension fund assets available for investment, limiting the effects of political contributions on the investment adviser

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<sup>622</sup> SIFMA Letter (“The books and records requirement under the Proposed Rule are under inclusive. . . . As an initial matter, the books and records requirements apply only to some of the advisers covered by the Proposed Rule – although the Proposed Rule applies to a substantial number of entities who are exempt from registration under the Advisers Act, the Proposed Rule’s additional books and records only modify the rules that apply to registered investment advisers.”).

<sup>623</sup> In addition, we note that advisers not subject to the amendments to rule 204-2 may nonetheless maintain some of the required records as part of a strong compliance program.

<sup>624</sup> See section 204 of the Advisers Act, 15 U.S.C. 80b-4 (that provides the Commission authority to prescribe recordkeeping for advisers, other than those specifically exempted from registration).

selection process should improve the mechanism by which capital is formed and allocated to investment opportunities.

### **VIII. STATUTORY AUTHORITY**

The Commission is adopting new rule 206(4)-5 and amending rule 206(4)-3 of the Advisers Act pursuant to the authority set forth in sections 206(4) and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-6(4), 80b-11(a)].

The Commission is amending rule 204-2 of the Advisers Act pursuant to the authority set forth in sections 204 and 211(a) of the Advisers Act [15 U.S.C. 80b-4 and 80b-11(a)].

#### **List of Subjects in 17 CFR Part 275**

Reporting and recordkeeping requirements; Securities.

For the reasons set out in the preamble, Title 17 Chapter II of the Code of Federal Regulations is amended as follows.

### **PART 275 -- RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

1. The authority citation for Part 275 continues to read in part as follows:

**Authority:** 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 275.204-2 is amended by adding paragraph (a)(18) and by revising paragraph (h)(1) to read as follows:

#### **§ 275.204-2 -- Books and records to be maintained by investment advisers.**

(a) \* \* \*

(18)(i) Books and records that pertain to § 275.206(4)-5 containing 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 investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years, but not prior to September 13, 2010;

(C) All direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a political party of a state or political subdivision thereof, or to a political action committee; and

(D) The name and business address of each regulated person to whom the investment adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf, in accordance with § 275.206(4)-5(a)(2).

(ii) Records relating to the contributions and payments referred to in paragraph (a)(18)(i)(C) of this section must be listed in chronological order and indicate:

(A) The name and title of each contributor;

(B) The name and title (including any city/county/state or other political subdivision) of each recipient of a contribution or payment;

(C) The amount and date of each contribution or payment; and



(D) Whether any such contribution was the subject of the exception for certain returned contributions pursuant to § 275.206(4)-5(b)(2).

(iii) An investment adviser is only required to make and keep current the records referred to in paragraphs (a)(18)(i)(A) and (C) of this section if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services.

(iv) For purposes of this section, the terms “contribution,” “covered associate,” “covered investment pool,” “government entity,” “official,” “payment,” “regulated person,” and “solicit” have the same meanings as set forth in § 275.206(4)-5.

\* \* \* \* \*

(h)(1) Any book or other record made, kept, maintained and preserved in compliance with §§ 240.17a-3 and 240.17a-4 of this chapter under the Securities Exchange Act of 1934, or with rules adopted by the Municipal Securities Rulemaking Board, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this section, shall be deemed to be made, kept, maintained and preserved in compliance with this section.

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3. Section 275.206(4)-3 is amended by adding paragraph (e) and removing the authority citation at the end of the section to read as follows:

**§ 275.206(4)-3 Cash payments for client solicitations.**

\* \* \* \* \*

(e) Special rule for solicitation of government entity clients. Solicitation activities involving a government entity, as defined in § 275.206(4)-5, shall be subject to the additional limitations set forth in that section.

4. Section 275.206(4)-5 is added to read as follows:

**§ 275.206(4)-5 Political contributions by certain investment advisers.**

(a) Prohibitions. As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)), it shall be unlawful:

(1) For any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)) to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made); and

(2) For any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)) or any of the investment adviser's covered associates:

(i) To provide or agree to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such

investment adviser unless such person is a regulated person or is an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the investment adviser; and

(ii) To coordinate, or to solicit any person or political action committee to make, any:

(A) Contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or

(B) Payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

(b) Exceptions.

(1) De minimis exception. Paragraph (a)(1) of this section does not apply to contributions made by a covered associate, if a natural person, to officials for whom the covered associate *was* entitled to vote at the time of the contributions and which in the aggregate do not exceed \$350 to any one official, per election, or to officials for whom the covered associate was *not* entitled to vote at the time of the contributions and which in the aggregate do not exceed \$150 to any one official, per election.

(2) Exception for certain new covered associates. The prohibitions of paragraph (a)(1) of this section shall not apply to an investment adviser as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the investment adviser unless such person, after becoming a covered associate, solicits clients on behalf of the investment adviser.

(3) Exception for certain returned contributions.

(i) An investment adviser that is prohibited from providing investment advisory services for compensation pursuant to paragraph (a)(1) of this section as a result of a contribution made by a covered associate of the investment adviser is excepted from such prohibition, subject to paragraphs (b)(3)(ii) and (b)(3)(iii) of this section, upon satisfaction of the following requirements:

(A) The investment adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution;

(B) Such contribution must not have exceeded \$350; and

(C) The contributor must obtain a return of the contribution within 60 calendar days of the date of discovery of such contribution by the investment adviser.

(ii) In any calendar year, an investment adviser that has reported on its annual updating amendment to Form ADV (17 CFR 279.1) that it has more than 50 employees is entitled to no more than three exceptions pursuant to paragraph (b)(3)(i) of this section, and an investment adviser that has reported on its annual updating amendment to Form ADV that it has 50 or fewer employees is entitled to no more than two exceptions pursuant to paragraph (b)(3)(i) of this section.

(iii) An investment adviser may not rely on the exception provided in paragraph (b)(3)(i) of this section more than once with respect to contributions by the same covered associate of the investment adviser regardless of the time period.

(c) Prohibitions as applied to covered investment pools. For purposes of this section, an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though that investment adviser were

providing or seeking to provide investment advisory services directly to the government entity.

(d) Further prohibition. As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of section 206(4) of Advisers Act (15 U.S.C. 80b-6(4)), it shall be unlawful for any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)), or any of the investment adviser's covered associates to do anything indirectly which, if done directly, would result in a violation of this section.

(e) Exemptions. The Commission, upon application, may conditionally or unconditionally exempt an investment adviser from the prohibition under paragraph (a)(1) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors:

(1) 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 (15 U.S.C. 80b);

(2) Whether the investment adviser:

(i) Before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of this section; and

(ii) Prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and

(iii) After learning of the contribution:

(A) Has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution; and

(B) Has taken such other remedial or preventive measures as may be appropriate under the circumstances;

(3) Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment;

(4) The timing and amount of the contribution which resulted in the prohibition;

(5) The nature of the election (*e.g.*, federal, state or local); and

(6) The contributor's apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.

(f) Definitions. For purposes of this section:

(1) Contribution means any gift, subscription, loan, advance, or deposit of money or anything of value made for:

(i) The purpose of influencing any election for federal, state or local office;

(ii) Payment of debt incurred in connection with any such election; or

(iii) Transition or inaugural expenses of the successful candidate for state or local office.

(2) Covered associate of an investment adviser means:

(i) Any general partner, managing member or executive officer, or other individual with a similar status or function;

(ii) Any 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 investment adviser or by any person described in paragraphs (f)(2)(i) and (f)(2)(ii) of this section.

(3) Covered investment pool means:

(i) An investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a) that is an investment option of a plan or program of a government entity; or

(ii) Any company that would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), but for the exclusion provided from that definition by either section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act (15 U.S.C. 80a-3(c)(1), (c)(7) or (c)(11)).

(4) Executive officer of an investment adviser means:

(i) The president;

(ii) Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);

(iii) Any other officer of the investment adviser who performs a policy-making function; or

(iv) Any other person who performs similar policy-making functions for the investment adviser.

(5) Government entity means any state or political subdivision of a state, including:

(i) Any agency, authority, or instrumentality of the state or political subdivision;

(ii) A pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a “defined benefit plan” as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a state general fund;

(iii) A plan or program of a government entity; and

(iv) Officers, agents, or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

(6) Official means 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.

(7) Payment means any gift, subscription, loan, advance, or deposit of money or anything of value.

(8) Plan or program of a government entity means any participant-directed investment program or plan sponsored or established by a state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to, a “qualified tuition plan” authorized by section 529 of the Internal Revenue Code (26 U.S.C. 529), a retirement plan authorized by section 403(b) or 457 of the Internal Revenue Code (26 U.S.C. 403(b) or 457), or any similar program or plan.



(9) Regulated person means:

(i) An investment adviser registered with the Commission that has not, and whose covered associates have not, within two years of soliciting a government entity:

(A) Made a contribution to an official of that government entity, other than as described in paragraph (b)(1) of this section; and

(B) Coordinated or solicited any person or political action committee to make any contribution or payment described in paragraphs (a)(2)(ii)(A) and (B) of this section; or

(ii) A “broker,” as defined in section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) or a “dealer,” as defined in section 3(a)(5) of that Act (15 U.S.C. 78c(a)(5)), that is registered with the Commission, and is a member of a national securities association registered under section 15A of that Act (15 U.S.C. 78o-3), provided that:

(A) The rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and

(B) The Commission, by order, finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers than this section imposes on investment advisers and that such rules are consistent with the objectives of this section.

(10) Solicit means:

(i) With respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and

(ii) With respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.

By the Commission.

Elizabeth M. Murphy  
Secretary

Dated: July 1, 2010