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SUMMARY OF THE SEC'S PAY-TO-PLAY RULE 206(4)-5

In general, "pay-to-play" refers to various arrangements by which investment advisers may seek to influence the award of advisory business by making or soliciting political contributions to the government officials charged with awarding such business. In response to a perceived spike in pay-to-play activity, the Securities and Exchange Commission (the "SEC") proposed and adopted, under the Investment Advisers Act of 1940 (the "Advisers Act"), Rule 206(4)-5 -- a prophylactic pay-to-play rule.[1] The SEC largely modeled Rule 206(4)-5 on the Municipal Securities Rulemaking Board's existing pay-to-play rules -- Rules G-37 and G-38. In general, Rule 206(4)-5 contains three key prohibitions:

- a two-year prohibition on an adviser's providing compensated services to a government entity following a political contribution to certain officials of that entity;
- a prohibition on the use of third-party solicitors who are not themselves "regulated persons" subject to pay-to-play restrictions on political contributions; and
- a prohibition on "bundling" and other efforts by advisers to solicit political contributions to certain officials of a government entity to which the adviser is seeking to provide services.[2]

The following is a discussion of Rule 206(4)-5, including these and other key elements of the rule.[3]

SCOPE OF RULE 206(4)-5

Rule 206(4)-5 applies to all advisers that are registered (or required to be registered) with the SEC, and those that are unregistered due to their reliance on the "private adviser exemption" provided by Section 203(b)(3) of the Advisers Act (i.e., for advisers with fewer than 15 clients during the last 12 months). Notably, however, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Obama signed into law on July 22, 2010, eliminates the Section 203(b)(3) exemption and replaces it with certain more limited exemptions for advisers, including an exemption for advisers that only advise private funds and have less than $150 million in assets under management and an exemption for venture capital fund managers.[4]

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[1] The SEC proposed Rule 206(4)-5 on August 3, 2009. After receiving numerous comments from industry participants, the SEC unanimously adopted a revised version of Rule 206(4)-5 on June 30, 2010.
[2] It is important to note that Rule 206(4)-5 does not preempt existing state and local pay-to-play rules. While there may be, in some cases, some degree of overlap between these rules and Rule 206(4)-5, state and local pay-to-play rules are often different from or more restrictive than the federal rule. As such, it is important that advisers continue to consider the full panoply of applicable rules imposing pay-to-play restrictions on their advisory activities.
[3] This document does not discuss a technical amendment to Rule 206(4)-3 under the Advisers Act (i.e., the "cash solicitation rule") effected by Rule 206(4)-5.
[4] Likely, the SEC will engage in rulemaking or other regulatory action to address this discrepancy caused by the Dodd-Frank bill.

TWO-YEAR "TIME-OUT"

General

The cornerstone of Rule 206(4)-5 is a two-year "time-out" from providing compensated advisory services following certain triggering contributions. Specifically, Rule 206(4)-5 prohibits advisers from receiving any compensation for providing investment advice to a "government entity" within two years after a contribution has been made by the adviser or one of its covered associates.[5] This two-year time-out applies regardless of whether the adviser is actually aware of the triggering contribution.

Prohibition on Providing Compensated Advisory Services

The rule requires a time-out during which an adviser cannot be compensated for advisory services provided to a government client. In accordance with its fiduciary duties to its government clients, an adviser that makes a triggering contribution may be obligated to continue to provide uncompensated advisory services for a reasonable period of time during the time-out to allow the government client to obtain replacement services. In considering whether the length of such transition period is reasonable, an adviser should primarily consider (i) any applicable law governing the process (including any state or local laws restricting government entities from receiving uncompensated services), (ii) the particular client's process for engaging advisers and (iii) the types of assets managed.

Applicable Government Officials

For purposes of the rule, an "official" includes an incumbent, candidate or successful candidate for office if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an adviser or has the authority to appoint such a person. The rule does not specify particular types of officials who could influence the hiring of an adviser. Instead, the scope of authority attendant to a particular office determines whether such official can ultimately influence the hiring decision. This remains true even with respect to officials who are candidates for federal office, provided that such official maintains influence over hiring decisions as a function of his or her current office.[6]

Applicable Contributions

The rule broadly defines "contributions" to include a gift, subscription, loan, advance, deposit of money or anything of value made for the purpose of influencing a federal, state or local election, including payments of campaign debts and transition or inaugural expenses incurred by successful candidates for state or local (but not federal) office. Such definition would not include (i) an individual's donated time (if the adviser does not solicit such person's efforts or provide the use of its resources) and (ii) charitable donations made at the request of a government entity. Importantly, contributions to political parties or political action committees ("PACs") do not directly implicate the rule's prohibitions on contributions if the contributions are not attributable to a particular

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[5] The term "government entity" includes all state and local governments, agencies and instrumentalities and government-sponsored plans, including public pension plans, 403(b), 457 and 529 plans.
[6] Here, contributions to either of the official's current office or federal election campaign would trigger application of the rule.

candidate.[7] Accordingly, advisers should discuss with a political party or PAC seeking a contribution the eventual use of any such contribution to ensure compliance with the rule.

Covered Associates

A "covered associate" includes (i) any partner, managing member or executive officer or individual with a similar status or function, (ii) any employee who solicits a government entity for the adviser (and any person who directly or indirectly supervises such employee) and (iii) any PAC controlled by the adviser or a covered associate.[8] A person's activities and not his or her title will ultimately determine whether he or she is a covered associate. For example, an "executive officer," under the rule, not only includes the president and vice-president in charge of a principal business unit, division or function, but also any other officer or person who performs a policy-making function.

Look Back (and Look Forward)

Rule 206(4)-5 contains a "look back" provision under which advisers must look back in time to determine whether a covered associate has made a triggering contribution.[9] Pursuant to the look back provision, contributions made by a covered associate will be attributed to an adviser if those contributions were made within (i) two years prior to the date the individual became a covered associate, in the case of covered associates who solicit clients for the adviser or (ii) six months prior to the date the individual became a covered associate, in the case of covered associates who do not solicit clients for the adviser. Importantly, the look back applies even in the context of a merger with or acquisition of an adviser. **As such, advisers should conduct due diligence of all relevant contribution activity of a target and its covered associates prior to effecting a merger or acquisition.**

De Minimis Contribution Exceptions

Rule 206(4)-5 contains certain exceptions to the two-year time-out for *de minimis* contributions.[10] First, there is an exception for contributions of $350 or less per election, per covered associate for any election in which that covered associate is entitled to vote. For purposes of this exception, a covered associate is "entitled to vote" for a person if such covered associate's primary residence is located in the area in which the official is running (e.g., an official who resides in Maryland can make *de minimis* contributions to a candidate for the Maryland state governor and applicable local officials). However, any U.S. resident covered associate can make a *de minimis* contribution to an official seeking the U.S. Presidency. Second, the rule permits *de minimis* contributions of $150 or less per election, per covered associate for any election in which the covered associate is not entitled to vote. With respect to both exceptions, a covered associate can contribute separately up to the full amount in both the primary and general elections without triggering the time-out.

Inadvertent Contribution Cure

Additionally, the rule contains a limited cure provision for certain "inadvertent" contributions. An adviser can automatically cure a contribution that does not exceed $350 per official, per election if the adviser (i) discovers the contribution within four months of the date of the contribution and (ii)

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[7] However, such contributions may implicate Rule 206(4)-5's catch-all provision (described below).

[8] Whether a particular communication is a "solicitation" is dependent on the surrounding facts and circumstances. In general, a solicitation would be a communication reasonably calculated to obtain the advisory client.

[9] Similarly, advisers must look forward with respect to the contributions of former covered associates, regardless of whether such individual remains employed by or affiliated with the adviser.

[10] Under the proposed rule, there would have been only one *de minimis* contribution exception of $250 per election, per covered associate for any election in which that covered associate was entitled to vote.

facilitates the return of the triggering contribution within 60 days of learning about it. The cure is "automatic" because an adviser need not notify the SEC in order to take advantage of it. Advisers have a limited number of opportunities to make use of this cure provision within a given time period. Advisers that have reported more than 50 employees in response to Item 5.A. on their most recent Form ADV can use this cure three times in a 12-month period, while smaller advisers can only use it two times within the same period.

Discretionary Exemption Process

Pursuant to Rule 206(4)-5 advisers may also apply for orders exempting themselves from the two-year time-out under circumstances in which application of the rule likely would not truly support the rule's intended purpose (e.g., when a disgruntled employee makes a contribution greater than $350 as he or she exits an advisory firm). Factors considered by the SEC in connection with an exemptive request include:

- whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Advisers Act;
- whether the adviser (a) before the triggering contribution was made, adopted and implemented policies and procedures reasonably designed to prevent violations of Rule 206(4)-5; (b) before or at the time the triggering contribution was made, had no actual knowledge of the contribution; and (c) after learning of the contribution, (1) has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution; and (2) has taken such other remedial or preventive measures as may be appropriate under the circumstances;
- whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the adviser, or was seeking such employment;
- the timing and amount of the contribution which resulted in the prohibition;
- the nature of the election (e.g., federal, state or local); and
- the contributor's apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.

BAN ON THIRD-PARTY SOLICITORS

Unlike the proposed rule, Rule 206(4)-5 does not contain an outright ban on an adviser's use of third-party solicitors to obtain government clients. In response to numerous comments objecting to such a ban, the SEC instead opted to impose a more limited restriction on such solicitation activities. Under the final rule, an adviser or its covered associate cannot provide (or agree to provide) direct or indirect payment (i.e., a gift, subscription, loan, advance, monetary deposit or anything else of value, including, in some cases, certain *quid pro quo* arrangements) to a third party solicitor of government clients, unless such solicitor is a "regulated person" subject to similarly restrictive pay-to-play restrictions.

More specifically, such permitted "regulated person" solicitors include the following:

- an SEC-registered broker-dealer that is also a member of a national securities association (the definition of which, currently, only includes the Financial Industry Regulatory Authority, "FINRA"), subject to the rules of the association (i) prohibiting its members from engaging in distribution or solicitation activities if certain contributions have been made and (ii) which rules the SEC has

found to be "substantially equivalent or more stringent" then those restrictions contained within Rule 206(4)-5;[11] and

- an SEC-registered adviser that has not, and whose covered associates have not, within two years of soliciting a government entity, made a contribution to an official of that entity, other than a *de minimis* contribution, or coordinated or solicited any political contribution.

BUNDLING PROHIBITION

Rule 206(4)-5 bars advisers and covered associates from "bundling" -- i.e., soliciting from a person or PAC contributions to officials of governmental entities to which the adviser seeks to provide investment advisory services. In addition, such advisers and covered associates may not solicit any payment (not simply payments deemed contributions) to a political party in a state or municipality where the adviser seeks to provide investment advisory services to a government entity. This latter prohibition does not directly implicate an advisers' ability to make a direct contribution to a political party, provided that the payment is not directly attributable to any particular official. An adviser is "seeking to provide advisory services" when (i) it responds to a request for proposal, (ii) communicates with a government entity regarding the formal selection process or (iii) engages in some other solicitation of business.

CATCH-ALL PROVISION

The rule contains a "catch-all" provision, which prohibits an adviser or a covered associate from doing indirectly what it may not do directly in accordance with the rule. For example, an adviser could not funnel its contributions through another party, such as a lawyer, spouse or family member. Further, the catch-all would cover contributions made to a third-party with the expectation that the third-party would make a contribution to the applicable government entity.

APPLICABILITY TO POOLED INVESTMENT VEHICLES

Rule 206(4)-5 also applies to advisers (and sub-advisers) that advise a "covered investment pool" in which a government entity invests. Generally, this affects (i) the investment of public funds in unregistered investment companies, such as hedge funds, private equity funds and venture capital funds and (ii) pooled investment vehicles sponsored or advised by an adviser as a funding vehicle or option within a participant-directed plan or program of a government entity (e.g., 529, 403(b) and 457 plans). Importantly, an adviser to a registered investment company is subject to the pay-to-play prohibitions set forth in Rule 206(4)-5 *only if* the registered investment company is an investment option of a plan or program of a government entity that is participant-directed.

Subject to the structural and legal particularities of the subject investment pool, an adviser may have limited options available to comply with the rule's prohibitions. For instance, in the Rule 206(4)-5 adopting release, the SEC mentioned only two viable options for an adviser to a registered investment company subject to the two-year time-out period: (i) the adviser can waive the advisory fee for the fund as a whole, in an amount approximately equal to the fees attributable to the government entity or (ii) the government entity can pay its portion of the advisory fee, and the adviser can rebate that amount to the fund as a whole.

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[11] As of the date of this summary, FINRA has yet to establish such rules for broker-dealers, but has committed to do so. As described below, this aspect of Rule 206(4)-5 is not effective until September 13, 2011 to provide an opportunity for FINRA to propose and the SEC to approve by final order appropriate pay-to-play rules.

RECORDKEEPING REQUIREMENTS

In connection with 206(4)-5, registered advisers are subject to enhanced recordkeeping requirements under Rule 204-2 of the Advisers Act. A registered adviser that provides advisory services to a government entity or covered entity in which a government entity invests must keep records related to contributions made by the adviser and its covered associates to officials and candidates and of payments to state or local political parties or PACs. Such records of contributions and payments must be listed in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment and whether a contribution was subject to Rule 206(4)-5's cure for inadvertent contributions.

Additionally, an adviser that has government clients must make and keep a list of its covered associates and the government entities to which the adviser has provided advisory services in the past five years. Here, the adviser must include the names, titles, and business and residence addresses of all covered associates.

Advisers to covered investment pools must make and keep a list of government entities that invest, or have invested in the past five years, in a covered investment pool, including any government entity that selects a covered investment pool to be an option of a plan or program of a government entity. Here, the rule does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but *only* the government entity.

Finally, advisers (regardless of whether they currently have government clients) must keep a list of the names and business addresses of each "regulated person" to which the adviser agrees to provide direct or indirect payment to solicit a government entity.

EFFECTIVENESS AND COMPLIANCE DATES

Rule 206(4)-5 formally goes into effect on September 13, 2010. Advisers subject to Rule 206(4)-5 must comply with the rule on March 14, 2011 and contributions made before that point would *not* trigger the two-year time-out. On this same date (and subject to the exception noted below), advisers also must comply with the enhanced recordkeeping requirements. Advisers must comply with the rule's provisions with respect to third-party solicitors as of September 13, 2011. Payments to third-party solicitors made before this date are *not* covered by the rule. As of this same date, advisers to registered investment companies that are covered investment pools must comply with the enhanced recordkeeping requirements.

ADVISER POLICIES AND PROCEDURES

In connection with Rule 206(4)-5, advisers should review and, where appropriate, revise their compliance policies, procedures and codes of ethics. In particular, advisers should consider implementing one or more of the following revisions to such policies, procedures and codes of ethics:

- Consider existing disclosure policies and procedures with respect to newly-hired or promoted employees. In particular, advisers should consider requiring such individuals to submit initial and periodic contribution reports in connection with relevant political contributions.
- Institute pre-clearance requirements for contribution activity by covered associates.

- Create a process through which to (i) otherwise monitor contribution activity by checking the list of covered associates against public lists of contributors and (ii) quickly correct or return such contributions.
- Implement policies with respect to providing uncompensated services during a time-out period.
- Revise procedures for contracting with placement agents and other solicitors (and the forms of agreements governing such relationships) to reflect the rule's prohibitions with respect to third-party solicitors.
- Implement appropriate training programs for covered associates (and other employees) regarding compliance with the rule.

If you have any questions concerning the material discussed herein, please contact the following members of our firm:

Tim Clark	212.841.1089	tclark@cov.com
Robert Kelner	202.662.5503	rkelner@cov.com
Brandon Gay	202.662.5808	bgay@cov.com

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