# SEC Proposes New Rule Under the Investment Advisers Act of 1940 to Curtail "Pay to Play" Practices

On August 3, 2009, the Securities and Exchange Commission ("SEC") released a proposed new rule under the Investment Advisers Act of 1940 ("Advisers Act") that would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates.[1] The SEC also released proposed amendments under the Advisers Act that would require investment advisers with government clients to keep records of contributions made by the adviser or certain of its executives or employees to certain elected officials or candidates.

## I. Background

Section 206(4) of the Advisers Act grants the SEC the authority to adopt rules reasonably designed to prevent fraudulent business practices.[2] Congress gave the SEC the authority to prohibit "specific evils" that the broad anti-fraud provisions may be incapable of covering.[3] In the SEC's view, this provision allows the SEC to enact prophylactic rules that prohibit acts that are not themselves fraudulent.[4]

## II. New Rule 206(4)-5

The proposals relate to investment advisers who manage, or seek to manage, plan assets which fund state and local governments' pension plans, retirement plans, college investment plans and similar government-related funding vehicles. The SEC is concerned that the fairness of the selection process of investment advisers to such plans is being undermined. The new rule is designed to prevent an adviser from making political contributions or hidden payments to influence the adviser's selection by government officials.

**Political Contributions**

Under the proposed rule, an investment adviser who makes a contribution to an elected official in a position to influence the selection of the adviser would be barred for two years from providing advisory services for compensation, either directly or through certain funds.[5] The rule would apply to a registered investment

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1 "Political Contributions by Certain Investment Advisers" Release No. IA-2910; File No. S7-18-09 (Aug. 3, 2009) (the "Release"), available at http://www.sec.gov/rules/proposed/2009/ia-2910.pdf.

2 15 U.S.C. 80b-6(4)

3 S. REP. No. 1760, 86th Cong., 2d Sess. 4, 8 (1960)

4 Release at 17. The issue of the SEC's power to adopt prophylactic rules without specifically identifying the conduct that would be fraudulent under a particular rule has been litigated before in the context of Section 14(e) of the Securities Exchange Act of 1934 which contains a provision nearly identical to Section 206(4). *See United States* v. *O'Hagan*, 521 U.S. 642, at 667, 673 (1997) (interpreting Section 14(e) as providing the SEC with the authority to adopt rules that are "definitional and prophylactic" and that may prohibit acts that are "not themselves fraudulent . . . if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'"). The SEC's authority to adopt these types of prophylactic rules may be litigated again.

5 Proposed rule 206(4)-5(a)(1) states:

> "As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the [Advisers] Act, it shall be unlawful: (1) for any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance

adviser, an investment adviser required to be registered and to an investment adviser exempt from registration under Section 203(b)(3) of the Advisers Act.[6]

The rule would apply to any adviser to a "covered investment pool" -- a term defined to include registered investment companies and companies which would be required to register under the Investment Company Act but for the exemptions from registration provided by Section 3(c)(1), 3(c)(7) or 3(c)(11) thereof.[7] In the case of an adviser to a publicly offered registered investment company, however, the two-year ban would only apply when the shares of the investment company were an investment or investment option of a plan or program of a government entity.[8]

The rule would apply to the investment adviser as well as "covered associates." The term covered associates includes the investment adviser's general partners, managing members, executive officers, or other individuals with a similar status or function.[9]

The rule would apply to contributions made to or solicited by political incumbents, candidates or successful candidates for elective office of a governmental entity if the individual is directly or indirectly responsible for, or can influence, the selection of an investment adviser, or has the authority to appoint an individual with such responsibility or influence.

Under the proposed rule, the two-year ban would continue in effect after the executive or employee who made the contribution has left the advisory firm. In addition, the contribution would be attributed to any other adviser that employs or engages the person who made the contribution within two years after the date of the contribution. An investment adviser therefore would be required to "look back" to determine whether it would be subject to any business restrictions when deciding to employ or engage an employee.

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on the exemption available under section 203(b)(3) of the Advisers Act, to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made)." [citations omitted]

6 Section 203(b)(3) is proposed to be amended and the exemption provided thereby narrowed considerably. See our Firm Memorandum "Obama Administration Proposes The 'Private Fund Investment Advisers Registration Act of 2009'" (July 23, 2009).

7 Section 3(c)(1) exempts from Investment Company Act registration a company having 100 or fewer security holders and which is not making and does not propose to make a public offering of its securities, Section 3(c)(7) exempts a company whose securities are owned at the time of acquisition solely by "qualified purchasers" (as defined) and which is not making and does not propose to make a public offering of its securities and Section 3(c)(11) exempts, among other things, collective trust funds maintained by a bank and consisting of assets of government plans.

8 Proposed rule 206(4)-5(c), (f)(3). The SEC defines a "plan or program of a government entity" in the proposed rule as any investment program or plan sponsored or established by a government entity, including, but not limited to, a "qualified tuition plan," such as a 529 plan, a retirement plan, such as a 403(b) plan or 457 plan, or any similar program or plan. Proposed rule 206(4)-5(f)(8).

9 Proposed rule 206(4)-5(f)(2)(i). The term "executive officer" includes the investment adviser's president and any vice president in charge of a principal business unit, division or function or any other executive officer who (i) performs or supervises someone who performs advisory services, (ii) solicits or supervises someone who solicits for an investment adviser or (iii) supervises an officer described in (i) and (ii) above. Thus, proposed Rule 206(4)-5 would not cover executives such as the firm's head of human resources, its comptroller, or its information technology manager.

In the SEC's view, the proposed rule does not implicate the First Amendment because the category of persons whose contributions would be covered is sufficiently narrow and there is a self-executing exception for inadvertent contributions as discussed *infra*. This issue has been litigated before and may be become the subject of litigation again.[10]

**Third-Party Solicitors**

The proposed rule would prohibit an adviser and certain of its executives and employees from paying third parties, such as a solicitor or placement agent, to solicit government entities on behalf of the investment adviser.[11]

**Solicitation of Contributions**

The proposed rule would also prohibit an adviser and certain of its executives or employees from coordinating, or soliciting another person or political action committee ("PAC") to:

- Make a contribution to an elected official, or candidate for the official's position, who can influence the selection of the adviser
- Make a payment to a political party of the state or locality where the adviser is seeking to provide advisory services to the government.[12]

**Indirect Contributions and Solicitations**

The rule would further prohibit an adviser and certain of its executives or employees from doing anything indirectly which, if done directly, would result in a violation of the proposed rule.[13] This provision is intended to prevent advisers from circumventing the rule by directing contributions through third parties such as spouses, lawyers or companies affiliated with the adviser.

**Exceptions**

The proposed rule provides an exception to the two-year ban for *de minimis* contributions by an executive or employee of up to $250 per election and per candidate if the person making the contribution is entitled to vote for the candidate.[14]

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10 *See Blount* v. *SEC*, 61 F.3d 938, 945 (DC Cir. 1995), *cert. denied*, 517 U.S. 1119 (1996) (upholding a First Amendment challenge to MSRB rule G-37, a rule restricting political contributions in the context of the municipal bond market. The Court left open the question of the appropriate level of scrutiny to be applied, but concluded that the rule satisfied even a strict scrutiny test.).

11 Proposed rule 206(4)-5(a)(2)(i).

12 Proposed rule 206(4)-5(a)(2)(ii).

13 Proposed rule 206(4)-5(d).

14 Proposed rule 206(4)-5(b)(1). Under the proposed rule, primary and general elections would be considered separate elections. Accordingly, a covered person of an investment adviser could, without triggering the prohibitions of the rule, contribute up to $250 in both the primary election campaign and the general election campaign (up to $500) of each official for whom the person making the contribution would be entitled to vote.

There would also be an exception in the event a contribution was made by a covered associate of an investment adviser provided the adviser discovers the contribution within four months of the date of the contribution and causes the contribution to be returned within sixty days of its discovery.[15] No adviser would be permitted to rely on this exception more than twice in a 12 month period[16] and not more than once with respect to the same executive or employee regardless of the time period.[17]

**Exemptions**

Under the proposed rule, an adviser would be permitted to apply for an exemption for contributions discovered after the fact or when imposing the rule's prohibitions is unnecessary to achieve the rule's purpose.[18] In determining whether to grant an exemption the SEC would look at various factors such as whether the adviser had actual knowledge of the contribution prior to or at the time of the contribution; whether the adviser had taken all available steps to cause the contribution to be returned; the timing and amount of the contribution; the nature of the election; and the contributor's apparent intent or motive in making the contribution.

## III. Proposed Amendments to Recordkeeping Rules

The SEC also proposed amendments to Advisers Act rule 204-2 requiring certain recordkeeping in order to facilitate compliance examinations by the SEC. The amendments would require an adviser with government clients to keep records of all direct and indirect contributions, including *de minimis* contributions, made to an official, candidate or PAC by the adviser and certain of its executives and employees.[19]

The SEC also proposed a technical amendment to Advisers Act rule 206(4)-3, the cash solicitation rule, to note the specialized provisions of proposed rule 206(4)-5 regarding third-party solicitors of government entities.[20]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Lara Corchado at 212.701.3064 or lcorchado@cahill.com.

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15 Proposed rule 206(4)-5(b)(2)(i).

16 Proposed rule 206(4)-5(b)(2)(ii).

17 Proposed rule 206(4)-5(b)(2)(iii).

18 Proposed rule 206(4)-5(e).

19 Proposed rule 204-2(a)(18)(i).

20 Proposed rule 206(4)-3(e)