

New SEC Rule Prohibits Pay-to-Play Practices

July 14, 2010

In response to recent criminal and regulatory enforcement actions concerning alleged “pay-to-play” practices in the public pension fund arena, the U.S. Securities and Exchange Commission (the “SEC”) has approved a new rule (Rule 206(4)-5) promulgated under the Investment Advisers Act of 1940 (the “Advisers Act”). This new rule is intended to eliminate “pay-to-play” practices with respect to the management of governmental pension fund assets by leveling the playing field for awarding contracts to advisers of public pension funds and investment funds in which public pension funds invest. The SEC believes this rule will significantly curtail the corrupting influence of pay-to-play practices of investment advisers.

Advisers Subject to the Rule

Once effective, the rule will affect both investment advisers that are required to register with the SEC and investment advisers that rely upon the “private adviser” exemption that currently exempts from registration investment advisers that do not hold themselves out to the public as investment advisers and have fewer than 15 clients. (As discussed in a recent Dewey & LeBoeuf Client Alert (http://www.deweyleboeuf.com/~media/Files/clientalerts/2010/20100702_DoddFrankWallStreetReform.ashx), the “private adviser” exemption appears likely to be eliminated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, subject to a remaining exemption for venture capital funds and foreign private fund advisers.)

Prohibitions

The new rule imposes three key prohibitions:

Two-Year Time Out

Under Rule 206(4)-5, investment advisers and their “covered associates”¹ will be prohibited from providing advisory services “for compensation” (either directly or through a pooled investment vehicle) to a government entity for a period of two years after making a political contribution (with an exception for *de minimis* amounts) to an elected official of the government entity (including, among other things, public pension plans, directed plans

¹ “Covered associates” generally include the investment adviser’s general partners, managing members, executive officers and individuals with similar functions.

and other collective government funds) who is in a position to influence the selection of the adviser. The rule defines a contribution 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 payments for debts incurred in such election. The donation of time by an individual would not be considered a contribution, provided that the adviser has not solicited the individual's efforts and the adviser's resources are not used. If an investment adviser makes a contribution that triggers the two-year time out, it may not accept any compensation for advisory services provided to the relevant government entity during the time out.

Bundling

The new rule also prohibits any advisory firms and their covered associates from soliciting or coordinating campaign contributions for an elected official in a position to influence the selection of the adviser as well as soliciting or coordinating payments to political parties in the state or locality where the adviser is seeking business. These restrictions are intended to prohibit "bundling" a large number of small employee contributions to circumvent the rule's prohibitions.

Third-Party Fundraisers

Rule 206(4)-5 prohibits payments to third-party solicitors or placement agents to solicit a government client on behalf of an investment adviser, unless such third parties are registered investment advisers or registered broker-dealers subject to prohibitions on political contributions similar to Rule 206(4)-5. This prohibition does not apply to the personnel of the investment adviser, including employees, general partners, managing members or executive officers of investment advisers who are compensated to solicit government clients on behalf of the investment adviser. However, third parties, including entities affiliated with the investment adviser, may not solicit government clients unless they are subject to regulation comparable to the rule. *Accordingly, once this rule is effective, it no longer will be permissible for advisers to use unregistered finders or placement agents to solicit government clients.*

The prohibition on the use of unregistered solicitors is intended to eliminate a significant opportunity for abuse. In adopting the rule, the SEC noted that placement agents had played a significant role in the "pay-to-play" practices that prompted the SEC to adopt the rule. By limiting solicitation of government entities to registered entities and their personnel, the SEC hopes to deter and prevent misconduct by subjecting

solicitors to the same consequences as advisers for political contributions, bringing the solicitors' activities squarely within the supervisory responsibilities of a registered entity and facilitating regulatory oversight of the activity by the SEC and the Financial Industry Regulatory Authority ("FINRA").

FINRA does not currently have a rule imposing prohibitions comparable to Rule 206(4)-5. The Adopting Release for Rule 206(4)-5 indicates, however, that FINRA is in the process of proposing such a rule, and the effective date of the third-party solicitor provisions of Rule 206(4)-5 was set so as to provide sufficient time for the completion of the FINRA rulemaking before the ban on the use of unregistered solicitors goes into effect.

Recordkeeping

The SEC is also adopting rule amendments that will require registered investment advisers that have government clients or provide investment advisory services to pooled investment vehicles in which a government entity investor invests to maintain certain records of political contributions made by the adviser or certain of its executives and employees and will allow the SEC to examine such records to ensure compliance with Rule 206(4)-5.

Effective and Compliance Dates

Rule 206(4)-5 will become effective sixty days after it is published in the Federal Register. Investment advisers subject to the rule are generally required to be in compliance within six months of the rule's effective date and may no longer use third parties to solicit government business unless in compliance with Rule 206(4)-5 within one year of the rule's effective date.

Observations

Rule 206(4)-5 was adopted under a provision of the Advisers Act permitting the SEC to adopt rules reasonably designed to prevent violations. Wrongful intent or an improper *quid pro quo* is not needed for a political contribution to violate this rule. Accordingly, the rule is significantly broader than existing civil and criminal prohibitions on bribery of public officials.

The breadth of the prohibition under the rule raises a question as to whether the prohibitions on political contributions under the rule improperly restrict the First Amendment rights of advisers and their personnel to free

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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speech and free association. The SEC addressed these issues in the Adopting Release and concluded that the rule would survive challenge on these grounds. However, it remains to be seen whether the rule is challenged on this ground and, if so, how the courts resolve this question.

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