



JULY 2010

## SEC Issues New Pay-To-Play Regulations on Investment Advisers

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On July 1, 2010, the SEC issued the first federal law in many years intended to crack down on "pay-to-play" practices. After extensive study and public comment, the SEC issued Rule 206(4)-5, titled "Political Contributions by Certain Investment Advisers," and related amendments under the Investment Advisers Act of 1940, "to significantly curtail the corrupting influence of 'pay-to-play' practices by investment advisers."<sup>1</sup> The new rule places substantial restrictions on investment advisers that work with and solicit investments from state and local investment officials who oversee public and governmental investment funds, such as U.S. pension fund assets, that today total more than \$2 trillion.

### BACKGROUND

The confluence of politics and money has made this area fertile ground for enforcement and regulation. In earlier official announcements, the SEC staked out this area as an enforcement priority and has brought several investigations and enforcement actions in New York, Connecticut, and elsewhere against investment advisers, consultants, and current and former politicians. Some notable cases were filed in conjunction with related criminal charges. In enforcement actions, the SEC has relied on existing general anti-fraud rules and the Municipal Securities Rulemaking Board's (MSRB) more specialized rules.

The SEC has also sought to expand its oversight of investment advisers with regulations that go beyond bringing select enforcement cases under existing federal securities laws. The SEC's proposal in August 2009 to prohibit political contributions by investment advisers and to ban payments from investment advisers to third parties or placement agents for soliciting business from government funds drew extensive comments from all quarters except plan beneficiaries, whom these regulations are intended to protect. The private equity sector strongly opposed the proposal, as did placement agents who thought it harmed law-abiding placement firms. Several public pension funds also counseled against it. In December 2009, the SEC backed away from part of the proposal and, in March 2010, the Financial Industry Regulatory Authority (FINRA) agreed to issue regulations concerning registered broker-dealers who act as placement agents.

FINRA, which is currently preparing its own guidelines for broker-dealers who act as placement agents, has stated that its rules will be "as rigorous and as expansive" as the SEC's. When the SEC issued its latest rule, the SEC Chairwoman also stated that the agency will keep a close eye on any continued improper influence by placement agents for government investment funds, and it may step in again and impose a complete ban if necessary. Investment advisers and their

counsel will thus have to monitor the developing regulatory landscape.

## OVERVIEW OF THE NEW PAY-TO-PLAY RULE AND ITS IMPACT

The rule is meant to address the concern that investment advisers are being selected to manage public and governmental investment funds based on political contributions and influence, as opposed to their investment services and merit. It applies to investment advisers registered with the SEC (regulated under the Investment Advisers Act) and to certain advisers exempt from registration because they have fewer than fifteen clients. The rule covers private equity firms and hedge funds and is similar to existing MSRB regulations that cover municipal securities dealers.

Among the key features of the new pay-to-play rule are the following:

- **Two-Year Timeout** : The rule subjects an investment adviser to a two-year ban from providing investment advisory services for compensation when, either directly or through a pooled investment vehicle, the adviser, or certain of its executives or employees (or an affiliated PAC), makes or directs a political contribution to an elected official or candidate who is in a position to influence the selection of that adviser. Indirect campaign contributions or "conduit" payments (such as those made by family members, lawyers, or a PAC) also trigger the two-year ban. There is a de minimis exception for individual contributions of \$350 or less made to candidates for whom the contributing person can vote or \$150 or less if the contributor cannot vote for the candidate. Both exceptions are per election, per candidate limits. There is also an exemption process whereby the adviser can apply to the SEC for an order exempting it from the ban if it is an inadvertent violation, such as when the adviser discovers a contribution only after it was made. It is expected that the SEC will infrequently grant these exemptions, on a case-by-case basis, when the situation warrants and when the adviser otherwise has in place the proper procedures to prevent violations of the rule.
- **Antibundling Prohibition**: The rule prevents an investment advisory firm and certain of its executives and employees from soliciting or coordinating campaign contributions from others (including an affiliated PAC), known as "bundling" or "arranging," for an elected official or candidate who is in a position to influence the selection of that adviser. It also prohibits solicitation and coordination of payments to political parties in the state or municipality where the adviser is seeking advisory business.
- **Third-Party Solicitor Ban**: The rule prohibits an adviser from paying or agreeing to pay, directly or indirectly, a third party, such as a solicitor or placement agent, to solicit a governmental or public client for advisory business on behalf of the investment adviser unless that third party is an SEC-registered investment adviser or broker-dealer, each subject to similar pay-to-play restrictions.
- **Record Keeping**: The rule requires the investment adviser to keep records of, and periodically disclose to the SEC, the contributions made by the firm, or covered employees or PACs.

The new rule is scheduled to go into effect on September 13, 2010, with investment advisers to be in compliance by March 14, 2011. This timing allows for a transition period and occurs after the 2010 election season for which contributions may have already been made or are in process. Compliance with the third-party solicitor ban and the provisions that apply to advisers to registered investment companies subject to the rule will be required one year after the effective date, by September 13, 2011, to permit FINRA time to issue its regulations that are under consideration.

## COMPLIANCE STEPS FOR THE NEW PAY-TO-PLAY RULE

Investment advisers may wish to consider implementing new or revising existing procedures to ensure compliance with the new rule, to prevent violations, and to avoid potential enforcement and litigation risk. Steps they might consider include the following:

1. Establishing written policies and procedures outlining the requirements of the new rule
2. Training covered employees, and legal and compliance staff, on the new rule

3. Identifying and evaluating the specific covered employees whose contributions could trigger the ban or violations (particularly for possible "look back" violations) and keeping that list updated
4. Identifying and requiring advance clearance of all covered employees' political contributions, and those of their family members and firm PACs, through the appropriate legal or compliance staff
5. Maintaining proper and complete records, and filing the required disclosures with the SEC to allow the adviser to show compliance with the rule and to permit the SEC to conduct routine examinations

Recently, Robinson & Cole's Business Litigation and Government Investigations Teams represented a consulting placement firm and its principal in one of the few prominent pay-to-play cases to go to trial. We are familiar with the SEC's strategies, as well as the risks and issues involved in these cases.

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1 17 C.F.R. § 275.206(4)-5.

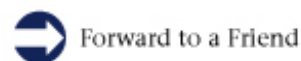
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To read the SEC Rule Release, please click <http://www.sec.gov/rules/final/2010/ia-3043.pdf>.

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