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SEC Proposes "Pay-to-Play" Restrictions for Investment Advisers

The Securities and Exchange Commission (the "SEC") has proposed a new rule under the Investment Advisers Act of 1940 (the "Advisers Act") that would apply a two-year ban on an investment adviser providing advisory services for compensation to a government client after the adviser, or its executives or certain employees, makes a contribution to certain elected officials, as well as eliminate the use of third-party marketers to solicit governmental entities. The rules are intended to protect public pension plans from the consequences of "pay-to-play" practices by disincentivizing an adviser's participation in such practices.

Proposed rule 205(4)-5 of the Advisers Act (the "Proposed Rule") would (1) eliminate the use of placement agents and third-party intermediaries to solicit public pension plans, (2) prohibit investment advisers from receiving compensation from public pension plans after making political contributions to a related person of such public pension plan and (3) prohibit investment advisers from coordinating fundraisers for public officials or government entities.

The Proposed Rule would be applicable to both registered investment advisers and investment advisers who are not required to be registered, because they do not hold themselves out to the public as investment advisers and have had fewer than 15 clients during the preceding 12 months.

Ban on Third-Party Solicitors

The Proposed Rule also would make it unlawful for all investment advisers, registered or unregistered, or any of their executives or employees, to provide payment to a third party to solicit a government entity. The provision is intended to eliminate the engagement of persons known as "finders," "solicitors," "placement agents" and "pension consultants."

Two-Year "Time Out" for Political Contributors

The Proposed Rule would prohibit investment advisers from providing advisory services for compensation to a government entity, either directly or indirectly, after a contribution by the investment adviser (or its "covered associates") to an official of the government entity. The Proposed Rule does not prohibit the investment adviser's ability to provide services to a government entity; however, the Proposed Rule prohibits the investment adviser from receiving compensation for such services. For purposes of the Proposed Rule, an official could be an incumbent or candidate for office, if the office has direct or indirect authority to select the investment adviser.

The two-year ban would continue even after the executive officer or employee who made the triggering contribution had left the investment adviser. Additionally, a contribution made by an executive officer or employee prior to the employment of such covered person by an investment adviser would be attributed to such investment adviser. Consequently, the investment adviser would have to "look back" to the time when such triggering contribution was made to determine what restrictions may apply to such investment adviser.

The Proposed Rule includes a *de minimis* exception of $250 if the covered person is entitled to vote for such person.

Ban on Solicitation and Coordinating Contributions

The Proposed Rule would prohibit an adviser and certain of its executives and employees from coordinating, or asking another person or political action committee to provide:

- contributions to an elected official or candidate for an office who can influence the selection of the adviser; or
- payments to a political party in a jurisdiction where the adviser seeks advisory business.

Anti-Avoidance Rule

The Proposed Rule would prohibit an investment adviser and its covered executives and employees from doing indirectly what they are prohibited from doing directly, including directing or funding contributions through third parties such as spouses, agents or companies having any relationship with the adviser.

Pooled Investment Vehicles

The Proposed Rule would extend to investment advisers that advise investment companies as defined pursuant to the Investment Company Act of 1940 (the "1940 Act"), including pooled investment vehicles that would be investment companies, but for the exclusions provided under Section 3(c)(1), Section 3(7) and Section 3(11) of the 1940 Act, in which a government entity has an investment. Each of the restrictions would apply to the extent that a government entity has an investment (or could make an investment) in a pooled investment vehicle (such as a private equity fund or hedge fund) or other investment company managed by an investment adviser subject to the Proposed Rule.

Compliance by Investment Advisers

Investment advisers will be required to implement written policies and procedures to comply with the new pay-to-play restrictions. If the Proposed Rule is adopted, investment advisers will need to identify certain employees whose contributions could trigger the penalties under the Proposed Rule. Pre-clearing processes and certifications by relevant employees will be necessary to ensure compliance. Investment advisers will need to be vigilant with respect to compliance and monitoring of employees with respect to the new rules, as these rules provide for strict liability, meaning that intent is not relevant to whether there has been a violation of the restrictions.

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The SEC's proposal is available on its Web site at www.sec.gov/rules/proposed/2009/ia-2910.pdf.

Comments should be provided to the SEC on or before October 6, 2009.

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