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It Doesn't Pay to "Pay to Play" --- Investment Adviser Compliance With Advisers Act Rule 206(4)-5 Is Now Mandatory: What You Should Do Now To Avoid Significant Penalties Later

March 14, 2011 marked the first critical transition date for investment advisers to comply with certain components of Rule 206(4)-5 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Rule 206(4)-5 was adopted in July 2010 and effective September 13, 2010, although certain transitional compliance dates have been provided, as indicated in Table 1 below. Rule 206(4)-5 is designed to prevent "pay-to-play" activity whereby investment advisers may seek to influence the award of investment advisory services from public pension funds and other government entities[1] in return for political contributions or fund raising. Rule 206(4)-5 is modeled after Municipal Securities Rulemaking Board ("MSRB") Rules G-37 and G-38, which address pay-to-play practices in the municipal securities market.

Pay-to-play practices can occur in a variety of ways, including through direct contributions to government officials, solicitation of third parties to make contributions or payments to government officials or political parties, or payments to third parties to solicit government business. Rule 206(4)-5 prohibits political contributions by certain employees of investment advisers. The failure to comply, even if inadvertent, may subject an adviser to significant forfeitures, potential penalties and other sanctions.

OVERVIEW

Rule 206(4)-5 applies to any adviser that is registered with the Securities and Exchange Commission ("SEC"), required to be registered, or is exempt from registration pursuant to Advisers Act Section 203(b)(3). The Rule applies broadly to investment advisers who are engaged by governmental entities to manage assets directly in separate accounts as well as those who manage government entity assets indirectly through certain "covered investment pools" in which such entities invest or are solicited to invest.[2] For purposes of the Rule, a "covered investment pool" includes: (i) any investment company registered under the Investment Company Act of 1940 that is an investment option of a plan or program of a government entity that is *participant directed*[3] or (ii) any company that is exempted from registration under the Investment Company Act of 1940 pursuant to

sections 3(c)(1), 3(c)(7) and 3(c)(11) of that Act. Elimination by the Dodd-Frank Act of the private adviser exemption previously available to U.S.-based advisers under Advisers Act Section 203(b)(3) will result in registration by many managers of hedge funds, private equity funds and venture capital funds and, therefore, subject them to the Rule. Many mid-sized advisers (e.g., those with less than $150 million in assets under management in the United States and who advise only private funds) that are exempted from registration under the Advisers Act Section 203(m) and proposed Rule 203(m)-1 thereunder, will be captured by the definition of "covered investment pools" and should therefore remain subject to the Rule. Nonetheless, to prevent any unintentional gaps in the application of Rule 206(4)-5 as a result of more recent Advisers Act amendments, the SEC proposed certain incremental amendments to Rule 206(4)-5 to clarify that the Rule would apply to exempt reporting advisers and foreign advisers.[4]

Rule 206(4)-5 contains three primary restrictions. The Rule generally:

1. Places a two year ban on the receipt of compensation by any investment adviser with respect to a governmental entity if the adviser or one of its covered associates (discussed more fully below) make certain contributions[5] to a government official or candidate for office that has the ability to directly or indirectly influence the award of advisory business by such governmental entity;
2. Prohibits advisers and their covered associates from soliciting or coordinating political contributions or payments to state or local political parties where the adviser seeks to do business; and
3. Prohibits advisers and their covered associates from paying third parties to solicit government entities for advisory business, unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to "pay-to-play" restrictions, defined as a "regulated person" under the Rule. (In its November rules implementation release, the SEC proposed to amend this section to permit payment only to a "regulated municipal advisor," which is a person registered under Section 15B of the Securities Exchange Act of 1934 and subject to MSRB pay-to-play rules.)

Relevant Transition/Compliance Dates	
Two year time-out; Prohibition on Soliciting or Coordinating Contributions	March 14, 2011
Restrictions on Using Third Parties to Solicit Government Business	September 13, 2011
Cash Solicitation Rule Amendment	September 13, 2011
Recordkeeping – Records of Covered Associates and their Political Contributions	March 14, 2011
Recordkeeping – Requirements Relating to RICs that are "Covered Investment Pools"	September 13, 2011

Two-Year Ban on Compensation for Making Political Contributions to Officials of Government Entities

The cornerstone of Rule 206(4)-5 is a prohibition on receiving compensation for providing advisory services to a government entity for two years if the adviser or a "covered associate" makes a non-exempt "contribution" to a public official or candidate who can influence the award of advisory business. First, and notably, the rule does not prohibit the provision of advisory services during the two-year period, only the receipt of compensation during such period. Second, the cooling off period is deemed to begin at the time the contribution is made, not when such contribution is discovered by the SEC's examination staff or the investment adviser. If discovered after the date of contribution, an adviser must return all compensation promptly upon discovering the triggering contribution.

For purposes of Rule 206(4)-5, an "official" is defined to include any incumbent, candidate, or successful candidate for elective office of a government entity. Rule 206(4)-5 is triggered when contributions are made to officials who **directly or indirectly** may influence the award of advisory business.[6] The prohibition applies even if the office does not influence investment decisions directly, but has the authority to appoint persons who themselves can directly or indirectly influence investment decisions.

An adviser may determine to manage a client's assets during the two year time-out period and, during such period, waive all fees and/or return all fees earned after the date of contribution to the government entity until expiration of the two-year period. An adviser also may seek to terminate the business relationship, though its fiduciary duty may require it to continue managing the account for an additional period of time in order to ensure an orderly transition of assets. In light of potential forfeiture of millions of dollars in fees, advisers should implement strong internal controls and rigorous reporting requirements in order to detect and prevent any unintended consequences.

Contributions by "Covered Associates"

The rule attributes to an adviser all contributions made by the investment adviser's "covered associates." Under the rule, a "covered associate" includes (i) any general partner, managing member, executive officer and any other individual[7] having a similar status or function; (ii) any employee who solicits a government entity on behalf of the adviser, and any direct or indirect supervisor of such person; and (iii) any political action committee ("PAC") controlled by the investment adviser or any individuals identified in (i) and (ii) above. The SEC takes a broad view of what it means to control a PAC and it includes the ability to direct or cause the direction of the governance or operations of the PAC.

Look Back Periods

Under Rule 206(4)-5, an adviser must apply either a two year or six month "look back" to every employee who becomes a covered associate of the investment adviser to determine whether any such

individuals made any contributions that would implicate the rule. The determining factor regarding whether a two year or six month look back applies is whether the person, upon becoming a "covered associate," solicits clients on behalf of an investment adviser.

- An adviser must look back two years prior to the hiring, acquisition or promotion of such "covered associate" if he or she solicits clients on behalf of such adviser.
- An adviser must look back six months where such covered associate is uninvolved in solicitation activities. This approach is consistent with the desire to focus restrictions on those employees most likely to engage in pay-to-play activities.

Every adviser subject to Rule 206(4)-5 must determine which employees are "covered associates." We believe it would also be prudent for an adviser's compliance team to closely coordinate with human resources personnel to carefully monitor new hires, promotions and internal reorganizations in order to detect and evaluate the impact of all such changes. Advisers should also review the political contribution activities of all new hires, as any new employee who has made a non-exempt contribution within the appropriate look back period will subject the adviser to the two year compensation ban, potentially requiring forfeiture of fees earned prior to the date such new employee was hired.

Exceptions

There are a few very narrow exceptions to the contribution restrictions. Covered associates may contribute up to an aggregate amount of $350 per election for each official they are entitled to vote for at the time of the contribution. Covered associates may also contribute an aggregate amount of up to $150 per election for officials they are not entitled to vote for. There is also a narrow exception for relatively small contributions that are promptly returned by the official.

The SEC has discretion to except an investment adviser from the prohibition on a case-by-case basis. Factors the SEC will consider in making this decision include **whether the adviser had internal policies and procedures in place and whether the adviser had retained outside counsel to assist in compliance**.

Prohibition on Soliciting and Coordinating Contributions

Investment advisers must now also be in compliance with Rule 206(4)-5's third restriction (highlighted above), which prohibits investment advisers and their covered associates from coordinating or soliciting any person or PAC to make a contribution to an official where the adviser is providing or seeks to provide investment advisory services. There is an additional restriction on soliciting contributions or payments to a political party of a state or locality where the adviser is providing or seeks to do business.

Advisers must tread carefully to ensure they do not solicit or coordinate prohibited contributions. **We strongly recommend**

consulting with outside counsel prior to taking any action that could be considered soliciting or coordinating a contribution on behalf of an official or a state or local political party.

Recordkeeping Requirements

Finally, investment advisers must now comply with significant additional recordkeeping requirements. Advisers Act Rule 204-2 requires an investment adviser to maintain lists that will include the following information:

- the name of each of the adviser's covered associates;
- the title(s), business address and residential addresses of such covered associates;
- all government entities that the adviser has provided investment advisory services to in the past five years (advisers are not required to maintain a record of government entities that were clients before September 13, 2010);
- all political contributions made by the adviser and its covered associate to a government official or candidate and contributions or payments to state or local political parties and PACS.
    - Such records 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 exception for certain returned contributions; and
- the names and business addresses of each regulated person to whom the adviser provides or agrees to provide directly or indirectly, payment to solicit a government entity on its behalf.

Conclusion

Even an inadvertent violation of Rule 206(4)-5 can result in the forfeiture of millions of dollars. It is crucial for investment advisers to be on top of this new rule and have a detailed, comprehensive compliance plan in place. Our professionals have a deep understanding of both political and securities law, and are ideally suited to assist investment advisers in complying with this complex, challenging new rule. Please contact one of the authors listed if you have any questions.

[1] For purposes of Rule 206(4)-5, the term "government entity" is defined to include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457, and 529 plans.

[2] Rule 206(4)-5 would not apply to small advisers that are registered with state securities authorities instead of the Commission or advisers that are unregistered in reliance on exemptions other than Section 203(b)(3) of the Advisers Act.

[3] These would include any registered investment company that is an investment option of a plan or program of a government entity. Such plans and programs include "529" college savings plans and both "403(b)" and "457" employee benefit retirement plans.

[4] *Rules Implementing Amendments to the Investment Advisers Act of* 1940, Investment Advisers Act Release No. 3110 (November 19, 2010).

[5] "Contribution" is defined to mean "any gift, subscription, loan, advance, or deposit of money or anything of value made for: (i) the purpose of influencing any election for federal, state or local office; (ii) payment of debt incurred in connection with any such election; or (iii) transition or inaugural expenses of the successful candidate for state or local office. Generally, a donation of time by an individual is not considered to be a contribution, provided the adviser has not solicited the individual's efforts and the adviser's resources, such as office space and telephones, are not used. Similarly, charitable donations made by an investment adviser to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code, or its equivalent in a foreign jurisdiction, at the request of an official of a government entity is not considered a contribution for purposes of rule 206(4)-5.

[6] The two-year cooling off period is triggered by contributions to elected officials who have legal authority to hire the adviser, as well as those (such as persons with appointment authority) who can influence the hiring of the adviser. Further, it is the scope of authority of the office of an official which is the determining factor, not the influence actually exercised by any such official.

[7] In the November rules implementation release, the SEC proposed to replace the word "individual" with "person" to clarify that a legal entity, and not just a natural person would meet the definition of "covered associate."

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