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SEC Adopts Pay to Play Rule for Investment Advisers

On June 30, 2010, the Securities and Exchange Commission adopted new Rule 206(4)-5 (the "Pay to Play Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). Release No. IA-3043, Political Contributions by Certain Investment Advisers, available at http://www.sec.gov/rules/final.shtml. The Pay to Play Rule prohibits certain "pay to play practices" of investment advisers. Pay to play is the practice of making campaign contributions and related payments to elected officials in order to influence the awarding of lucrative contracts for the management of public pension plan assets and similar government investment accounts.

We reported in August 2009 on the SEC's proposal of the Pay to Play Rule, including its complete ban on the use of third-party solicitors or placement agents. The proposed ban met with significant negative comment and has been limited in the Pay to Play Rule as adopted to permit the use of SEC-registered investment advisers or broker-dealers who are subject to similar pay to play restrictions.

The Pay to Play Rule includes prohibitions intended to capture not only direct political contributions by investment advisers, but also other ways that advisers may engage in pay to play arrangements.

Applicability

Consistent with the proposed rule, the Pay to Play Rule applies to any investment adviser required to be registered with the SEC and to those who are exempt from registration under Section 203(b)(3) of the Advisers Act, which exempts investment advisers who neither hold themselves out to the public as investment advisers nor advise a registered investment company and who have had fewer than 15 clients during the course of the past 12 months.

The Pay to Play Rule also applies to investment advisers that manage assets of a government entity through a hedge fund or other type of pooled investment vehicle, which the Pay to Play Rule refers to as "covered investment pools." Registered investment companies are also included but only if they are an investment option of a plan or program of a government entity that is participant-directed. This brings within the scope of the Pay to Play Rule two common types of arrangements: 1) the investment of public funds in a hedge fund or other type of pooled investment vehicle; and 2) the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a "529" plan.

The Pay to Play Rule does not apply to state-registered investment advisers or to advisers that are unregistered in reliance on any exemption other than the exemption in Section 203(b)(3) described above.

Key Provisions

The Pay to Play Rule has three key elements:

- It prohibits an investment adviser from providing advisory services for compensation — either directly or through a pooled investment vehicle — for two years, if the adviser or certain of its executives or employees make a political contribution to an elected official who is in a position to influence the selection of the adviser. There are di minimus exceptions for 1) contributions of up to $350, per election, by an individual covered associate to an elected official or candidate for whom the individual is entitled to vote, and up to $150, per election, to an elected official or candidate for whom the individual is not entitled to vote; and 2) inadvertent political contributions made by a covered associate to an official for whom that covered associate is not entitled to vote. The inadvertent contributions must not exceed, in the aggregate, $350 to any one official per election, must be discovered within four months of the date of the contribution, and must be returned within 60 days after discovery of the contribution.
- It prohibits an advisory firm and certain executives and employees from soliciting or coordinating campaign contributions from others — a practice referred to as "bundling" — for an elected official who is in a position to influence the selection of the adviser. It also prohibits solicitation and coordination of payments to political parties in the state or locality where the adviser is seeking business.
- It prohibits an adviser from paying a third party, such as a solicitor or placement agent, to solicit a government client on behalf of the investment adviser, unless that third party is an SEC-registered investment adviser or a broker-dealer subject to similar pay to play restrictions.

There is a catch-all provision that prohibits the making of contributions through a spouse or an affiliate.

Recordkeeping Requirements

The SEC also amended Rule 204-2 of the Advisers Act to include new recordkeeping requirements in connection with the Pay to Play Rule. Registered investment advisers who provide advisory services to government entities or to covered investment pools in which a government entity invests must maintain records that document contributions made by its covered associates including a list of all of its advisory clients that are government entities (including any government entities that invest in a pooled fund managed by the investment adviser). Registered investment advisers that solicit government entities on behalf of other investment advisers are also subject to these recordkeeping requirements.

Effective Date

The Rule becomes effective 60 days after its publication in the Federal Register. Compliance with the Rule's provisions generally will be required within six months of the effective date. Compliance with the third-party ban and those provisions applicable to advisers to registered investment companies subject to the Rule is deferred for one year after the effective date to allow those advisers time to modify their systems and processes to monitor relevant activities.

For more information, please feel free to contact your Butzel attorney, the authors listed below or other attorneys of the Investment Management Practice Group.

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