

E-ALERT | Election Law and Private Equity

July 2, 2010

SEC UNANIMOUSLY ADOPTS PAY-TO-PLAY RULE

The Securities and Exchange Commission (“SEC”) yesterday released the final text of a new rule under the Investment Advisers Act of 1940 (the “Advisers Act”) aimed at preventing pay-to-play practices by investment advisers. The SEC had unanimously voted to approve the new rule on Wednesday. Drawing significantly from the Municipal Securities Rulemaking Board’s Rules G-37 and G-38 and the SEC’s own August 2009 pay-to-play rule proposal, new Rule 206-4(5) under the Advisers Act contains three key pay-to-play prohibitions:

- a two-year prohibition on an investment adviser’s providing compensated services to a government entity following a political contribution to certain officials of that entity;
- a prohibition on “bundling” and other efforts by investment advisers to solicit political contributions to certain officials of a government entity to which the investment adviser is seeking to provide services; and
- a prohibition on the use of third-party solicitors who are not regulated persons subject to pay-to-play restrictions.

The following is a brief summary of the new rule, which will not take effect until 60 days after it is published in the Federal Register. In general, compliance will be required within six months after the effective date. Compliance with the third-party solicitor prohibitions described below will be required within one year after the effective date. This gradual phase in of the rule is intended to give firms a relatively generous period of time within which to adopt appropriate compliance policies, and to ensure that the new rule will not effect contributions made during the 2010 election, as to which some individuals may already have made commitments.

I. TWO-YEAR “TIME-OUT”

As in the August 2009 proposal, the centerpiece of Rule 206-4(5) is a two-year “time-out” from providing investment advisory services (either directly or through a pooled investment vehicle) to a state or local government entity following a political contribution made to certain officials of such entities (or candidates for certain offices) by an investment adviser or any of its “covered associates.” Notably, the universe of officials for whom this prohibition is applicable is limited to those in a position to directly or indirectly influence the selection of the investment adviser. The SEC rejected requests to define more precisely which state and local officials are covered by the rule, and instead opted to rely on state and local laws defining the authority of such officials’ offices (the same approach adopted by the MSRB under its Rule G-37).

The final rule does depart somewhat from the August 2009 proposal with respect to who counts as a “covered associate” of an investment adviser. Covered associates include any general partner, managing partner, or “executive officer,” or other individuals with a similar status or function; any employee who solicits government business or supervises someone who does; and any PAC “controlled by” the investment adviser or one of its covered associates. The final rule clarifies that “executive officer” includes the president, vice presidents in charge of principal business units,

divisions, or functions, as well as “any other officer of the investment adviser who performs a policy-making function.” This modification was intended to exclude persons with significant sounding titles who nonetheless do not play a policy making role. The final rule also expands the definition of “covered associate” to include *all* employees who solicit a government entity for the investment adviser and *any* person who supervises such employees. Significantly, the SEC made clear that “covered associates” could in fact include employees of an investment adviser’s parent company. The SEC cited by analogy a recent report in the G-37 context, in which the SEC determined that the G-37 pay-to-play bar extended to an employee of a parent company, where that employee supervised the activities of a municipal securities dealer. This issue will merit close attention as firms develop their new pay-to-play compliance programs.

There is a two-year “look back” period for contributions made by employees who become covered associates and who are engaged in soliciting business from government entities, but in contrast to the August 2009 proposal, the look back period is only six months for employees who become covered associates but who do not solicit such business.

In addition, there are certain exceptions to the prohibition on contributions. Contributions of \$350 or less per election per candidate are excepted as *de minimis* if the contributor is entitled to vote for the applicable official or candidate. Contributions of \$150 or less per election per candidate also will not trigger the prohibition, even if the contributor is not entitled to vote for the candidate or official. In addition, the rule provides the SEC with broad authority to exempt investment advisers from the two-year time-out in other appropriate circumstances. The SEC emphasizes that a key factor in determining whether to exempt a firm in circumstances in which a violation occurs will be whether the firm has adopted and implemented an adequate pay-to-play compliance program.

II. BUNDLING PROHIBITION

Rule 206-4(5) also prohibits investment advisers and certain of their executives and employees from “bundling” – or soliciting or coordinating campaign contributions for a covered official from individuals or political action committees. Again, the applicable covered official must be in a position to influence the selection of the investment adviser. This prohibition would also cover the solicitation and coordination of payments to political parties of the state or locality where the investment adviser is seeking to provide advisory services to the government.

III. LIMITED BAN ON THIRD-PARTY SOLICITORS

In a significant departure from the August 2009 proposal, Rule 206-4(5) does *not* impose an outright ban on the use of third-party solicitors to procure government clients. Instead, the rule takes the more limited step of prohibiting an investment adviser from paying third-party solicitors or placement agents who are not “regulated persons” (i.e., registered investment advisers or broker-dealers) subject to similarly stringent pay-to-play prohibitions against making contributions. This more limited measure was prompted by the considerable number of comments received by the SEC opposing the outright ban as potentially harming smaller and less established investment advisers who rely on such solicitors to support their businesses. In support of Rule 206-4(5), the Financial Industry Regulatory Authority apparently has committed itself to craft pay-to-play rules applicable to broker-dealers at least as rigorous as those imposed by the SEC with respect to investment advisers. As noted above, the SEC has delayed the application of this part of the rule for one year, in part to permit FINRA to develop such rules.

IV. OTHER NOTABLE ITEMS

- *Scope of the Rule.* Rule 206-4(5) applies to registered investment advisers, as well as those taking advantage of the private adviser exemption. In addition, it also applies to investment advisers who manage the assets of a government entity through a pooled investment vehicle, such as a hedge fund.
 - *Catch-all Provision.* Rule 206-4(5) prohibits acts done indirectly which, if done directly, would result in a violation of the rule (e.g., funneling contributions through an investment adviser's attorneys, spouses or affiliated companies to avoid the two-year time-out).
 - *Related Amendments.* Rule 206-4(5) amends the recordkeeping and cash solicitation rules under the Advisers Act to reflect the new focus on pay-to-play activities.
-

If you have any questions concerning the material discussed in this client alert, please contact the following Covington attorneys:

Timothy Clark	212-841-1089	tclark@cov.com
Robert Kelner	202.662.5503	rkelner@cov.com
Brandon Gay	202.662.5808	bgay@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.

© 2010 Covington & Burling LLP, 1201 Pennsylvania Avenue, NW, Washington, DC 20004-2401. All rights reserved.