

## SEC Adopts Final Amendments To Pay To Play Rule

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The U.S. Securities and Exchange Commission ("SEC") recently adopted amendments to Rule 206(4)-5 (the "Pay to Play Rule") under the Investment Advisers Act of 1940 ("Advisers Act"). These amendments are designed to:

- **Scope:** Synchronize the scope of the Pay to Play Rule after the elimination of the private adviser exemption as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), by extending it to apply to exempt reporting advisers and exempt foreign private advisers, in addition to registered investment advisers.
- **Municipal Advisors and the Ban on Third-Party Solicitation:** Add registered municipal advisors, in addition to registered investment advisers and registered broker dealers, as a type of "regulated person" that may be compensated by covered investment advisers under the Pay to Play Rule for soliciting state or local government entities, provided that they are subject to restrictions at least as stringent as the Pay to Play Rule.
- **Extension of Compliance Date for the Ban on Third-Party Solicitation:** Extend the date by which covered investment advisers must comply with the ban on third-party solicitation from September 13, 2011, to June 13, 2012.

The Pay to Play amendments, which become effective September 19, 2011, were adopted as part of a larger set of new rules and amendments under the Advisers Act to implement the Dodd-Frank Act.<sup>1</sup>

### The Pay to Play Rule Generally

On July 1, 2010, the SEC adopted the Pay to Play Rule to curtail what the SEC believes represents "pay to play" practices and arrangements involving state and local government entities, including public pension plans.<sup>2</sup> Generally, as originally adopted, an investment adviser registered or required to be registered under Section 203 of the Advisers Act, and investment advisers that are unregistered pursuant to the private adviser exemption under Section 203(b)(3) of the Advisers Act, are required to comply with the Pay to Play Rule. The Pay to Play Rule also generally applies to an investment adviser that manages covered investment pools in which a government entity invests or is solicited to invest.

Under the SEC Pay to Play Rule, as originally adopted, among other restrictions:

- A covered investment adviser is prohibited from, directly or indirectly, providing investment advisory services for compensation to a state or local government entity within two years after a triggering 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)
- A covered investment adviser, and its covered associates, also are prohibited from providing or agreeing to provide, directly or indirectly, payment to any third party (e.g., a solicitor or placement agent, but not an investment adviser's employees, general partners, managing members or executive officers) to solicit a state or local government entity for investment advisory services on behalf of such covered investment adviser, unless such third parties are "regulated persons" as discussed herein (regardless of whether the regulated persons are affiliated or non-affiliated with the covered investment adviser).

The SEC Pay to Play Rule became effective September 13, 2010, and compliance was required for covered investment advisers by March 14, 2011, except that covered investment advisers were not required to comply with the Pay to Play Rule's prohibition on paying third parties to solicit business from state and local government entities, except in compliance with the Pay to Play Rule until a later date (which, as discussed herein, is now June 13, 2012).<sup>3</sup>

## Scope of the Pay to Play Rule

As noted above, the Pay to Play Rule, prior to its amendment, applied to registered investment advisers and private advisers exempt from registered pursuant to Section 203(b)(3) of the Advisers Act.<sup>4</sup> Title VII of the Dodd-Frank Act repealed the private adviser exemption, and replaced it with three limited exemptions to required SEC registration:

- Under new Section 203(l) of the Advisers Act, investment advisers solely to private funds that constitute venture capital funds as defined in the regulations ("Exempt Venture Capital Fund Advisers")
- Under new Section 203(m) of the Advisers Act, investment advisers solely to private funds with less than \$150 million of assets under management ("AUM") in the United States ("Exempt Private Fund Advisers")
- Under amended Section 203(b)(3) of the Advisers Act, investment advisers constituting exempt foreign private advisers, meaning an investment adviser (1) with no place of business in the United States, (2) who has in total fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser, (3) who has AUM attributed to that group of clients and investors of less than \$25 million, (4) who does not hold itself out generally to the public in the United States as an investment adviser and (5) who does not advise a 1940 Act registered investment company or a company that has elected to be treated as a business development company ("Exempt Foreign Private Advisers").

The SEC refers to Exempt Venture Capital Fund Advisers and Exempt Private Fund Advisers as "Exempt Reporting Advisers" because, under the Advisers Act, these types of exempt advisers are required to maintain certain records and submit certain reports/information to the SEC.<sup>5</sup>

To synchronize the scope of the Pay to Play Rule given the replacement of the "private adviser" exemption with the exemptions for Exempt Reporting Advisers and Exempt Foreign Private Advisers, in the Implementing Release, the SEC amended the scope of the Pay to Play Rule to apply to Exempt Reporting Advisers and Exempt Foreign Private Advisers. According to the SEC in the Implementing Release, the Pay to Play Rule "is necessary and appropriate to prevent [covered investment advisers] from engaging in fraudulent pay to play practices in the U.S.," and this amendment of the Pay to Play Rule "prevents the unintended narrowing of the application of the rule resulting from the repeal of the 'private adviser' exemption."

## Municipal Advisors and the Ban on Third-Party Solicitation

As noted above, under the Pay to Play Rule, a covered investment adviser, and its covered associates, may only pay "regulated persons" to solicit a state or local government entity for investment advisory services on behalf of such covered investment adviser. A "regulated person," as originally defined, generally included registered investment advisers and registered broker-dealers, in each case themselves subject to SEC oversight (i.e., registered with the SEC) (and, in the case of broker-dealers, the oversight of a registered national securities association, such as Financial Industry Regulatory Authority ("FINRA")). Registered broker-dealers also had to be subject to substantially equivalent or more stringent pay to play restrictions.

After the Dodd-Frank Act was enacted, the SEC proposed on November 19, 2010, certain amendments to the SEC Pay to Play Rule, which (among other changes) proposed to replace the concept of "regulated persons" with "regulated municipal advisors," and to replace references in the Pay to Play Rule to FINRA's pay to play rules with references to the MSRB.<sup>6</sup> Given the Pay to Play Rule's

requirement that regulated persons, such as registered municipal advisors, must be subject to substantially equivalent or more stringent pay to play restrictions, the MSRB issued MSRB Notice 2011-04 on January 19, 2011, which contained proposed MSRB Rule G-42, a "pay to play" rule for municipal advisors.<sup>7</sup> A side effect of the SEC's proposal to replace the term "regulated persons" as used in the Pay to Play Rule, as originally adopted, with the term "regulated municipal advisors" would be that a covered investment adviser would not be permitted under the amended Pay to Play Rule to pay an affiliated solicitor registered as a broker-dealer or investment adviser to solicit investment advisory business from municipal entities unless the affiliated solicitor registered as a municipal advisor (even if it was not otherwise required to register as a municipal advisor). Unlike municipal advisor registration requirements,<sup>8</sup> the SEC Pay to Play Rule does not contain an exception permitting payments to related persons (e.g., affiliates) and employees of related persons. In the Proposing Implementation Release, the SEC indicated that such affiliated solicitors may voluntarily register as municipal advisors and subject themselves to the MSRB rules, including the Proposed MSRB Rule.

In the Implementing Release, rather than replace the concept of "regulated persons" with "regulated municipal advisors," the SEC added registered municipal advisors to the definition of "regulated persons" under the Pay to Play Rule. As a result, a covered investment adviser may compensate a registered municipal advisor, in addition to SEC-registered investment advisers and registered broker dealers, for soliciting government entities, provided that they are subject to restrictions at least as stringent as the Pay to Play Rule. The SEC concluded in the Implementing Release that "[a]dvisers may only compensate third-party solicitors that are subject to the Commission's regulatory oversight and examination and to a regulatory regime that the Commission has determined is equally or more stringent than the [Pay to Play Rule]."

As a result of the SEC changing its proposal, affiliated solicitors of covered investment advisers that are registered broker-dealers or registered investment advisers with the SEC will not need to "voluntarily" register as a municipal advisor to continue to receive payments solely because of their solicitation activities on behalf of their affiliated covered investment advisers. Of course, if such affiliated solicitors also solicit state or local government entities for investment advisory services on behalf of non-affiliated, third-party investment advisers (or otherwise engage in activity for which municipal advisor registration is required), registration as a municipal advisor is required.<sup>9</sup>

### **Extension of Compliance Date for the Ban on Third-Party Solicitation**

Since the SEC changed its proposal to replace the concept of "regulated persons" with "regulated municipal advisors," and, by doing so, expanded the definition of "regulated persons," the SEC also extended the compliance date for the ban on third-party solicitation from September 13, 2011, to June 13, 2012. This compliance date extension is intended to provide time for the MSRB and FINRA to adopt pay to play rules that are at least as stringent as the Pay to Play Rule, and to give third-party solicitors additional time to come into compliance with applicable rules.

### **Conclusion**

In addition to registered investment advisers under the Advisers Act, the amendments to the Pay to Play Rule will impact Exempt Reporting Advisers, Exempt Foreign Private Advisers, and affiliated SEC-registered investment adviser and broker-dealer solicitors of covered investment advisers. These entities will need to review their compliance policies and procedures and confirm compliance with the Pay to Play Rule. As you begin to analyze how these amendments will affect your organization, Reed Smith's Investment Management Group is available to assist you.

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1. The adopting release for these new rules and amendments is entitled *Rules Implementing Amendments to the Investment Advisers Act of 1940*, SEC Rel. No. IA-3221 (June 22, 2011) (the "Implementing Release"), and is available on the SEC's website at

[www.sec.gov/rules/final/2011/ia-3221.pdf](http://www.sec.gov/rules/final/2011/ia-3221.pdf). The SEC also has promulgated a companion release to the Implementing Release, *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers*, SEC Rel. No. IA-3222 (June 22, 2011) (the "Exemptions Release"), which is available on the SEC's website at [www.sec.gov/rules/final/2011/ia-3222.pdf](http://www.sec.gov/rules/final/2011/ia-3222.pdf). For further information on the Implementing Release and Exemptions Release, please refer to the following additional Reed Smith publications (collectively, the "Recent Advisers Act Alerts"): The SEC recently published the final rule on the private fund adviser exemption under the Advisers Act. See *Private Funds*, SEC Rel. IA-3221 (June 22, 2011) (Private Funds Release"), available at: [www.sec.gov/rules/final/2011/ia-3221.pdf](http://www.sec.gov/rules/final/2011/ia-3221.pdf). For further information on the Private Funds Release, please refer to Reed Smith Investment Management Alert 11-162, *SEC Finalizes Dodd-Frank Rules Affecting Investment Advisers: Private Fund Adviser Exemption and Reporting Requirements*, available at [reedsmithupdate.com/ve/ZZTV31pGuXYvS616](http://reedsmithupdate.com/ve/ZZTV31pGuXYvS616). The SEC also recently published the final rule on mid-sized investment advisers state registration. See *Mid-Sized Investment Advisers*, SEC Rel. IA-3221 (June 22, 2011) ("Mid-Sized Investment Advisers Release"), available at [www.sec.gov/rules/final/2011/ia-3221.pdf](http://www.sec.gov/rules/final/2011/ia-3221.pdf). For further information on the Mid-Sized Investment Advisers Release, please refer to Reed Smith Investment Management Alert 11-168, "SEC Finalizes Dodd-Frank Rules Affecting Investment Advisers: Many 'Mid-Sized Advisers' Must Transition from SEC Registration to State Registration," available at [reedsmithupdate.com/ve/ZZ677181HVd8178x71j95](http://reedsmithupdate.com/ve/ZZ677181HVd8178x71j95). The SEC also recently published the final rule on the family office exemption under the Advisers Act. See *Family Offices*, SEC Rel. IA-3220 (June 22, 2011) ("Family Office Release"), available at [www.sec.gov/rules/final/2011/ia-3220.pdf](http://www.sec.gov/rules/final/2011/ia-3220.pdf). For further information on the Family Office Release, please refer to Reed Smith Investment Management Alert 11-176, *The SEC Adopted a Rule To Define 'Family Offices' That Will Be Excluded From the Definition of an Investment Adviser Under the Investment Advisers Act of 1940*, available at [reedsmithupdate.com/ve/ZZPLtRM65Wa3163t7](http://reedsmithupdate.com/ve/ZZPLtRM65Wa3163t7). The SEC also recently published the final rule on Non-US Advisers. See *Non-US Advisers*, SEC Rel. IA-3222 (June 22, 2011) ("Non-US Advisers Release"), available at [www.sec.gov/rules/final/2011/ia-3222.pdf](http://www.sec.gov/rules/final/2011/ia-3222.pdf). For further information on the Non-US Advisers Release, a Reed Smith Investment Management Alert titled Final Dodd-Frank Registration Rules Affecting Non-US Advisers will be forthcoming.

2. See *Political Contributions by Certain Investment Advisers*, SEC Rel. No. IA-3043 (July 1, 2010), available at [www.sec.gov/rules/final/2010/ia-3043.pdf](http://www.sec.gov/rules/final/2010/ia-3043.pdf).

3. For a more complete discussion of the SEC Pay to Play Rule, please refer to Reed Smith Investment Management Alert 10-190, *SEC Adopts Rule to Curtail "Pay to Play" Practices Involving State and Local Government Entities*, available at [reedsmithupdate.com/veZZx61608861iW82Wk265](http://reedsmithupdate.com/veZZx61608861iW82Wk265). For a discussion of the Municipal Securities Rulemaking Board's ("MSRB") proposed pay to play rule, and its interaction with the SEC's Pay to Play Rule, please refer to Reed Smith Investment Management Alert 11-031, *MSRB Antes Up: Proposes 'Pay to Play' Rule for Municipal Advisers*, available at [reedsmithupdate.com/ve/ZZWL31uILRB8664z](http://reedsmithupdate.com/ve/ZZWL31uILRB8664z).

4. Under Section 203(b)(3) of the Advisers Act, private advisers were investment advisers that qualified for an exemption from registration under the Advisers Act because they had fewer than 15 clients during the course of the preceding 12 months, and neither held themselves out generally to the public as an investment adviser nor acted as an investment adviser to any investment company registered under the Investment Company Act of 1940 ("1940 Act"), or a company that elected to be a business development company pursuant to Section 54 of the 1940 Act.

5. For a more complete discussion of Exempt Venture Capital Fund Advisers, Exempt Private Fund Advisers and Exempt Foreign Private Advisers, please see the Recent Advisers Act Alerts, supra note 1.

6. See *Rules Implementing Amendments to Investment Advisers Act of 1940*, SEC Rel. No. IA-3110 (Nov. 19, 2010) ("Proposed Implementing Release"), available at [www.sec.gov/rules/proposed/2010/ia-3110.pdf](http://www.sec.gov/rules/proposed/2010/ia-3110.pdf).

7. Under proposed MSRB Rule G-42, among other restrictions, municipal advisors would be prohibited from engaging in municipal advisory business with municipal entities for compensation for two years after a triggering political contribution is made to a state or local government official with authority to hire the municipal advisors, and from paying compensation for soliciting certain types of third-party business from municipal entities. For a more complete discussion of MSRB Rule G-42, and its interaction with the Pay to Play Rule, please refer to Reed Smith Investment Management Alert 11-031, *MSRB Antes Up: Proposes "Pay to Play" Rule for Municipal Advisors*, available at [reedsmithupdate.com/ve/ZZWL31uLRB8664z](http://reedsmithupdate.com/ve/ZZWL31uLRB8664z). For further information on municipal advisor registration requirements, please refer to Reed Smith Investment Management Alert 10-215, *Municipal Advisor Registration Requirements: Are You Required To Register With the SEC by October 1, 2010?* available at [reedsmithupdate.com/ve/ZZe318029uuLxxB86N](http://reedsmithupdate.com/ve/ZZe318029uuLxxB86N).

8. Persons who solicit investment advisory business from state or local government entities on behalf of their affiliates are not within the definition of "municipal advisor" under Section 975 of the Dodd-Frank Act; therefore, such affiliated solicitors are not required to register as municipal advisors solely because of their solicitation activities on behalf of their affiliates.

9. On July 5, 2011, the MSRB issued a news release expressing concern that some municipal advisor firms engaging in municipal advisory activities may not be registered both with the MSRB and the SEC, and warning that "[u]nregistered municipal advisor firms providing municipal advisory services may be in violation of federated securities laws and MSRB rules if they are not registered as municipal advisors with both regulatory organizations." The MSRB encouraged municipal entities and obligated persons that retain municipal advisor firms to verify their registration with the MSRB and the SEC. The MSRB emphasized that "brokers, dealers and municipal securities dealers that also act as municipal advisors are required to register with both regulators as municipal advisors even if they previously registered with the MSRB as dealers." See *MSRB Expresses Concern About Municipal Advisor Registration Compliance and Recommends Municipal Entities Check the Status of Their Advisors* (July 5, 2011), available at [www.msrb.org/News-and-Events/Press-Releases/2011/MSRB-Reminds-Municipal-Advisors-of-Registration-Requirements.aspx](http://www.msrb.org/News-and-Events/Press-Releases/2011/MSRB-Reminds-Municipal-Advisors-of-Registration-Requirements.aspx).

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