MEMO# 23831

September 30, 2009

ICI Draft Letter on SEC Pay-to-Play Restrictions for Investment Advisers; Comments Requested by October 5

[23831]

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TO: SEC RULES COMMITTEE No. 58-09
529 PLAN ADVISORY COMMITTEE No. 4-09
INVESTMENT ADVISERS COMMITTEE No. 5-09 RE: ICI DRAFT LETTER ON SEC PAY-TO-PLAY RESTRICTIONS FOR INVESTMENT ADVISERS; COMMENTS REQUESTED BY OCTOBER 5

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] Specifically, the proposal would: (1) impose a two-year "time out" on conducting compensated advisory business with a government client after a contribution is made; (2) prohibit advisers from paying third parties to solicit government entities for advisory business; (3) make it unlawful for an advisor to solicit or to coordinate contributions for a government official to which the adviser is seeking to provide advisory services 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; and (4) prohibit an adviser from doing anything indirectly which, if done directly, would violate the proposed rule. The Institute has prepared a draft comment letter on the proposed amendments, which is attached and briefly summarized below.

Pursue Policies and Procedures Regulation of Pay-to-Play Activity

The draft letter notes that the Institute supports the goal of prohibiting pay-to-play conduct. It states, however, that the Commission's proposal overreaches in many ways with respect to the potential conflict of interest political contributions may raise. The draft letter, therefore, recommends that the Commission amend the compliance rules, Rule 38a-1 under the Investment Company Act of 1940 and Rule 206 (4)-7 under the Investment Advisers Act of 1940, to require advisers and mutual funds to have written policies and procedures designed to prevent pay-to-play activity, with attendant recordkeeping requirements. In support of this recommendation, the letter details the comprehensive regulatory regime to which mutual funds are subject, including the specific requirements in Rule 38a-1. The letter notes that the Commission has been successful with imposing policies and procedures regulation to address conflicts of interest, including, for example, conflicts raised by personal trading by fund employees, and explains that a similar approach is appropriate in the case of pay-to-play activity.

In addition, the letter explains the various ways in which the Commission's extensive reliance on the MSRB's pay-to-play rules as the framework for the proposed rule is misplaced.

Modify and Clarify Provisions in the Proposed Rule

If the Commission determines that a policies and procedures approach is inadequate for mutual funds, the draft letter recommends a series of modifications and clarifications to the proposed rule. These include the following:

Two-Year Ban for Contributions

- Limit the applicability of the proposed rule to the award of investment advisory contracts for pension and other employee benefit plans and the advisory personnel involved in such business.
- Consider graduated sanctions for pay-to-play activity to more appropriately address the facts and circumstances of questionable conduct and better account for inadvertent contributions that would trigger the proposed ban.
- Provide additional clarity regarding the meaning of a "reasonable amount of time," with respect to the period an adviser would need to provide advice to an affected government client. The draft letter suggests that a timeframe of 30 days would be reasonable.
- Provide guidance with respect to pre-existing advisory agreements/contracts that states that the prohibition on receipt of compensation applies only to new business following a prohibited contribution.
- Provide a limited, conditional exception to the ban in the case of mergers, acquisitions, and other business combinations where a ban is triggered because a person who made a contribution becomes a covered associate of the new entity. Also,

exclude sub-advisory relationships from the scope of the proposed rule.

- Provide guidance on how to identify officials who would be in a qualifying "position of influence" to aid advisers in their compliance efforts.
- Narrow the term "executive officer" to include only those executive officers who directly oversee the performance or solicitation of government advisory services.
- Eliminate the "look back" provision in which the ban would continue in effect after a covered associate who made a prohibited contribution left the advisory firm. Alternatively, shorten the look back period to three months and allow advisers to rely on the representations and certifications of employees and applicants with respect to prior contributions.
- Raise the threshold of the de minimis exception to $1,000 and expand the applicability of the exception to officials to whom an individual is not entitled to vote.
- Expand the exception for returned contributions to encompass any inadvertent contribution, above the de minimis threshold, that is returned in the time and manner described in the proposal. In addition, eliminate the restriction on the number of times an adviser may rely on the exception for inadvertent contributions.

Eliminate or Modify the Ban on Using Third Parties to Solicit Government Business

- Narrow the proposed ban to advisers using third party solicitors who make contributions to government officials that the adviser would be prohibited from making directly. In addition, allow the adviser to determine how to enforce this prohibition and require the adviser to maintain records designed to demonstrate compliance with it.
- Expressly provide in the rule text or adopting release that any payments made in the normal course of business by a mutual fund's investment adviser to a broker-dealer or any other financial intermediary that distributes mutual fund shares would not be considered a "payment . . . to solicit a government entity" even if such broker-dealer or financial professional or firm maintains a government entity's account.

Provide Clarity with Respect to Soliciting and Coordinating Contributions and Payments

- Confirm that the prohibition would not be triggered by contributions to federal incumbents, federal level political parties, or separate segregated funds. Also confirm that an adviser is not "in control" of a PAC organized, operated, and run by the adviser's parent, even if advisory employees participate on or in the PAC.

Exemptions

- Provide a 30-day period by which the Commission must grant or deny exemptive requests, after which applications not acted upon are automatically granted.

Recordkeeping Requirements

- Apply the recordkeeping requirements prospectively and only to new accounts that are established after a period of time that would be sufficient to enable mutual funds to redesign their account application forms and systems to capture information regarding the “government entity” status of a shareholder.
- If the Commission determines not to limit the proposed requirements as recommended, outline how the Commission expects funds to conduct effective searches to discern their shareholders that are government entities or government officials acting in their official capacity.

Transition Period

- Adopt a transition period of at least 12 months to provide mutual fund advisers sufficient time to redesign their new account applications and their internal policies and procedures to capture the information that advisers would be required to maintain on government entities, government officials, and covered associates.
- Apply the rule prospectively only, so compliance is delayed until such time as funds can accomplish these tasks. In addition, the information on government entities required by Rule 204-2 should be applied only to those government entities that open an account after the fund has the ability to capture the accountholder’s status as a government entity.

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Attachment (in .pdf format)

endnotes

[1] See Memorandum to SEC Rules Committee No. 46-09, 529 Plan Advisory Committee No. 3-09, and Investment Advisers Committee No. 4-09 [23683], dated August 7, 2009.

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