The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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August 7, 2009

SEC Proposes Pay-to-Play Restrictions for Investment Advisers

[23683]

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TO: SEC RULES COMMITTEE No. 46-09
529 PLAN ADVISORY COMMITTEE No. 3-09
INVESTMENT ADVISERS COMMITTEE No. 4-09 RE: SEC PROPOSES PAY-TO-PLAY RESTRICTIONS FOR INVESTMENT ADVISERS

The Securities and Exchange Commission has proposed to inhibit pay-to-play practices by investment advisers through restrictions on political contributions to government officials who are in a position to influence the award of advisory business. [1] First, the proposal would impose a two-year "time out" on conducting compensated advisory business with a government client after a contribution is made. Second, the proposal would prohibit advisers from paying third parties to solicit government entities for advisory business. Third, it would make it unlawful for an advisor to solicit or to coordinate (1) contributions for a government official to which the adviser is seeking to provide advisory services or (2) 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. Fourth, the proposal would prohibit an adviser from doing anything indirectly which, if done directly, would violate the proposed rule. It is important to note that the proposal would apply to an adviser to certain pooled investment vehicles, including mutual funds, in which a government entity invests or is solicited to invest.

Comments on the proposal, which is summarized below, are due to the SEC on or before October 6, 2009.

We have scheduled a conference call for Thursday, August 13 at 2:00 p.m. Eastern time to discuss the Institute's comment letter on the proposal. The dial-in information for the conference call is 1-866-541-3298 and the passcode for the call is 6501781. If you plan to participate on the call, please contact Ruth Tadesse by email at rtadesse@ici.org or 202-326-5836.

Advisers and Services Subject to the Proposal

The proposal would apply to any adviser registered with the SEC or unregistered in reliance on the exemption available under Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Act"). It would not apply to most small advisers that are registered with the state securities authorities, and certain other advisers that are exempt from registration with the SEC, such as intrastate investment advisers. Under the proposal, advisory services would include directly managing or advising government-run funds, or managing or advising a private investment pool. Government funds would include, among others, public pension funds, 529 plans, and 403(b) plans.

Two-Year "Time Out" for Contributors

The proposal would prohibit an adviser, or its covered associates, from providing advice for compensation to a government entity within two years after a contribution to an official of the government entity in a position to influence the selection of the adviser. [2] Despite an adviser's fiduciary obligations, the Release states that an adviser would not be required to provide uncompensated advice indefinitely if it triggered the prohibition. Rather, the adviser would need to continue to provide advice for only a reasonable period of time.

As proposed, the new rule would apply to political incumbents as well as candidates. [3] It would define contributions generally as any 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. [4] An adviser's covered associates would include its general partners, managing partners, managing members, executive officers, or other individuals with a similar status or function. In other words, the proposal would apply to all executive officers who, as part of their regular duties, perform investment advisory services or supervise someone who performs them. In addition, a covered associate would include any employee of the adviser who solicits government entity clients for the adviser and any political action committee ("PAC") controlled by the adviser or any of the adviser's covered associates.

The proposal would include a "look back" provision in which the two-year time out would continue in effect after the covered associate who made the triggering contribution left the advisory firm. Further, a contribution made by a covered associate of an adviser would be attributed to any other adviser that employees or engages the person who made the contribution within two years after the date the contribution was made.

The two-year time out provision would include two exceptions. First, it would include a *de minimis* exception allowing a covered associate to make contributions of up to $250 per election per candidate if the contributor is entitled to vote for the candidate. Second, it would include a limited exception for inadvertent contributions by a covered associate to officials other than those for whom the associate was entitled to vote at the time of the contribution and that do not exceed the $250 per election per candidate restriction. To claim this exception, the adviser must have discovered the contribution within four months of the date of such contribution and, within sixty days of discovery, must cause the contribution to be returned to the contributor. The exception would be available to an adviser only twice in a twelve-month period, and only once with respect to the same covered associate, regardless of the time period.

Ban on Using Third Parties to Solicit Government Business

The proposal would prohibit an adviser from paying a third party, such as a solicitor, finder, pension consultant, or placement agent, to obtain government clients. The prohibition would not cover third-party solicitations on behalf of an adviser by a person who is a related person of the adviser, [5] any of the related person's employees if the related person is a company, or any executive officer or partner of the adviser. These persons would instead trigger the proposed two-year time out provision. Although the proposal would broadly define "solicit" to capture communications for the purpose of obtaining or retaining a client or a contribution, the determination as to whether a particular communication constitutes a solicitation would depend on the facts and circumstances relating to the communication. [6]

If adopted as proposed, advisers registered or required to be registered with the SEC would no longer be able to rely on the cash solicitation rule to pay third-party solicitors to obtain *government* clients. [7] The proposal would add a new paragraph to the cash solicitation rule to reflect this proposed prohibition.

Restriction on Soliciting and Coordinating Contributions and Payments

The proposal would prohibit an adviser, its covered associates, or its PAC from soliciting, or coordinating, contributions on behalf of a covered elected official or payments to a political party of the state or locality where the adviser is providing or seeking to provide advisory services to the government. The proposal would prohibit bundling contributions or payments as well as coordinating contributions or payments through a third party, like a gatekeeper. A direct contribution to a political party by an adviser or its covered associates, however, would not trigger the proposed prohibition or the two-year time out provision, unless the contribution was earmarked or known to be provided for the benefit of a particular government official.

Indirect Contributions and Solicitations

The proposal would prohibit an adviser from doing indirectly what it would be prohibited

from doing directly, such as directing or funding contributions through third parties such as spouses, lawyers, or companies affiliated with the adviser.

Pooled Investment Vehicles

In contrast to the SEC's 1999 pay-to-play proposal, [8] covered investment pools subject to the proposal's prohibitions would include mutual funds, as well as hedge funds, private equity funds, and other collective investment pools. [9] Accordingly, an adviser would be subject to the proposed restrictions and prohibitions if it manages assets of a government fund through the fund's investment in a mutual fund managed by that adviser – i.e., an adviser would be treated as though it were providing or seeking to provide investment advisory services directly to the government entity.

The proposal includes some limited modifications and exceptions for advisers to mutual funds. In particular, the proposed two-year time out provision would apply to advisers to mutual funds only when the fund is included in a plan or program of a government entity, e.g., if a particular mutual fund is selected to be an investment option for participants in a 529 plan. The provision would not be applicable if a state government invested its pension fund assets in that same mutual fund. Thus, the proposed rule would prohibit the receipt of compensation from the mutual fund by the adviser, not the inclusion of the mutual fund in the 529 plan, and would prohibit the receipt of any advisory fee to which the adviser is entitled if it is also a direct adviser to the 529 plan. [10]

Exemptions

The proposal would include a provision under which an adviser could apply to the SEC for an order exempting it from the proposed two-year compensation ban. Applying a facts and circumstances analysis, the SEC would consider situations in which (1) an adviser discovers contributions that trigger the ban only after they have been made or when (2) imposition of the prohibitions is unnecessary to achieve the proposed rule's intended purpose.

Recordkeeping Requirements and Transition Period

The proposal would require an adviser that seeks government clients or provides advisory services to a covered investment pool in which a government entity invests, or is solicited to invest, to make and keep certain records of contributions. Such records would be 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. They would include:

- the names, titles, and business and residence addresses of all covered associates of the adviser;
- all government entities for which the adviser or any of its covered associates is providing or seeking to provide investment advisory services, or which are investors

or are solicited to invest in any covered investment pool to which the adviser provides investment advisory services, as applicable;
- all government entities to which the adviser has provided investment advisory services, along with any related covered investment pool(s) to which the adviser has provided investment advisory services and in which the government entity has invested, as applicable, in the past five years, but not prior to the effective date of the proposed rule; and
- all direct or indirect contributions or payments made by the adviser or any of its covered associates to an official of a government entity, a political party of a state or political subdivision thereof, or a PAC.

The prohibition and recordkeeping requirements would apply to contributions made on or after the effective date of the rule, if adopted. The Release seeks comment on whether an additional transition period would be necessary.

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endnotes

[1] See Securities and Exchange Commission Release No. IA-2910 (August 3, 2009), 74 FR 39839 (August 7, 2009) ("Release"), available at http://www.sec.gov/rules/proposed/2009/ia-2910.pdf.

[2] The proposal would not limit the adviser from receiving compensation from other government entities as to which triggering contributions have not been made.

[3] A candidate for federal office may be an official under the proposed rule because of the office he or she currently holds.

[4] The Release explains that volunteer campaign work by an individual would not be considered a contribution provided the adviser has not solicited the individual's efforts and the adviser's resources, such as office space, are not used.

[5] A related person would be any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control with the adviser.

[6] As proposed, solicit would mean: (1) 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 adviser; and (2) with respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.

[7] Advisers making payments to solicitors must comply with the cash solicitation rule, Rule 206(4)-3 under the Act. This rule makes it unlawful, except under specified circumstances and subject to certain conditions, for an adviser to make a cash payment to a person who directly or indirectly solicits any client for, or refers any client to, an adviser.

[8] See also Securities and Exchange Commission Release No. IA-1812 (August 4, 1999),

64 FR 43556 (August 10, 1999) and Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 2, 2000 (commenting on the SEC's 1999 proposal). The SEC is withdrawing its 1999 proposal.

[9] The Release explains that a bank maintaining a collective investment trust ("CIT") would not be subject to the proposal if the bank falls within the exclusion from the definition of investment adviser. In contrast, a person who falls within the definition, that provides advisory services with respect to a CIT in which a government entity invests, would be subject to the proposal.

[10] The Release seeks comment on how best to apply the compensation restriction to the different types of pooled investment vehicles. It suggests, for example, that an adviser of a mutual fund could waive its advisory fee for the fund as a whole in an amount approximately equal to fees attributable to the government entity.
