SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-3043; File No. S7-18-09

RIN 3235-AK39

Political Contributions by Certain Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting a new rule under the Investment Advisers Act of 1940 that prohibits 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. The new rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser, unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay to play restrictions. Additionally, the new rule prevents an adviser from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The Commission also is adopting rule amendments that require a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees. The new rule and rule amendments address “pay to play” practices by investment advisers.

DATES: Effective Date: September 13, 2010.

Compliance Dates: Investment advisers subject to rule 206(4)-5 must be in compliance with the rule on March 14, 2011. Investment advisers may no longer use third parties to solicit government business except in compliance with the rule on September 13, 2011.

Advisers to registered investment companies that are covered investment pools must comply with the rule by September 13, 2011. Advisers subject to rule 204-2 must comply with amended rule 204-2 on March 14, 2011. However, if they advise registered investment companies that are covered investment pools, they have until September 13, 2011 to comply with the amended recordkeeping rule with respect to those registered investment companies. See section III of this Release for further discussion of compliance dates.

FOR FURTHER INFORMATION CONTACT: Melissa A. Roverts, Senior Counsel, Matthew N. Goldin, Branch Chief, Daniel S. Kahl, Branch Chief, or Sarah A. Bessin, Assistant Director, at (202) 551-6787 or IArules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is adopting rule 206(4)-5 [17 CFR 275.206(4)-5] and amendments to rules 204-2 [17 CFR 275.204-2] and 206(4)-3 [17 CFR 275.206(4)-3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] ("Advisers Act" or "Act").[1]

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15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified, and when we refer to rule 206(4)-5, rule 204-2, rule 204A-1, rule 206(4)-3, or any paragraph of these rules, we are referring to 17

CFR 275.206(4)-5, 17 CFR 275.204-2, 17 CFR 275.204A-1 and 17 CFR 275.206(4)-3, respectively, of the Code of Federal Regulations, in which these rules are published.

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I. BACKGROUND

Investment advisers provide a wide variety of advisory services to state and local governments,[2] including managing their public pension plans.[3] These pension plans have over $2.6 trillion of assets and represent one-third of all U.S. pension assets.[4] They are among the largest and most active institutional investors in the United States;[5] the management of these funds affects publicly held companies[6] and the securities markets.[7] But most significantly, their management affects taxpayers and the beneficiaries of these

[2] *See* SOFIA ANASTOPOULOS, AN INTRODUCTION TO INVESTMENT ADVISERS FOR STATE AND LOCAL GOVERNMENTS (2d ed. 2007); Werner Paul Zorn, *Public Employee Retirement Systems and Benefits*, LOCAL GOVERNMENT FINANCE, CONCEPTS AND PRACTICES 376 (John E. Peterson & Dennis R. Strachota eds., 1st ed. 1991) (discussing the services investment advisers provide for public funds).

[3] To simplify the discussion, we use the term "public pension plan" interchangeably with

"government client" and "government entity" in this Release. However, our rule applies broadly to investment advisory activities for government clients, such as those mentioned here in this Section of the Release, regardless of whether they are retirement funds. For a discussion of how the proposed rule would apply with respect to investment programs or plans sponsored or established by government entities, such as "qualified tuition plans" authorized by section 529 of the Internal Revenue Code [26 U.S.C. 529] and retirement plans authorized by section 403(b) or 457 of the Internal Revenue Code [26 U.S.C. 403(b) or 457], see section II.B.2(e) of this Release.

[4] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS AND OUTSTANDINGS, FOURTH QUARTER 2009 78 tbl.L.119 (Mar. 11, 2010). Since 2002, total financial assets of public pension funds have grown by 28%. *Id*.

[5] According to a recent survey, seven of the ten largest pension funds were sponsored by state and municipal governments. *The Top 200 Pension Funds/Sponsors*, PENS. & INV. (Sept. 30, 2008), *available at* http://www.pionline.com/article/20090126/CHART/901209995.

[6] *See* Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008) ("Collectively, public pension funds have the potential to be a powerful shareholder force, and the example of CalPERS and its activities have spurred many to advocate greater institutional activism.").

[7] Federal Reserve reports indicate that, of the $2.6 trillion in non-federal government plans, $1.5 trillion is invested in corporate equities. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *supra* note 4, at 78 tbl.L.119.

funds, including the millions of present and future state and municipal retirees[8] who rely on the funds for their pensions and other benefits.[9] Public pension plan assets are held, administered and managed by government officials who often are responsible for selecting investment advisers to manage the funds they oversee.

Elected officials who allow political contributions to play a role in the management of these assets and who use these assets to reward contributors violate the public trust. Moreover, they undermine the fairness of the process by which public contracts are awarded. Similarly, investment advisers that seek to influence government officials' awards of advisory contracts by making or soliciting political contributions to those officials compromise their fiduciary duties to the pension plans they advise and defraud prospective clients. These practices, known as "pay to play," distort the process by which advisers are selected.[10] They can harm pension plans that may subsequently receive inferior advisory services and pay higher fees. Ultimately, these violations of trust can harm the millions of retirees that rely on the plan or the taxpayers of the state and municipal governments that must honor those obligations.[11]

[8] *See* PAUL ZORN, 1997 SURVEY OF STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT SYSTEMS 61 (1997) (hereinafter "1997 SURVEY") ("[t]he investment of plan assets is an issue of immense consequence to plan participants, taxpayers, and to the economy as a whole" as a low rate of return will require additional funding from the sponsoring government, which "can place an additional strain on the sponsoring government and may require tax increases").

[9] The most current census data reports that public pension funds have 18.6 million beneficiaries. 2007 Census of Governments, U.S. Bureau of Census, Number and Membership of State and Local Government Employee-Retirement Systems by State: 2006-2007 (2007) (at Table 5), *available at* http://www.census.gov/govs/retire/2007ret05.html.

[10] Among other things, pay to play practices may manipulate the market for advisory services by creating an uneven playing field among investment advisers. These practices also may hurt smaller advisers that cannot afford the required contributions.

[11] *See*1997 SURVEY, *supra* note 8.

Pay to play practices are rarely explicit: participants do not typically let it be publicly known that contributions or payments are made or accepted for the purpose of influencing the selection of an adviser. As one court noted, "[w]hile the risk of corruption is obvious and substantial, actors in this field are presumably shrewd enough to structure their relations rather indirectly."[12] Pay to play practices may take a variety of forms, including an adviser's direct contributions to government officials, an adviser's solicitation of third parties to make contributions or payments to government officials or political parties in the state or locality where the adviser seeks to provide services, or an adviser's payments to third parties to solicit (or as a condition of obtaining) government business. As a result, the full extent of pay to play practice remains hidden and is often hard to prove.

Public pension plans are particularly vulnerable to pay to play practices. Management decisions over these investment pools, some of which are quite large, are typically made by one or more trustees who are (or are appointed by) elected officials.

And the elected officials or appointed trustees that govern the funds are also often involved, directly or indirectly, in selecting advisers to manage the public pension funds' assets. These officials may have the sole authority to select advisers,[13] may be members of a governing board that selects advisers,[14] or may appoint some or all of the board members who make the selection.[15]

[12] *Blount v. SEC*, 61 F.3d 938, 945 (D.C. Cir. 1995), *cert. denied*, 517 U.S. 1119 (1996).

[13] *See, e.g.*, 2 N.Y. COMP. CODES R. & REGS. TIT. 2 § 320.2 (2009) (placement of state and local government retirement systems assets (valued at $109 billion as of March 2009) is under the sole custodianship of the New York State Comptroller).

[14] *See, e.g.*, S.C. CODE ANN. §§ 9-1-20, 1-11-10 (2008) (board consists of all elected officials); CAL. GOV'T CODE § 20090 (Deering 2008) (board consists of some elected officials, some appointed members, and some representatives of interest groups chosen

Numerous developments in recent years have led us to conclude that the selection of advisers, whom we regulate under the Investment Advisers Act, has been influenced by political contributions and that, as a result, the quality of management service provided to public funds may be negatively affected. We have been particularly concerned that these contributions have been funneled through "solicitors" and "placement agents" that advisers engage (or believe they must engage) in order to secure a client relationship with a public pension plan or an investment from one.[16] As we will discuss in more detail below, in such an arrangement the contribution may be made in the form of a substantial fee for what may constitute no more than an introduction service by a "well connected" individual who may use the proceeds of the fee to make (or reimburse himself for having made) political contributions or provide some form of a "kickback" to an official or his or her family or friends.[17]

XCoin (sol_xcoin)

address on Pump.fun -
https://pump.fun/coin/EoKDHWBcNqn1xz7N1n7qTiMGie4NGsDgyKERcZ247t3z
Contract address - oKDHWBcNqn1xz7N1n7qTiMGie4NGsDgyKERcZ247t3z

X Corp and Elon Musk are considering acquiring 100% of the existing token supply from its creators to convert it into the official token of the X social network, with an initial deal budget of $400 million and additional participation from BlackRock, Vanguard, Pantera Capital, and Polychain Capital, potentially bringing the total investment volume to $2 billion.

by the members of those groups); MD. CODE ANN., STATE PERS. & PENS. § 21-104 (2008) (pension board consists of some elected officials, some appointed members, and some representatives of interest groups chosen by the members of those groups).

[15] *See, e.g.*, ARIZ. REV. STAT. ANN. § 38-713 (2008) (governor appoints all nine members); HAWAII REV. STAT. § 88-24 (2008) (governor appoints three of eight members); IDAHO

CODE ANN. § 59-1304 (2008) (governor appoints all five members).

[16] For example, in one recent action we alleged that, in connection with a pay to play scheme in New York State, investment advisers paid sham "placement agent" fees, portions of which were funneled to public officials, as a means of obtaining public pension fund investments in the funds those advisers managed and that participants, in some instances, concealed the third-party solicitor's role in transactions from the investment management firms that paid fees to the solicitor by making misrepresentations about the solicitor's involvement and covertly using one of the solicitor's legal entities as an intermediary to funnel payments to the solicitor. *SEC v. Henry Morris, et al.*, Litigation Release No. 20963 (Mar. 19, 2009).

[17] *See id.* (along with the Commission's complaint in the action, available by way of a hyperlink from the litigation release). *See also, e.g.*, *In the Matter of Quadrangle Group LLC*, AGNY Investigation No. 2010-044 (Apr. 15, 2010) (finding that "private equity firms and hedge funds frequently use placement agents, finders, lobbyists, and other intermediaries . . . to obtain investments from public pension funds . . . , that these placement agents are frequently politically connected individuals selling access to public money. . ."); Complaint, *Cal. v. Villalobos, et al.*, No. SC107850 (Cal. Super. Ct., W.

The details of pay to play arrangements have been widely reported as a consequence of the growing number of actions that we and state authorities have brought involving investment advisers seeking to manage the considerable assets of the New York State Common Retirement Fund.[18] In addition, we have brought enforcement actions against the former treasurer of the State of Connecticut and other parties in which we alleged that the former treasurer awarded state pension fund investments to private equity fund managers in exchange for payments, including political contributions, funneled through the former treasurer's friends and political associates.[19] Criminal

Dist. of L.A. County, May 5, 2010), *available at* http://ag.ca.gov/cms_attachments/press/pdfs/n1915_filed_complaint_for_civil_penalties.pdf (alleging, *inter alia*, that a top executive and a board member at CalPERS accepted various gifts from a former CalPERS board member, "known among private equity firms as a person who attempts to exert pressure on CalPERS' representatives," who was acting as a placement agent trying to secure investments from the California public pension fund).

[18] *See SEC v. Henry Morris, et al.*, Litigation Release No. 21036 (May 12, 2009); *In the Matter of Quadrangle Group LLC*, AGNY Investigation No. 2010-044 (Apr. 15, 2010); *In the Matter of GKM Newport Generation Capital Servs., LLC*, AGNY Investigation No. 2010-017 (Apr. 14, 2010); *In the Matter of Kevin McCabe*, AGNY Investigation No. 2009-152 (Apr. 14, 2010); *In the Matter of Darius Anderson Platinum Advisors LLC*, AGNY Investigation No. 2009-153 (Apr. 14, 2010); *In the Matter of Global Strategy Group*, AGNY Investigation No. 2009-161 (Apr. 14, 2010); *In the Matter of Freeman Spogli & Co.*, AGNY Investigation No. 2009-174 (Feb. 1, 2010); *In the Matter of Falconhead Capital, LLC*, AGNY Investigation No. 2009-125 (Sept. 17, 2009); *In the Matter of HM Capital Partners I, LP*, AGNY Investigation No. 2009-117 (Sept. 17, 2009); *In the Matter of Ares Management LLC*, AGNY Investigation No. 2009-173 (Feb. 17, 2010); *In the Matter of Levine Leichtman Capital Partners*, AGNY Investigation No. 2009-124 (Sept. 17, 2009); *In the Matter of Access Capital Partners*, AGNY Investigation No. 09-135 (Sept. 17, 2009); *In the Matter of The Markstone Group*, AGNY Investigation No. 10-012 (Feb. 28, 2010); *In the Matter of Wetherly Capital Group, LLC and DAV/Wetherly Financial, L.P.*, AGNY Investigation No. 2009-172 (Feb. 8, 2010) (in each case, banning the use of third-party placement agents pursuant to a "Pension Reform Code of Conduct").

[19] *See SEC v. Paul J. Silvester, et al.*, Litigation Release No. 16759 (Oct. 10, 2000); Litigation Release No. 20027 (Mar. 2, 2007); Litigation Release No. 19583 (Mar. 1, 2006); Litigation Release No. 18461 (Nov. 17, 2003); Litigation Release No. 16834 (Dec. 19, 2000); *SEC v. William A. DiBella et al.,* Litigation Release No. 20498 (Mar. 14, 2008) (2007 U.S. Dist. LEXIS 73850 (D. Conn., May 8, 2007), *aff'd* 587 F.3d 553 (2nd Cir. 2009)). *See also U.S. v. Ben F. Andrews*, Litigation Release No. 19566 (Feb. 15,

authorities have in recent years brought cases in New York,[20] New Mexico,[21] Illinois,[22] Ohio,[23] Connecticut,[24] and Florida,[25] charging defendants with the same or similar conduct.

2006); *In the Matter of Thayer Capital Partners, TC Equity Partners IV, L.L.C., TC Management Partners IV, L.L.C., and Frederick V. Malek*, Investment Advisers Act Release No. 2276 (Aug. 12, 2004); *In the Matter of Frederick W. McCarthy*, Investment Advisers Act Release No. 2218 (Mar. 5, 2004); *In the Matter of Lisa A. Thiesfield*, Investment Advisers Act Release No. 2186 (Oct. 29, 2003).

[20] *See New York v. Henry "Hank" Morris and David Loglisci*, Indictment No. 25/2009 (NY Mar. 19, 2009) (alleging that the deputy comptroller and a "placement agent" engaged in enterprise corruption and state securities fraud for selling access to management of public

funds in return for kickbacks and other payments for personal and political gain).

[21] *See U.S. v. Montoya*, Criminal No. 05-2050 JP (D.N.M. Nov. 8, 2005) (the former treasurer of New Mexico pleaded guilty); *U.S. v. Kent Nelson*, Criminal Information No. 05-2021 JP, (D.N.M. 2007) (defendant pleaded guilty to one count of mail fraud); *U.S. v. Vigil*, 523 F. 3d 1258 (10th Cir. 2008) (affirming the conviction for attempted extortion of the former treasurer of New Mexico for requiring that a friend be hired by an investment manager at a high salary in return for the former treasurer's willingness to accept a proposal from the manager for government business).

[22] *See* Jeff Coen, et al., *State's Ultimate Insider Indicted*, CHI. TRIB., Oct. 31, 2008, *available at* http://www.chicagotribune.com/news/local/chi-cellini-31 oct31,0,6465036.story (describing the thirteenth indictment in an Illinois pay to play probe); Ellen Almer, Oct. 27, 2000, *available at* http://www.chicagobusiness.com/cgi bin/news.pl?id=775 (discussing the guilty plea of Miriam Santos, the former treasurer of the City of Chicago, who told representatives of financial services firms seeking city business that they were required to raise specified campaign contributions for her and personally make up any shortfall in the amounts they raised). *See also SEC v. Miriam Santos, et al.*, Litigation Release No. 17839 (Nov. 14, 2002); Litigation Release No. 19269 (June 14, 2005) (355 F. Supp. 2d 917 (N.D. Ill. 2003)).

[23] *See* Reginald Fields, *Four More Convicted in Pension Case: Ex-Board Members Took Gifts from Firm*, CLEVELAND PLAIN DEALER, Sept. 20, 2006 (addressing pay to play activities of members of the Ohio Teachers Retirement System).

[24] *See U.S. v. Joseph P. Ganim*, 2007 U.S. App. LEXIS 29367 (2d Cir. 2007) (affirming the district court's decision to uphold an indictment of the former mayor of Bridgeport, Connecticut, in connection with his conviction for, among other things, requiring payment from an investment adviser in return for city business); *U.S. v. Triumph Capital Group, et al.,* No. 300CR217 JBA (D. Conn. 2000) (the former treasurer, along with certain others, pleaded guilty—while others were ultimately convicted). One of the defendants, who had been convicted at trial, recently won a new trial. *U.S. v. Triumph Capital Group, et al.*, 544 F.3d 149 (2d Cir. 2008).

[25] *United States v. Poirier*, 321 F.3d 1024 (11th Cir.), *cert. denied sub nom. deVegter v. United States*, 540 U.S. 874 (2003) (partner at Lazard Freres & Co., a municipal services firm, was convicted for conspiracy and wire fraud for fraudulently paying $40,000

Allegations of pay to play activity involving state and municipal pension plans in other jurisdictions continue to be reported.[26] In the course of this rulemaking we received a letter from one public official detailing the role of pay to play arrangements in the selection of public pension fund managers and the harms it can inflict on the affected plans.[27] In addition, other public officials wrote to express support for a Commission rule to prohibit investment advisers from participating in pay to play arrangements.[28]

On August 3, 2009, we proposed a new antifraud rule under the Advisers Act designed to prevent investment advisers from obtaining business from government entities in return for political contributions or fund raising—*i.e.*, from participating in pay

through an intermediary to Fulton County's independent financial adviser to secure an assurance that Lazard would be selected for the Fulton County underwriting contract).

[26] *See, e.g.*, Aaron Lester, et al., *Cahill Taps Firms Tied to State Pension Investor*, BOSTON.COM, Mar. 21, 2010 (suggesting that an investment adviser may have bundled out-of-state donations to the Massachusetts State Treasurer's campaign in return for a state pension fund investment management contract); Kevin McCoy, *Do Campaign Contributions Help Win Pension Fund Deals*, USA TODAY, Aug. 28, 2009; Ted Sherman, *Pay to Play Alive and Well in New Jersey*, NJ.COM, Nov. 28, 2009 (noting more generally that pay to play continues to occur with government contracts of all kinds in New Jersey); Imogen Rose-Smith and Ed Leefeldt, *Pension Pay to Play Casts Shadow Nationwide*, INSTITUTIONAL INVESTOR, Oct. 1, 2009 (suggesting connections between a private equity fund principal's fundraising activities and pension investments in the fund). *See also* sources cited *supra* note 17.

[27] Comment Letter of Suzanne R. Weber, Erie County Controller (Oct. 6, 2009) ("Weber Letter") ("I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen."). *See also* Comment Letter of David R. Pohndorf (Aug. 4, 2009) ("Pohndorf Letter") (noting that when the sole trustee of a major pension fund changed several years ago, a firm managing some of the fund's assets "began to receive invitations to fundraising events for the new trustee with suggested donation amounts.").

[28] *See, e.g.*, Comment Letter of New York State Comptroller Thomas P. DiNapoli (Oct. 2, 2009) ("DiNapoli Letter"); Comment Letter of New York City Mayor Michael R. Bloomberg (Sept. 9, 2009) ("Bloomberg Letter"). *See also* Comment Letter of Kentucky Retirement Systems Trustee Chris Tobe (Sept. 18, 2009) ("Tobe Letter") (suggesting the negative effects of pay to play activities on the Kentucky Retirement System's investment performance).

to play practices.[29] We modeled our proposed rule on those adopted by the Municipal Securities Rulemaking Board, or MSRB, which since 1994 has prohibited municipal securities dealers from participating in pay to play practices.[30] We believe these rules have significantly curbed pay to play practices in the municipal securities market.[31] Along the lines of MSRB rule G-37,[32] our proposed rule would have prohibited 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.[33] It also would have prohibited an adviser and certain of its executives and employees from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business.[34] In

[29] *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 2910 (Aug. 3, 2009) [74 FR 39840 (Aug. 7, 2009)] (the "Proposing Release").

[30] MSRB rule G-37 was approved by the Commission and adopted in 1994. *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule*, Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)]. The MSRB's pay to play rules include MSRB rules G 37 and G-38. They are available on the MSRB's Web site at http://www.msrb.org/msrb1/rules/ruleg37.htm and http://www.msrb.org/msrb1/rules/ruleg38.htm, respectively.

[31] *See* Proposing Release, at n.23. *See also infra* note 101; Comment Letter of the Municipal Securities Rulemaking Board (Oct. 23, 2009) ("MSRB Letter"); Comment Letter of Common Cause (Oct. 6, 2009) ("Common Cause Letter").

[32] *See* MSRB rule G-37(b). Our proposal, like MSRB rule G-37, was designed to address our concern that pay to play activities were "undermining the integrity" of the relevant market, in particular the market for the provision of investment advisory services to government entity clients. *See Blount*, 61 F.3d at 939 (referring to the MSRB's concerns that pay to play practices were "undermining the integrity of the $250 billion municipal securities market" as its motivation for proposing MSRB rule G-37).

[33] Proposed rule 206(4)-5(a)(1). *See also* MSRB rule G-37(b).

[34] Proposed rule 206(4)-5(a)(2)(ii). *See also* MSRB rule G-37(c).

addition, similar to MSRB rule G-38,[35] our proposed rule would have prohibited the use of third parties to solicit government business.[36] We also proposed amendments to rule 204-2 under the Advisers Act that would have required registered advisers to maintain certain records regarding political contributions and government clients. As discussed in more detail below, our proposed rule departed in some respects from the MSRB rules to reflect differences between advisers and broker-dealers and the scope of the statutory authority we have sought to exercise.

We received some 250 comment letters on our proposal, many of which were from advisers, third-party solicitors, placement agents, and their representatives.[37] Public pension plans and their officials were divided—some embraced the rule, including one that stated that the rule is an important means to "increase transparency and public confidence in the investment activities of all public pension funds,"[38] while others were critical, arguing, for example, that our proposal "may result in unintended hardships being placed upon public pension funds."[39] We received no letters from plan beneficiaries whom we sought to protect with the proposed rule,[40] although two public

[35] *See* MSRB rule G-38(a).

[36] Proposed rule 206(4)-5(a)(2)(i).

[37] Other commenters included pension plans and their officials, trade associations, law firms, and public interest groups. Comments letters submitted in File No. S7-25-06 are available on the Commission's web site at: http://www.sec.gov/comments/s7-18 09/s71809.shtml.

[38] Comment Letter of New York City Comptroller William C. Thompson, Jr. (Oct. 6, 2009)

("Thompson Letter").

[39] Comment Letter of Executive Director and Secretary to the Board of Trustees of the State Retirement and Pension System of Maryland R. Dean Kenderdine (Oct. 5, 2009).

[40] We note, however, that subsequent to our proposal, AFSCME, which represents 1.6 million state and local employees and retirees, issued a report that strongly endorses sanctions to prevent pay to play activities. AFSCME, ENHANCING PUBLIC RETIREE PENSION PLAN SECURITY: BEST PRACTICE POLICIES FOR TRUSTEES AND PENSION

interest groups supported it strongly.[41] Advisers, third-party solicitors and placement agents, fund sponsors, and others whose business arrangements could be affected by the rule generally supported our goal of eliminating advisers' participation in pay to play practices involving public plans.[42] Nonetheless, most of them objected to our adoption under the Advisers Act of a rule similar to MSRB rules G-37 and G-38.[43] Most particularly opposed the proposed prohibition on payments to third parties for soliciting

SYSTEMS (2010), *available at* http://www.afscme.org/docs/AFSCME-report-pension best-practices.pdf.

[41] *See, e.g.*, Common Cause Letter; Comment Letter of Fund Democracy/Consumer Federation of America (Oct. 6, 2009) ("Fund Democracy/Consumer Federation Letter").

[42] *See, e.g.*, Comment Letter of the Investment Adviser Association (Oct. 5, 2009) ("IAA Letter") (noting "support [for] measures to combat pay to play activities, *i.e.*, the practice of investment advisers or their employees making political contributions intended to influence the selection or retention of advisers by government entities. Pay to play practices undermine the principle that advisers are selected on the basis of competence, qualifications, expertise, and experience. The practice is unethical and undermines the integrity of the public pension plan system and the process of selecting investment advisers."); Comment Letter of John R. Dempsey (Aug. 8, 2009) ("Dempsey Letter") (noting applause for efforts "to stop the 'pay-to-play' practice which only serves to undermine public trust in investment advisors and regulators."); Comment Letter of Barry M. Gleicher (Sept. 7, 2009) (noting strong support for the proposal "with no modifications. . . . The Rule is necessary to curb elaborated practices that would deprive taxpayers and beneficiaries of cost effective and honest administration of pension funds"); Tobe Letter.

[43] *See, e.g.*, IAA Letter ("We respectfully submit, however, that the structure of the MSRB

rules is not appropriately tailored to the investment advisory business. . . . We believe the Commission should make significant changes to the Proposal, which would permit it to accomplish its important goals."); Comment Letter of Wesley Ogburn (Aug. 4, 2009) ("Ogburn Letter"); Comment Letter of the Third Party Marketers Association (Aug. 27, 2009) ("3PM Letter"); Comment Letter of Preqin (Aug. 28, 2009) ("Preqin Letter I") (suggesting that institutional private equity investors polled favored a private equity specific proposal rather than relying on the framework from the municipal securities industry); Comment Letter of Dechert LLP (Oct. 22, 2009) ("Dechert Letter"); Comment Letter of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association (Oct. 13, 2009) ("ABA Letter"); Comment Letter of Fidelity Investments (Oct. 7, 2009) ("Fidelity Letter"); Comment Letter of Sutherland Asbill & Brennan LLP (Oct. 6, 2009) ("Sutherland Letter"); Comment Letter of the Investment Company Institute (Oct. 6, 2009) ("ICI Letter"); Comment Letter of the Massachusetts Mutual Life Insurance Company (Oct. 6, 2009) ("MassMutual Letter"); Comment Letter of Skadden, Arps, Slate, Meagher & Flom LLP (Oct. 6, 2009) ("Skadden Letter"); Comment Letter of the Managed Funds Association (Oct. 6, 2009) ("MFA Letter").

or marketing to government entities modeled on MSRB rule G-38.[44] Several urged that, if we were to adopt a rule based on the approach taken in our proposal, we should broaden exceptions and exemptions under the rule to accommodate certain business arrangements.[45] We respond to these comments below.[46]

II. DISCUSSION

As discussed in more detail below, we have decided to adopt rule 206(4)-5, which we have revised to reflect comments we received. For the reasons we discuss above and in the Proposing Release, we believe rule 206(4)-5 is a proper exercise of our rulemaking authority under the Advisers Act to prevent fraudulent and manipulative conduct.

The Commission regulates investment advisers under the Investment Advisers Act of 1940. Section 206(1) of the Advisers Act prohibits an investment adviser from employ[ing] any device, scheme or artifice to defraud any client or prospective client."[47]

[44] *See, e.g.*, Comment Letter of Ounavarra Capital, LLC (Aug. 28, 2009) ("Ounavarra Letter") (noting that banning third-party marketers in the municipal securities industry

did not adversely affect most bankers' ability to conduct basic marketing whereas banning third-party marketers for small advisers could have a stronger impact on advisers that have either no or very limited marketing capability of their own); Comment Letter of MVision Private Equity Advisers USA LLC (Sept. 2, 2009) ("MVision Letter") (arguing that, whereas placement agents for municipal bond offerings are usually regulated entities, the restrictions in the municipal securities arena were targeted at consultants who offer only their contacts and influence with government officials and provided no valuable services to the financial services industry or investors); Comment Letter of Kalorama Capital (Sept. 8, 2009) (arguing that a better analogy, at least with respect to the operation of third-party marketers, is to the licensed professional presenting an IPO to a pension fund). For further discussion of these comments, see section II.B.2(b) of this Release.

[45] *See, e.g.*, Comment Letter of the Committee on Investment Management Regulation and the Committee on Private Investment Funds of the Association of the Bar of the City of New York (Oct. 26, 2009) ("NY City Bar Letter") (arguing that broker-dealer rules have sufficient safeguards and that adopting the proposed pay to play rule will interfere with traditional distribution arrangements); Dechert Letter; Sutherland Letter; MFA Letter.

[46] Particular comments on the various aspects of our proposal are summarized in the corresponding sub-sections of section II of this Release.

[47] 15 U.S.C. 80b-6(1).

Section 206(2) prohibits an investment adviser from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[48] The Supreme Court has construed section 206 as establishing a federal fiduciary standard governing the conduct of advisers.[49]

We believe that pay to play is inconsistent with the high standards of ethical conduct required of fiduciaries under the Advisers Act. We have authority under section 206(4) of the Act to adopt rules "reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative."[50] Congress gave us this authority to prohibit "specific evils" that the broad antifraud provisions may be incapable of covering.[51] The provision thus permits the Commission to adopt prophylactic rules that may prohibit acts that are not themselves fraudulent.[52]

[48] 15 U.S.C. 80b-6(2).

[49] *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

[50] 15 U.S.C. 80b-6(4).

[51] S. REP. NO. 1760, 86th Cong., 2d Sess. 4, 8 (1960). The Commission has used this

authority to adopt seven rules addressing abusive advertising practices, custodial arrangements, the use of solicitors, required disclosures regarding advisers' financial conditions and disciplinary histories, proxy voting, compliance procedures and practices, and deterring fraud with respect to pooled investment vehicles. 17 CFR 275.206(4)-1; 275.206(4)-2; 275.206(4)-3; 275.206(4)-4; 275.206(4)-6; 275.206(4)-7; and 275.206(4) 8.

[52] Section 206(4) was added to the Advisers Act in Pub. L. No. 86-750, 74 Stat. 885, at sec. 9 (1960). *See* H.R. REP. NO. 2197, 86th Cong., 2d Sess., at 7-8 (1960) ("Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit . . . [Section 206(4)] would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of business which are fraudulent, deceptive, or manipulative. This is comparable to Section 15(c)(2) of the Securities Exchange Act [15 U.S.C. 78o(c)(2)] which applies to brokers and dealers."). *See also* S. REP. NO. 1760, 86th Cong., 2d Sess., at 8 (1960) ("This [section 206(4) language] is almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers."). The Supreme Court, in *United States v. O'Hagan*,

Investment advisers that seek to influence the award of advisory contracts by public pension plans, by making political contributions to, or soliciting them for, those officials who are in a position to influence the awards, compromise their fiduciary obligations to the public pension plans they advise and defraud prospective clients.[53] In making such contributions, the adviser hopes to benefit from officials who "award the contracts on the basis of benefit to their campaign chests rather than to the governmental entity"[54] or by retaining a contract that might otherwise not be renewed. If pay to play is a factor in the selection or retention process, the public pension plan can be harmed in interpreted nearly identical language in section 14(e) of the Securities Exchange Act [15 U.S.C. 78n(e)] as providing the Commission with 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.'" *United States v. O'Hagan*, 521 U.S. 642, 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Securities Exchange Act. *See also Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] (stating, in connection with the suggestion by commenters that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under a particular rule, "We believe our authority is broader. We do not believe that the commenters' suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors.").

[53] *See* Proposing Release, at section I; *Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999) [64 FR 43556 (Aug. 10, 1999)] ("1999 Proposing Release"). As a fiduciary, an adviser has a duty to deal fairly with clients and prospective clients, and must make full disclosure of any material conflict or potential conflict. *See, e.g.*, *Capital Gains Research Bureau*, 375 U.S. at 189, 191-92; *Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)]. Most public pension plans establish procedures for hiring investment advisers, the purpose of which is to obtain the best possible management services. When an adviser makes political contributions for the purpose of influencing the selection of the adviser to advise a public pension plan, the adviser seeks to interfere with the merit-based selection process established by its prospective clients—the public pension plan. The contribution creates a conflict of interest between the adviser (whose interest is in being selected) and its prospective client (whose interest is in obtaining the best possible management services).

[54] *See Blount*, 61 F.3d at 944-45.

several ways. The most qualified adviser may not be selected or retained, potentially leading to inferior management or performance. The pension plan may pay higher fees because advisers must recoup the contributions, or because contract negotiations may not occur on an arm's-length basis. The absence of arm's-length negotiations may enable advisers to obtain greater ancillary benefits, such as "soft dollars," from the advisory relationship, which might be used for the benefit of the adviser, potentially at the expense of the pension plan, thereby using the pension plan's assets for the adviser's own purposes.[55]

As we discuss above, pay to play practices are rarely explicit and often hard to prove.[56] In particular, when pay to play involves granting of government advisory business in exchange for political contributions, it may be difficult to prove that an adviser (or one of its executives or employees) made political contributions for the purpose of obtaining the government business, or that it engaged a solicitor for his or her political influence rather than substantive expertise.[57] Pay to play practices by advisers to public pension plans, which may generate significant contributions for elected officials and yield lucrative management contracts for advisers, will not stop through voluntary efforts. This is, in part, because these activities create a "collective action" problem in

[55] *Cf. In re Performance Analytics, et al.*, Investment Advisers Act Release No. 2036 (June 17, 2002) (settled enforcement action in which an investment consultant for a union pension fund entered into a $100,000 brokerage arrangement with a soft dollar component in which the investment consultant would continue to recommend the investment adviser to the pension fund as long as the investment adviser sent its trades to one particular broker-dealer).

[56] *Cf. Blount*, 61 F.3d at 945 ("no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic").

[57] *See id.* at 944 ("actors in this field are presumably shrewd enough to structure their relations rather indirectly").

two respects.[58] First, government officials who participate may have an incentive to continue to accept contributions to support their campaigns for fear of being disadvantaged relative to their opponents. Second, advisers may have an incentive to participate out of concern that they may be overlooked if they fail to make contributions.[59] Both the stealth in which these practices occur and the inability of markets to properly address them argue strongly for the need for us to adopt the type of prophylactic rule that section 206(4) of the Advisers Act authorizes.

A. First Amendment Considerations

The Commission believes that rule 206(4)-5 is a necessary and appropriate measure to prevent fraudulent acts and practices in the market for the provision of investment advisory services to government entities by prohibiting investment advisers from engaging in pay to play practices. We have examined a range of alternatives to our proposal, carefully considered some 250 comments we received on the proposal and made revisions to the proposed rule where we concluded it was appropriate. We believe the rule represents a balanced response to the developments we discuss above regarding pay to play activities occurring in the market for government investment advisory services. The rule provides specific prohibitions to help ensure that adviser selection is based on the merits, not on the amount of money given to a particular candidate for

[58] Collective action problems exist, for example, where participants may prefer to abstain from an unsavory practice (such as pay to play), but nonetheless participate out of concern that, even if they abstain, their competitors will continue to engage in the practice profitably and without adverse consequences. As a result, collective action problems, such as those raised by pay to play practices, call for a regulatory response. For further discussion, *see infra* note 459 and accompanying text.

[59] In our view, the collective action problem we are trying to address is analogous to the one noted in the case upholding MSRB rule G-37. *See Blount*, 61 F.3d at 945 ("Moreover, there appears to be a collective action problem tending to make the misallocation of resources persist"). For a discussion of concerns raised regarding our proposed rule that are similar to those raised regarding MSRB rule G-37, see section II.A of this Release.

office, while respecting the rights of industry participants to participate in the political process. The rule is not unique; Congress, for instance, has barred federal contractors from making contributions to public officials.[60]

Before we address particular aspects of the rule, we would like to respond to commenters' assertions that the fact that the rule's limitations on compensation are triggered by political contributions represents an infringement on the First Amendment guarantees of freedom of speech and association.[61] These commenters acknowledge that selection of an investment adviser by a government entity should not be a "pay back" for political contributions, but argue that the rule impermissibly restricts the ability of advisers and certain of their employees to demonstrate support for state and local officials.

The Commission is sensitive to, and has carefully considered, these constitutional concerns in adopting the rule. Though it is not a ban on political contributions or an attempt to regulate state and local elections, we acknowledge that the two-year time out provision may affect the propensity of investment advisers to make political contributions. Although political contributions involve both speech and associational rights protected by the First Amendment, a "limitation upon the amount that any one person or group may contribute to a candidate or political committee entails only a

[60] 2 U.S.C. 441c.

[61] *See, e.g.*, Comment Letter of W. Hardy Callcott (Aug. 3, 2009) ("Callcott Letter I"); Comment Letter of W. Hardy Callcott (Jan. 21, 2010) ("Callcott Letter II"); Comment Letter of the National Association of Securities Professionals, Inc. (Oct. 6, 2009) ("NASP Letter"); Comment Letter of Caplin & Drysdale, Chartered (Oct. 6, 2009) ("Caplin & Drysdale Letter"); Comment Letter of the Securities Industry and Financial Markets Association (Oct. 5, 2009) ("SIFMA Letter"); ABA Letter; Sutherland Letter; Comment Letter of IM Compliance LLC (Oct. 6, 2009) ("IM Compliance Letter"); Comment Letter

of the American Bankers Association (Oct. 6, 2009) ("American Bankers Letter").

marginal restriction upon the contributor's ability to engage in free communication."[62] Limitations on contributions are permissible if justified by a sufficiently important government interest that is closely drawn to avoid unnecessary abridgment of protected rights.[63]

Prevention of fraud is a sufficiently important government interest. [64] We believe that payments to state officials as a *quid pro quo* for obtaining advisory business as well as other forms of "pay to play" violate the antifraud provisions of section 206 of the Advisers Act. As discussed in our Proposing Release, "pay to play" arrangements are inconsistent with an adviser's fiduciary obligations, distort the process by which investment advisers are selected, can harm advisers' public pension plan clients and the beneficiaries of those plans, and can have detrimental effects on the market for investment advisory services.[65] The restrictions inherent in rule 206(4)-5 are in the

[62] *Buckley v. Valeo*, 424 U.S. 1, 20 (1976). *See also SpeechNow.org, et al. v. FEC*, 599 F.3d 686 (D.C. Cir. 2010); *McConnell v. FEC*, 540 U.S. 93, 135-36 (2003).

[63] *Buckley*, 424 U.S. at 25. *See also FEC v. Wisconsin Right to Life, Inc.*, 551 U.S. 449 (2007); *Republican Nat'l Comm. v. FEC,* No. 08-1953, 2010 U.S. Dist. LEXIS 29163 (D.D.C. Mar. 26, 2010) (three judge panel). This standard is lower than the strict scrutiny standard employed in reviewing such forms of expression as independent expenditures. Under the higher level of scrutiny, a restriction must be narrowly tailored to serve a compelling governmental interest. *Blount,* 61 F.3d at 943. *See also Citizens United v. FEC*, 130 S. Ct. 876 (2010) (distinguishing restrictions on "independent expenditures" from restrictions on "direct contributions" and leaving restrictions on direct contributions untouched while striking down a restriction on independent expenditures as unconstitutional). We note that in *Blount,* 61 F.3d at 949, the court upheld MSRB rule G 37 even assuming that strict scrutiny applied. For the reasons stated by the court in that decision, we believe that Rule 206(4)-5 would be upheld under a strict scrutiny standard as well as under the standard the Supreme Court has applied to contribution restrictions.

[64] *Blount,* 61 F.3d at 944.

[65] *See* Proposing Release, at section I. The prohibitions on solicitation and coordination of

campaign contributions are justified by the same overriding purposes which support the two-year time out provisions. The provisions are intended to prevent circumvention of the time out provisions in cases where an investment adviser has or is seeking to establish a business relationship with a government entity. Absent these restrictions, solicitation and coordination of contributions could be used as effectively as political contributions to

nature of conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries.[66] Pursuant to our authority under section 206(4) of the Advisers Act, which we discuss above, we may adopt rules that are reasonably designed to prevent such acts, practices and courses of business.

As detailed in the following pages, we have closely drawn rule 206(4)-5 to accomplish its goal of preventing *quid pro quo* arrangements while avoiding unnecessary burdens on the protected speech and associational rights of investment advisers and their covered employees. The rule is therefore closely drawn in terms of the conduct it prohibits, the persons who are subject to its restrictions, and the circumstances in which it is triggered. The United States Court of Appeals for the District of Columbia Circuit upheld the similarly designed MSRB rule G-37 in *Blount v. SEC*. [67] Indeed, the *Blount* opinion has served as an important guidepost in helping us shape our rule.[68]

distort the adviser selection process. The solicitation and coordination restrictions relate only to fundraising activities and would not prevent advisers and their covered employees from expressing support for candidates in other ways, such as volunteering their time.

[66] *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule*

Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule, Exchange Act Release No. 33868 (Apr. 7, 1994) [59 FR 17621 (Apr. 13, 1994)] (noting, in connection with the Commission's approval of MSRB rule G-37, that the restrictions inherent in that pay to play rule "are in the nature of conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries.").

[67] 61 F.3d at 947-48.

[68] Notwithstanding the *Blount* decision, some commenters asserted that subsequent

Supreme Court jurisprudence, including *Randall v. Sorrell,* 548 U.S. 230 (2006), and *Citizens United*, 130 S. Ct. 876 (decided following the closing of the comment period for rule 206(4)-5), would result in the proposed rule being found unconstitutional because it is not narrowly tailored to advance the Commission's interests in addressing pay to play by investment advisers. *See, e.g.*, Callcott Letter I; Callcott Letter II; NASP Letter; American Bankers Letter. We disagree. The cases cited by commenters are distinguishable. *Citizens United* deals with certain independent expenditures (rather than contributions to candidates), which are not implicated by our rule. *Randall* involved a

First, the rule is limited to contributions to officials of government entities who can influence the hiring of an investment adviser in connection with money management mandates.[69] These restrictions are triggered only in situations where a business relationship exists or will be established in the near future between the investment adviser and a government entity.[70]

Second, the rule does not in any way impinge on a wide range of expressive conduct in connection with elections. For example, the rule imposes no restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches, and other conduct.[71]

generally applicable state campaign finance law limiting overall contributions (and expenditures), which the Court feared would disrupt the electoral process by limiting a candidate's ability to amass sufficient resources and mount a successful campaign. *Randall*, 548 U.S. at 248-49. By contrast, our rule is not a general prohibition or limitation, but rather is a focused effort to combat *quid pro quo* payments by investment advisers seeking governmental business. Comparable restrictions targeted at a particular industry have been upheld under *Randall* because the loss of contributions from such a small segment of the electorate "would not significantly diminish the universe of funds available to a candidate to a non-viable level." *Green Party of Conn. v. Garfield*, 590 F. Supp. 2d 288, 316 (D. Conn. 2008). *See also Preston v. Leake*, 629 F. Supp. 2d 517, 524 (E.D.N.C. 2009) (differentiating the "broad sweep of the Vermont statute" that "restricted essentially any potential campaign contribution" from a statute that "only applies to lobbyists"); *In re Earle Asphalt Co*., 950 A.2d 918, 927 (N.J. Super. Ct. App. Div. 2008), *aff'd* 957 A.2d 1173 (N.J. 2008) (holding that a limitation on campaign contributions by government contractors and their principals did not have the same capacity to prevent candidates from amassing the resources necessary for effective campaigning as the statute in *Randall*). One commenter expressly dismissed arguments that *Randall* would have implications for the Commission's proposed rule. Fund Democracy/Consumer Federation Letter.

[69] *See* section II.B.2(a)(2) of this Release (discussing the definition of "official" of a government entity for purposes of rule 206(4)-5).

[70] *See* section II.B.2(a)(1) of this Release (discussing the prohibition on compensation for providing advisory services to the client during rule 206(4)-5's two-year time out).

[71] *See Citizens United*, 130 S. Ct. at 908-09 (noting that a government interest cannot be sufficiently compelling to limit independent expenditures by corporate entities). *See also SpeechNow.org*, 599 F.3d at 692 (spelling out the different standards of constitutional review established by the Supreme Court for restrictions on independent expenditures and direct contributions). Some commenters expressed concern, for example, that rule 206(4)-5 may quell volunteer activities, deter employees of investment

Third, it does not prevent anyone from making a contribution to any candidate, as covered employees may contribute $350 to candidates for whom they may vote, and $150 to other candidates. A limitation on the amount of a contribution involves little direct restraint on political communication, because a person may still engage in the symbolic expression of support evidenced by a contribution.[72] Furthermore, the rule takes the form of a restriction on providing compensated advisory business following the making of contributions rather than a prohibition on making contributions in excess of the relevant ceilings.[73]

Fourth, the rule only applies to investment advisers that are registered with us,[74] or unregistered in reliance on section 203(b)(3) of the Advisers Act, that have (or that are seeking) government clients.[75] It applies only to the subset of the significantly broader advisers from running for office, or chill charitable contributions. *See, e.g.*, Caplin & Drysdale Letter; NASP Letter. We have expressly clarified that volunteer activities and charitable contributions generally would not trigger the rule's time out provision and that employees running for office would not be subject to the contribution limitation. *See infra* notes 157 and 139, respectively.

[72] *Buckley*, 424 U.S. at 21. *See also* section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to covered associates' contributions triggering the two-year time out). Some commenters raised constitutional concerns regarding the levels of the *de minimis* exception in our proposal. *See, e.g.*, Callcott Letter I; Callcott Letter II; Caplin & Drysdale Letter; IM Compliance Letter; Sutherland Letter. As discussed below, we have both raised the amount of the *de minimis* exception in line with inflation and added an additional exception.

[73] *See* section II.B.2(a)(1) of this Release (discussing the two-year time out on receiving compensation for advisory services).

[74] Unless indicated expressly otherwise, each time we refer to a "registered" investment adviser in this Release, we mean an adviser registered with the Commission.

[75] *See* section II.B.1 of this Release (discussing advisers covered by the rule). One commenter raised constitutional concerns by arguing that the rule would apply beyond the advisory business of an adviser that solicits government clients, no matter how separate the other product or service offerings of the adviser are from the governmental business. ABA Letter. But we believe we have made clear that the rule's time out provisions, which are designed to eliminate *quid pro quo* arrangements and ameliorate market distortions, apply only with respect to the provision of advisory services to

set of advisers over which we have antifraud authority that we believe are most likely to be engaged by government clients to manage public assets either directly or though investment pools.[76]

Finally, the rule is not a restriction on contributions that is applicable to the public and is not intended to eliminate corruption in the electoral process. Rather, it is focused exclusively on conduct by professionals subject to fiduciary duties, seeking profitable business from governmental entities. The rule is targeted at those employees of an adviser whose contributions raise the greatest danger of *quid pro quo* exchanges,[77] and it covers only contributions to those governmental officials who would be the most likely targets of pay to play arrangements because of their authority to influence the award of advisory business.[78]

B. Rule 206(4)-5

We are today adopting new rule 206(4)-5 under the Advisers Act that is designed to protect public pension plans and other government investors from the consequences of pay to play practices by deterring advisers' participation in such practices.[79] As we noted

government clients, which is consistent with our authority under the Advisers Act. *See* section II.B.2(a)(1) of this Release.

[76] *See* section II.B.1 of this Release.

[77] *See* section II.B.2(a)(4) of this Release (discussing the definition of "covered associates," whose contributions could trigger the two-year time out).

[78] *See* section II.B.2(a)(2) of this Release (discussing the definition of "official" of a government entity for purposes of the rule 206(4)-(5)). Some commenters argued that the definition of "official" we included in our proposal was ambiguous. *See, e.g.*, Caplin & Drysdale Letter. In response, we have provided additional guidance. *See* section II.B.2(a)(2) of this Release.

[79] Rule 206(4)-5 is targeted to a concrete business relationship between contributors and candidates' governmental entities. It is not intended to restrict the voices of persons and interest groups, reduce the overall scope of election campaigns, or equalize the relative ability of all votes to affect electoral outcomes. Indeed, if investment advisers do not seek government business from those to whom they and their covered associates make

in the Proposing Release, advisers and government officials might, in order to circumvent our rule, attempt to structure their transactions in a manner intended to hide the true purpose of a contribution or payment.[80] Therefore, our pay to play restrictions are intended to capture not only direct political contributions by advisers, but also other ways that advisers may engage in pay to play arrangements. Rule 206(4)-5 prohibits several principal avenues for pay to play activities.

First, the rule makes it unlawful for an adviser to receive compensation for providing advisory services to a government entity for a two-year period after the adviser or any of its covered associates makes a political contribution to a public official of a government entity or candidate for such office who is or will be in a position to influence the award of advisory business.[81] Importantly, as we noted in the Proposing Release, rule 206(4)-5 would not ban or limit the amount of political contributions an adviser or its covered associates could make; rather, it would impose a two-year time out on conducting compensated advisory business with a government client after a contribution

contributions or for whom they solicit contributions, the rule's limitations will not be triggered. Rather, the rule is intended to prevent direct *quid pro quo* arrangements, fraudulent and manipulative acts and practices, and improve the mechanism of a free and open market for investment advisory services for government entity clients. With pay to play activities, the conflict of interest is apparent, the likelihood of stealth in the arrangements is great, and our regulatory purpose is prophylactic. *See Blount*, 61 F.3d at 945 (describing the court's similar characterization of MSRB rule G-37).

[80] Proposing Release, at section II.A.

[81] Rule 206(4)-5(a)(1) makes it unlawful for any investment adviser covered by the rule 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, as defined in the rule, of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made). As noted below, an "official" includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has the authority to appoint any person who is directly or indirectly responsible for or can influence the outcome of the hiring of an investment adviser. *See* section II.B.2(a)(2) of this Release.

is made.[82] This first prohibition is substantially similar to our proposal. However, as discussed below, we have made certain modifications to some of the definitions of terms in this prohibition.[83]

Second, the rule generally prohibits advisers 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.[84] That is, an adviser is prohibited from providing or agreeing to provide, directly or indirectly, payment to any person for solicitation of government advisory business on behalf of such adviser unless that person is registered with us and subject to pay to play restrictions either under our rule or the rules of a registered national securities association.[85] This represents a modification from our proposal, which included a flat ban without an exception for any brokers or investment advisers.[86] As discussed below,

[82] Proposing Release, at section II.A.

[83] *See generally* section II.B.2(a) of this Release.

[84] Rule 206(4)-5(a)(2)(i) makes it unlawful for any investment adviser covered by the rule

> and its covered associates (as defined in the rule) to provide or agree to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless such person is a regulated person or is an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the investment adviser.

"Regulated person" is defined in rule 206(4)-5(f)(9). *See* section II.B.2(b) of this Release for a discussion of this definition.

[85] *See* section II.B.2(b) of this Release. While our rule would apply to any registered national securities association, the Financial Industry Regulatory Authority, or FINRA, is currently the only registered national securities association under section 19(a) of the Exchange Act [15 U.S.C. 78s(b)]. As such, for convenience, we will refer directly to FINRA in this Release when describing the exception for certain broker-dealers from the rule's ban on advisers paying third parties to solicit government business on their behalf. The Commission's authority to consider rules proposed by a registered national securities association is governed by section 19(b) of the Exchange Act [15 U.S.C. 78s(b)] ("No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.").

[86] *See* Proposing Release, at section II.A.3(b).

commenters persuaded us that the objective of the rule in eliminating pay to play activities of advisers could be preserved if the third parties they hire are themselves registered investment advisers subject to Commission oversight or are broker-dealers subject to pay to play restrictions imposed by a registered national securities association that the Commission must approve.

Third, the rule makes it unlawful for an adviser itself or any of its covered associates to solicit or to coordinate: (i) contributions to an official of a government entity to which the investment adviser is seeking to provide investment advisory services; or (ii) payments to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.[87] We are adopting this aspect of the rule as proposed.

Fourth, as it is not possible for us to anticipate all of the ways advisers and government officials may structure pay to play arrangements to attempt to evade the prohibitions of our rule, the rule includes a provision that makes it unlawful for an adviser or any of its covered associates to do anything indirectly which, if done directly, would result in a violation of the rule.[88] This provision in the rule we are adopting today is identical to our proposal.[89]

[87] Rule 206(4)-5(a)(2)(ii) makes it unlawful for any investment adviser covered by the rule

> and its covered associates to coordinate, or to solicit any person [including a political action committee] to make, any: (A) contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or (B) payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity. *See* section II.A.2.(c) of this Release.

[88] Rule 206(4)-5(d) makes it unlawful for any investment adviser covered by the rule and its covered associates to do anything indirectly which, if done directly, would result in a violation of this section. *See* section II.B.2(d) of this Release.

[89] *See* Proposing Release, at section II.A.3(d).

Finally, for purposes of our rule, an investment adviser to certain pooled investment vehicles in which a government entity invests or is solicited to invest will be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity.[90] This provision is substantially similar to our proposal, although we have made certain modifications described below.[91]

1. Advisers Subject to the Rule

Rule 206(4)-5 applies to registered investment advisers and certain advisers exempt from registration. In particular, it applies to any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b 3(b)(3)).[92] The rule would not, however, apply to most small advisers that are registered with state securities authorities instead of the Commission,[93] or advisers that are unregistered in reliance on exemptions other than section 203(b)(3) of the Advisers Act.[94]

[90] Rule 206(4)-5(c) states that, for purposes of rule 206(4)-5, an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest, shall be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity. See section II.B.2(e) of this Release.

[91] *See* section II.B.2(e) of this Release.

[92] Rule 206(4)-5(a)(1) and (2). Section 203(b)(3) [15 U.S.C. 80b-3(b)(3)] exempts from registration any investment adviser that is not holding itself out to the public as an

investment adviser and had fewer than 15 clients during the last 12 months. We are including this category of exempt advisers within the scope of the rule in order to make the rule applicable to the many advisers to private investment companies that are not registered under the Advisers Act.

[93] Advisers with less than $25 million of assets under management are prohibited from registering with the Commission by section 203A of the Advisers Act [15 U.S.C. 80b 3A].

[94] The rule would also not apply to certain other advisers that are exempt from registration with the Commission. *See, e.g.*, section 203(b)(1) of the Advisers Act [15 U.S.C. 8b 3(b)(1)] (exempting from registration intrastate investment advisers). As explained in the Proposing Release, we believe these advisers are unlikely to advise public pension plans.

We received limited comment on this aspect of the rule. One commenter explicitly agreed with the scope of our proposed rule, noting that it would capture most, if not all, advisers that provide discretionary management with respect to public pension fund assets, regardless of whether they are registered.[95] Other commenters recommended that the rule apply more broadly to all advisers that may manage assets of government entities.[96] The primary effect of such an expansion of the rule would be to apply it to smaller firms, the regulatory responsibility for which Congress has previously allocated to the state securities authorities.[97] It is our understanding that few of these firms manage public pension plans or other public funds.[98] Accordingly, we have decided to adopt this provision as proposed.

See Proposing Release, at n.64 and accompanying text. The rule would also not apply to persons who are excepted from the definition of investment adviser under section 202(a)(11) of the Advisers Act [15 U.S.C. 80b-2(a)(11)]. For a discussion, in particular, of the exclusion of banks and bank holding companies which are not investment companies from the Advisers Act's definition of "investment adviser," see *infra* note 274.

[95] Comment Letter of the California Public Employees' Retirement System (Oct. 6, 2009) ("CalPERS Letter") ("CalPERS agrees that the scope of the proposed rule would capture most if not all external managers who have discretion over the investment of public pension fund assets, including hedge fund managers, real estate managers, private equity managers, traditional long-only managers, money managers, and others, regardless of

whether the managers are registered investment advisors. CalPERS supports application of the rule to investment advisers, as defined in the proposed rule.").

96 These suggestions included applying the rule to all registered (including SEC-registered and state-registered) and unregistered advisers (*see, e.g.*, 3PM Letter (arguing that selective application of the rule could lead to convoluted organizational structures designed to bypass its reach and that the proposal represents the kind of patchwork regulation that will lead to the kind of inconsistency the Commission is seeking to correct), and extending the rule to state-registered advisers (*see, e.g.*, Comment Letter of the Cornell Securities Law Clinic (Oct. 6, 2009) ("Cornell Law Letter")).

97 Amendments to the Advisers Act in 1996 placed the regulatory responsibility for these advisers in the hands of state regulators. *See* section 203A of the Advisers Act [15 U.S.C. 80b-3a] enacted as part of Title III of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

98 *See* Proposing Release, at n.64. We did not receive any comment challenging our understanding.

2. Pay to Play Restrictions

(a) Two-Year "Time Out" for Contributions

Rule 206(4)-5(a)(1) prohibits investment advisers from receiving compensation for providing advice to a "government entity" within two years after a "contribution" to an "official" of the government entity has been made by the investment adviser or by any of its "covered associates."[99] The rule does not ban political contributions and does not limit the amount of any political contribution. Instead, the rule imposes a ban—a "time out"—on receiving compensation for conducting advisory business with a government client for two years after certain contributions are made. The two-year time out is intended to discourage advisers from participating in pay to play practices by requiring a "cooling-off period" during which the effects of a political contribution on the selection process can be expected to dissipate.

Rule 206(4)-5(a)(1) is based largely on MSRB rule G-37 under which a broker dealer is prohibited from engaging in the municipal securities business for two years after making a political contribution.[100] As noted above and as explained in the Proposing Release, we modeled the rule on the MSRB rules because we believe that they have significantly curbed pay to play practices in the municipal securities market.[101] We also

[99] Rule 206(4)-5(a)(1).

[100] Proposing Release, at section II.A.2.

[101] *See id.* at n.23 (citing others, including the MSRB, who agree that the MSRB rules have been effective: MSRB, *MSRB Notice 2009-62, Amendments Filed to Rule G-37 Regarding Contributions to Bond Ballot Campaigns* (Dec. 4, 2009), *available at* http://msrb.org/msrb1/archive/2009/2009-62.asp ("Rule G-37, in effect since 1994, has provided substantial benefits to the industry and the investing public by greatly reducing the direct connection between political contributions given to issuer officials and the awarding of municipal securities business to brokers, dealers and municipal securities dealers ("dealers"), thereby effectively assisting with eliminating pay-to-play practices in the new issue municipal securities market."); MSRB, *MSRB Notice 2009-35, Request for Comment: Rule G-37 on Political Contributions and Prohibitions on Municipal*

pointed out that our approach would minimize the compliance burdens on firms that would be subject to both rule regimes. But we requested comment on our proposed approach and whether alternative models might be appropriate.

Several commenters supporting the rule explicitly addressed the appropriateness of the MSRB approach. One, for example, asserted that the proposed rule "appropriately expands upon MSRB G-37 and G-38."[102] Another agreed that the MSRB rules "provide an appropriate regulatory analogy for addressing [pay to play] issues."[103] Many other commenters, however, sought to distinguish advisers and municipal securities dealers, and asserted that, because of the differences between the two, MSRB rule G-37 is an

Securities Business – Bond Ballot Campaign Committee Contributions (June 22, 2009) ("The MSRB believes the rule has provided substantial benefits to the industry and the investing public by greatly reducing the direct connection between political contributions given to issuer officials and the awarding of municipal securities business to dealers, thereby effectively eliminating pay-to-play practices in the new issue municipal securities market." [footnote omitted]); MSRB, *MSRB Notice 2003-32, Notice Concerning Indirect Rule Violations: Rules G-37 and G-38* (Aug. 6, 2003) ("The impact of Rules G-37 and G 38 has been very positive. The rules have altered the political contribution practices of municipal securities dealers and opened discussion about the political contribution practices of the entire municipal industry."); Letter from Darrick L. Hills and Linda L. Rittenhouse of the CFA Institute to Jill C. Finder, Asst. Gen. Counsel of the MSRB (Oct. 19, 2001), *available at* http://www.cfainstitute.org/Comment%20Letters/20011019.pdf (stating, "We generally believe that the existing [MSRB] pay-to-play prohibitions have been effective in stemming practices that compromise the integrity of the [municipal securities] market by using political contributions to curry favor with politicians in positions of influence."); COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (stating, upon describing MSRB Rule G-37 and the 2005 amendments to MSRB Rule G-38, "Taken together, the MSRB's rules have largely put an end to the old "pay to play" practices in municipal underwriting.")). *See also* Comment letter of Professors Alexander W. Butler, Larry Fauver and Sandra Mortal (Sept. 30, 2009) ("Butler Letter") (citing Alexander W. Butler, Larry Fauver & Sandra Mortal*, Corruption, Political Integrity, and Municipal Finance*, 22 R. OF FIN. STUD. 2673-705 (2009)).

[102] Common Cause Letter.

[103] Comment Letter of Credit Suisse Securities (USA) LLC (Sept. 14, 2009) ("Credit Suisse Letter").

inappropriate model on which to base an investment adviser pay to play rule.[104] Some argued that the long-term nature of advisory relationships is fundamentally different from discrete municipal underwriting transactions, and consequently, the two-year time out is more disruptive and severe for advisers and the governments that retain them than for municipal securities dealers who are simply banned from obtaining "new" business as opposed to terminating a long-term relationship.[105] Some commenters asserted that the relationships are different because advisers provide ongoing and continuous advice as a fiduciary, rather than a one-time transaction such as an underwriting, and that advisory services are typically subject to an open competitive bid process instead of through negotiated transactions that are typical of municipal underwritings.[106]

We disagree that the differences between municipal securities underwriting and money management are sufficient to warrant an alternative approach. Commenters are correct that municipal securities underwriters provide episodic services rather than ongoing services often provided by money managers. But underwriters seek to provide

[104] *See, e.g.*, IAA Letter; ICI Letter; SIFMA Letter; ABA Letter; Dechert Letter; Skadden Letter; Comment Letter of Jones Day (Oct. 5, 2009) ("Jones Day Letter"); Comment Letter of Simpson Thacher & Bartlett LLP on behalf of Park Hill Group LLC and its affiliates (Sept. 21, 2009) ("Park Hill Letter"); Comment Letter of Monument Group, Inc. (Sept. 18, 2009) ("Monument Group Letter"). One commenter suggested, in particular, that the rule's two-year time out provision is outside of our authority because it imposes an "automatic penalty, subject only to discretionary post facto review." Comment Letter of Edwin C. Laurenson (Dec. 31, 2009). We disagree. The two-year time out is not a penalty. Rather, it is a "cooling-off period" to dissipate any effects of a *quid pro quo*. A violation of the provision would result from receiving, or continuing to receive, payment after making the contribution, not from the making of the contribution itself.

[105] *See, e.g.*, IAA Letter; ABA Letter; Dechert Letter; Skadden Letter; Jones Day Letter; Park Hill Letter; Monument Group Letter. *But see* Credit Suisse Letter ("G-37 and G-38 provide an appropriate regulatory analogy"); Butler Letter ("This practice [municipal underwriting pay to play] was analogous to the type of pay to play currently under consideration by the Commission").

[106] *See, e.g.*, IAA Letter; ICI Letter; SIFMA Letter; ABA Letter; Dechert Letter; Skadden Letter; Jones Day Letter; Park Hill Letter; Monument Group Letter.

repeated, if not ongoing, services, and the imposition of a two-year time out can have considerable competitive consequences to a broker-dealer whose government client must employ the services of a competitor whose services it may continue to employ after MSRB rule G-37's two-year time out has run its course. That advisers are in a fiduciary relationship with their public pension plan clients argues for at least as significant consequences for participation in pay to play practices that can harm these clients.

Our decision to adopt a rule based on the MSRB model is influenced primarily by our judgment that the MSRB rules have significantly curbed pay to play practices in the municipal securities market[107] and that alternative approaches, including those suggested by commenters, would fail to provide an adequate deterrent to pay to play activities. We considered each of the principal suggestions offered by commenters.

Some commenters suggested requiring advisers to disclose their contributions to state and local officials.[108] Statutes requiring disclosure of political contributions are, in part, designed to inform voters about a candidate's financial supporters; an informed electorate can then use the information to vote for or against a candidate.[109] But voters' possible reactions, if any, to such disclosure would not necessarily resolve the concerns we are trying to address in this rulemaking. Our concern is protecting advisory clients and investors whom we have the responsibility to protect under the Advisers Act—

[107] *See supra* notes 31 and 101 and accompanying text.

[108] *See, e.g.*, SIFMA Letter; Preqin Letter I; Comment Letter of Triton Pacific Capital, LLC (Sept. 1, 2009) ("Triton Pacific Letter"); Comment Letter of the State Association of County Retirement Systems (Sept. 8, 2009); Comment Letter of CapLink Partners (Sept. 9, 2009) ("CapLink Letter"); Comment Letter of Parenteau Associates, LLC (Aug. 7, 2009) ("Parenteau Letter").

[109] *See Buckley*, 424 U.S. at 67 (1976) (noting that campaign financing disclosure requirements "deter actual corruption and avoid the appearance of corruption by exposing large contributions and expenditures to the light of publicity").

namely, the public pension plans and their beneficiaries who are affected by pay to play practices.[110] Disclosure to a plan's trustees might be insufficient where the trustee (particularly a sole trustee) has received the contributions and is presumably well aware of the conflicts involved. Moreover, and as we pointed out in the Proposing Release, requiring advisers to disclose political contributions to beneficiaries would be unlikely to protect them since most cannot act on the information by moving their pension assets to a different plan or by reversing the plan trustees' adviser hiring decisions.[111] Not all beneficiaries may be entitled to vote (or withhold their vote) for the official to whom a contribution was made, and those that are may need to wait a substantial period of time until a future election to exercise their vote. Further, as beneficiaries may constitute only a small proportion of the electorate, they may not be able to influence an election; therefore, reliance on the electoral process may be insufficient to protect government plans and their beneficiaries from pay to play. In addition, even if the fact of a contribution is disclosed (which is required in many states), the contribution's true purpose is unlikely to be disclosed.

Several commenters suggested that the Commission adopt a requirement that an adviser include in its code of ethics[112] a policy that prohibits contributions made for the

[110] As discussed above, our purposes in this rulemaking are preventing fraud, protecting investors and maintaining the integrity of the adviser selection process, not campaign finance reform. *See* section I of this Release.

[111] *See* Proposing Release, at section II.A.2. Some commenters made the same points. *See, e.g.*, NY City Bar Letter; Cornell Law Letter; 3PM Letter. *See also Blount*, 61 F.3d at 947 (explaining, in the context of the municipal securities industry, the potential inadequacy of disclosure to address pay to play concerns, that "disclosure would not likely cause market forces to erode 'pay to play . . .'" because the ". . . purpose of protecting the integrity of the market [would] . . . 'be achieved less effectively.'").

[112] Registered investment advisers are required to have codes of ethics under the Advisers Act. *See* Advisers Act rule 204A-1.

purpose of influencing the selection of the adviser.[113] Several commenters recommended, similarly, that we require advisers to adopt policies and procedures[114] reasonably designed to prevent and detect contributions designed to influence the selection of an adviser.[115] Many of these commenters suggested that preclearance of employee contributions could be required under an adviser's code of ethics or compliance policies and procedures.[116] One commenter asserted that an advantage of this approach is that it would allow an adviser to customize sanctions based on the severity of the violation.[117]

We do not, however, believe that codes of ethics or compliance procedures alone would be adequate to stop pay to play practices, particularly when the adviser or senior officers of the adviser are involved either directly or indirectly. First, it is those senior officers who, as noted below, have the greatest incentives to engage in pay to play and therefore are most likely to make contributions, who would themselves ultimately be responsible for enforcing *their own* compliance with the firm's ethics code or compliance procedures. Second, violations of codes of ethics or compliance procedures do not themselves establish violations of the federal securities laws. Moreover, the comments suggesting these alternatives would have us require the codes or procedures be designed to prevent or detect contributions *intended to influence* the selection of the adviser by a

[113] *See, e.g.*, IAA Letter; ABA Letter; Comment letter of the National Society of Compliance Professionals, Inc. (Oct. 6, 2009) ("NSCP Letter"); NY City Bar Letter; Fidelity Letter.

[114] Registered investment advisers are required to adopt and implement policies and procedures reasonably designed to prevent violation by the adviser or its supervised persons of the Advisers Act and the rules the Commission has adopted thereunder. *See* Advisers Act rule 206(4)-7.

[115] *See, e.g.*, ABA Letter; NY City Bar Letter; IAA Letter; ICI Letter; NSCP Letter.

[116] *See, e.g.*, IAA Letter; NY City Bar Letter; ABA Letter.

[117] ABA Letter.

government entity. As discussed extensively above and in our Proposing Release, pay to play is an area in which intent is often very difficult to prove, and is often hidden in the guise of legitimate conduct.[118] Political contributions are made ostensibly to support a candidate; the burden on a regulator or prosecutor of proving a different intent presents substantial challenges absent unusual evidence. Commenters would thus have us give the adviser, which stands to benefit from the contribution, the discretion to determine whether contributions were intended to influence its selection by the government entity. We do not believe codes of ethics or policies and procedures alone, without a rule providing for specific, prophylactic prohibitions, are adequate to address this type of conduct.[119]

On balance, we believe that adopting a two-year time out for investment advisers similar to the two-year time out applicable to broker-dealers underwriting municipal securities is appropriate. Our years of experience with MSRB rule G-37 suggests that the "strong medicine" provided by that rule has both significantly curbed participation in pay to play and provides a reasonable cooling-off period to mitigate the effect of a political contribution. We are sensitive about potential implications of the operation of the rule on public pension funds, which could lose the services of an investment adviser subject to a time out. While we have designed the rule to reduce its impact,[120] investment advisers are best positioned to protect these clients by developing and enforcing robust

[118] *See, e.g.*, Proposing Release, at n.16 and accompanying text.

[119] We note that, under our rules, an adviser's code of ethics must require compliance with the rule we are today adopting (rule 204A-1(a)(2)) and the adviser must adopt policies and procedures designed to prevent violation of the rule (rule 206(4)-7(a)).

[120] *See*, *e.g.*, section II.B.2(a)(6) of this Release (discussing the *de minimis* exceptions to the two-year time out); section II.B.2(f) of this Release (discussing the rule's exemptive provision).

compliance programs designed to prevent contributions from triggering the two-year time out.

(1) Prohibition on Compensation

As noted above, investment advisers subject to new rule 206(4)-5 are not prohibited from providing advisory services to a government client, even after triggering the two-year time out. Instead, an adviser is prohibited from receiving *compensation* for providing advisory services to the government client during the time out.[121] We have taken this approach to enable an adviser to act consistently with its fiduciary obligations so it will not have to abandon a government client after making a triggering contribution, but rather may provide uncompensated advisory services for a reasonable period of time to allow the government client to replace the adviser.[122] We are adopting this element of the rule as proposed.

One commenter supported the prohibition on compensation as the least disruptive option to government clients,[123] while others argued that the prohibition on compensation

[121] Rule 206(4)-5(a)(1) makes it unlawful for investment advisers covered by the rule to provide investment advisory services *for compensation* to a government entity within two years after a triggering contribution. Under the rule, the two-year time out begins to run once the contribution is made and not when the contribution is discovered either by our examination staff or by the adviser. The adviser, therefore, should return all such compensation promptly upon discovering the triggering contribution. For the application of the rule to investments by government entities in pooled investment vehicles, see section II.B.2(e) of this Release.

[122] Proposing Release, at section II.A.3(a)(1). An investment adviser's fiduciary duties may

require it to continue providing advisory services for a reasonable period of time under these circumstances. For another instance in which an adviser's fiduciary duties may require its continued provision of services, see *Temporary Exemption for Certain Investment Advisers*, Investment Advisers Act Release No. 1736 (July 22, 1998) [63 FR 40231, 40232 (July 28, 1998)] (describing an investment adviser's fiduciary duties to an investment company in the case of an assignment of the advisory contract).

[123] Cornell Law Letter.

was unreasonable and, in some cases, difficult or near impossible to implement.[124] A coalition of commenters representing state and local governments asserted that, due to restrictions on accepting uncompensated services under state and local law, it was unlikely that government entities would accept uncompensated services even if an adviser were willing or required to provide them.[125] Commenters representing advisers took the opposite view, expressing concern that they would be locked into providing uncompensated services for extended periods of time as a result, and wanted the Commission to provide guidelines as to what a reasonable amount of time is for a government client to claim or move its assets.[126] One asserted that it would be unreasonable to require advisers to provide uncompensated services altogether.[127]

[124] *See, e.g.*, ICI Letter; Jones Day Letter. Some commenters argued for more flexibility in sanctions (Skadden Letter; ABA Letter; Fidelity Letter; ICI Letter; MassMutual Letter; Comment Letter of Wells Fargo Advisors (Oct. 6, 2009) ("Wells Fargo Letter"); IAA Letter).

[125] Comment Letter of the National Conference of State Legislatures, National Association of Counties, National League of Cities, International City/County Management Association, National Association of State Auditors, Comptrollers and Treasurers, Government Finance Officers Association, National Association of State Retirement Administrators, National Conference on Public Employee Retirement Systems, and National Council on Teacher Retirement (Oct. 6, 2009) ("National Organizations Letter"). With respect to direct advisory relationships, because restrictions on governments receiving services without payment would be a function of particular state or local laws, we believe government entities and their advisers are in the best position to

work out arrangements that are consistent with both state and local law and the compensation prohibition of our rule. With respect to investments by government entities in pooled investment vehicles, in particular, such restrictions could be avoided. *See* section II.B.2(e)(2) of this Release (describing possible arrangements for continued payment to investment pools even after a time out is triggered).

[126] *See, e.g.*, Comment Letter of Davis Polk & Wardwell LLP (Oct. 6, 2009) ("Davis Polk Letter") (recommending that three months would be reasonable); ICI Letter (suggesting 30 days). Other commenters raised concern regarding the potential harm of a time out to government investors for whom identifying new managers may be a lengthy process. *See, e.g.*, NASP Letter. We believe, however, that, on balance, pension funds and their beneficiaries are best served by the rule's deterrent effect against engaging in pay to play activities. An adviser's fiduciary obligations to continue to provide services for a reasonable amount of time, combined with the extended compliance dates described in section III of this Release which should afford the ability of market participants to

Few of the commenters who opposed this provision appeared to favor its elimination, which would require the adviser to immediately cease providing advisory services upon making a triggering contribution.[128] Rather, they appeared to oppose the two-year time out more generally.[129]

We are not persuaded by their arguments. We believe the prohibition on compensation is both appropriate and administrable. The incentives to engage in pay to play may be significant, precisely because of the long-term nature of many advisory relationships from which the adviser could benefit for several years. As a result, the consequences of engaging in pay to play need to be commensurate with these incentives for the prophylactic rule to have a meaningful deterrent effect.[130] We acknowledge that the rule will involve compliance costs and could adversely affect an adviser's business.[131]

On the other hand, a political contribution would not affect the ability of an adviser to provide compensated services to other clients, including other government clients.

organize themselves in a way to adapt to the rule's requirements, should be sufficient to minimize the impact on pension plans to the extent they need to prepare to transition to a new money manager after a two-year time out is triggered.

[127] Jones Day Letter. Other commenters argued that the specter of a two-year time out might cause some firms to ban or require pre-clearance of all employees' contributions. *See, e.g.*, Caplin & Drysdale Letter. Although the rule does not require this approach, as a result of commenters' assertions, we address this possibility in our cost-benefit analysis. *See* section IV of this Release.

[128] *See, e.g.,* Davis Polk Letter; ICI Letter.

[129] *See, e.g.*, National Organizations Letter; ICI Letter; Jones Day Letter; Dechert Letter.

[130] This deterrent effect is the basis for our view that the two-year time out should not apply only to "new business" and that advisers should not be able to "negotiate" for lesser consequences. *See supra* note 124 (pointing to commenters who called for more flexibility regarding the two-year time out). As we point out above, our concerns extend to contributions designed to enable advisers to retain contracts that might not otherwise be renewed.

[131] For a discussion of costs and other burdens that may be imposed by our rule, see generally sections IV-V of this Release.

Moreover, the fiduciary obligations of an adviser would not require it to provide uncompensated advice indefinitely—rather, the adviser may need to continue to provide advice for only a reasonable period of time during which its client can seek to obtain advisory services from others.[132]

Some commenters urged us to permit advisers to continue to receive compensation during the two-year time out for services provided pursuant to an existing management contract,[133] without distinguishing whether the contract was acquired as a result of political contributions. One commenter further suggested specifically that we permit advisory services to continue to be provided by the adviser at cost during the time out to remove the profit motive of pay to play.[134] We are also not persuaded by their suggestions. Allowing contracts acquired as a result of political contributions to continue uninterrupted would eviscerate the rule. Were a "free pass" available for contracts

[132] *See supra* note 122 and accompanying text. The amount of time a client might need in good faith to find and engage a successor to the adviser would, in our view, be the primary consideration of the length of a reasonable period, which may depend in part on such matters as applicable law, the client's customary process of finding and engaging advisers and the types of assets managed by the adviser that is subject to the time out. In some cases, a client may be able to quickly engage a "transition adviser" to manage its assets until a permanent successor is found. *See*, *e.g.*, *Illinois State Board Sets Transition Manager RFP*, PENSIONS & INVESTMENTS, Feb. 8, 2010 *available at* http://www.pionline.com/article/20100208/PRINTSUB/302089976. In other cases, the client may be required by the law under which it operates to undertake a specified process to obtain a new manager, such as a solicitation for proposals from potential managers.

[133] *See, e.g.*, Dechert Letter; Fidelity Letter; ICI Letter; Jones Day Letter (in some instances, pointing to the MSRB's approach of not necessarily applying MSRB rule G-37's two year time out when a contribution is made after a business contract is signed). *See* MSRB, *Interpretation on the Effect of a Ban on Municipal Securities Business under Rule G-37 Arising During a Pre-Existing Engagement Related to Municipal Fund Securities*, MSRB Rule G-37 Interpretive Notice (April 2, 2002), *available at* http://msrb.org/msrb1/archive/ContributionsNotice.htm). As we explain above, due to the long-term nature of typical advisory contracts and our belief that the consequences of giving a contribution need to be commensurate with the potential benefits obtained, we are not taking this approach.

[134] Dechert Letter.

merely because they were entered into prior to discovery of a contribution, advisers would be strongly incentivized against "discovering" contributions.[135] Because no new business from a government client may even be available to the adviser until the two-year period has run its course, advisers whose contributions succeeded in acquiring a management contract for two years or more could escape any consequences under such an exception.[136] Further, in our judgment, the potential loss of profits will not operate as an adequate deterrent. It is our understanding that being selected to manage public pension plan assets has a reputational value that itself contributes to advisory profits by attracting additional assets under management regardless of the profits derived directly from the management of government client assets.[137]

[135] An approach that applied the two-year time out only to new business would preclude the adviser from receiving compensation only from additional contracts that *might* be awarded by the government entity during the two-year period. In our judgment, the risk of the potential loss of additional advisory contracts for a two-year period would provide an inadequate deterrent to contributions designed to influence the award of such additional advisory contracts.

[136] We are concerned that limiting application of the rule to new business could invite abuse. For example, pension officials seeking contributions after a contract has been awarded could attempt to offer an adviser additional assets to manage under the existing contract with the condition that the adviser subsequently make political contributions.

[137] *See, e.g.*, Kevin McCoy, *Do Campaign Contributions Help Win Pension Fund Deals*, USA TODAY, Aug. 28, 2009, *available at* http://www.usatoday.com/money/perfi/funds/2009-08-26-pension-fund-political donations_N.htm (referring to advisory firms winning management mandates from pension funds, stating: "The awards generate lucrative fees and lend prestige that could help lure new clients."); Louise Story, *Quadrangle Facing Questions Over Pension Funds*, N.Y. TIMES, Apr. 21, 2009, *available at* http://www.nytimes.com/2009/04/22/business/22quadrangle.html (highlighting an indirect benefit of a pension fund investment, stating: "the prestige associated with it helped the firm lure other big investors.").

(2) Officials of a Government Entity

The rule's two-year time out is triggered by a contribution to an "official" of a "government entity."[138] An official includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.[139] Government entities 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.[140]

The two-year time out is thus triggered by contributions, not only to elected officials who have legal authority to hire the adviser, but also to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser. We have not modified this approach from our proposal.[141] As we noted in the Proposing Release, a person appointed by an elected official is likely to be subject to that official's

[138] Rule 206(4)-5(a)(1) makes it unlawful for covered investment advisers 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 of its covered associates.

[139] Rule 206(4)-5(f)(6). For purposes of the rule, we would not interpret the definition of "official" as covering an individual who is also a "covered associate" of the adviser. Accordingly, under the rule, a covered associate who is an incumbent or candidate for office is not limited to contributing the *de minimis* amount to his or her own campaign. The MSRB takes a similar view with respect to its rule G-37. MSRB, *Questions and Answers Concerning Political Contributions and Prohibitions on Municipal Securities Business: Rule G-37,* MSRB rule G-37 Interpretive Notice, *available at* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37 Frequently-Asked-Questions.aspx ("MSRB Rule G-37 Q&A"), Question II.10 (May 24, 1994).

[140] Rule 206(4)-5(f)(5).

[141] *See* Proposing Release, at section II.A.3(a)(2).

influences and recommendations.[142] It is the scope of authority of the particular *office* of an official, not the influence actually exercised by the individual, that would determine whether the individual has influence over the awarding of an investment advisory contract under the definition.[143] We are adopting these provisions as proposed.[144]

Some commenters asserted that the rule should be more specific as to which public officials to whom a contribution is made would trigger application of the rule in order to reduce uncertainty and compliance burdens.[145] But state and municipal statutes vary substantially with respect to whom they entrust with the management of public

[142] *Id.*

[143] As such, executive officers or legislators whose official position gives them the authority to influence the hiring of an investment adviser generally would be "government officials" under the rule. For example, a state may have a pension fund whose board of directors, which has authority to hire an investment adviser, is constituted, at least in part, by appointees of the governor and members of the state legislature. *See, e.g.*, The Commonwealth of Pennsylvania Public School Employees' Retirement Board, *Statement of Organization, By-Laws and Other Procedures* (rev. Jun. 11, 2009), art. II, sec. 2.1, *available at* http://www.psers.state.pa.us/org/board/policies/201001_bylaws.pdf (noting that the board shall be composed of, *inter alia*, two persons appointed by the Pennsylvania State Governor, two Pennsylvania state senators and two members of the Pennsylvania state house of representatives). In such circumstances, the governor and the members of the state legislature serving on the board would be officials of the government entity. Conversely, a public official who is tasked with performing an audit of the selection process but has no influence over hiring outcomes would not be an official of a government entity for purposes of the rule.

[144] These definitions and their application are substantively the same as those in MSRB rule G-37. *See* MSRB rule G-37(g)(ii) and (g)(vi).

[145] *See, e.g.*, IAA Letter; NSCP Letter; Comment Letter of T. Rowe Price Associates, Inc. (Oct. 6, 2009) ("T. Rowe Letter"); MFA Letter; Davis Polk Letter. For a discussion of the potential costs involved in identifying officials to whom contributions could trigger the rule's prohibitions, see section IV of this Release (presenting our cost-benefit analysis). Another commenter suggested that advisers should be able to rely on certifications from candidates and officials regarding whether their office would render them an "official" for purposes of the rule—*i.e.*, identifying the range, if any, of public investment vehicles over

which the relevant office directly or indirectly influences the selection of investment advisers or appoints individuals who do). Caplin & Drysdale Letter. We are concerned that such a safe harbor would undercut the purposes of the rule, not least because officials will be incentivized to offer such certifications liberally (and will presumably sometimes do so inappropriately) to encourage contributions.

funds, and any effort we make in a rule of general application to identify specific officials who are in a position to influence the selection of an adviser would certainly be over inclusive in some circumstances and under-inclusive in others.[146] Others urged that triggering contributions should be limited to contributions to officials directly responsible for the selection of advisers.[147] Excluding from the application of the rule contributions to those who are in a position to *indirectly* influence the selection of an investment adviser could simply lead officials to re-structure their relationships to avoid application of the rule to advisers that may contribute to those officials.

Two commenters argued that the rule should not cover contributions to candidates for federal office,[148] while another contended that it should.[149] Under our rule, as proposed, a candidate for federal office could be an "official" under the rule not because of the office he or she is running for, but as a result of an office he or she currently holds.[150] So long as an official has influence over the hiring of investment advisers as a function of his or her current office, contributions by an adviser could have the same effect, regardless to which of the official's campaigns the adviser contributes. For that

[146] Like us, the MSRB does not specify which officials have the authority to influence the granting of government business for purposes of its rule G-37. *See* MSRB, *Campaign for Federal Office*, MSRB Rule G-37 Interpretive Notice (May 31, 1995), *available at* http://msrb.org/msrb1/rules/interpg37.htm ("The Board does not make determinations concerning whether a particular individual meets the definition of "official of an issuer.").

[147] *See, e.g.*, IAA Letter; NASP Letter; NY City Bar Letter; Davis Polk Letter.

[148] *See, e.g.*, NSCP Letter; Dechert Letter.

[149] Fund Democracy/Consumer Federation Letter.

[150] As a result, if a state or municipal official were, for example, a candidate for the U.S. Senate, House of Representatives, or presidency, an adviser's contributions to that official would be covered by the rule. MSRB rule G-37's time out provision is also triggered by contributions to state and local officials running for federal office. *See* MSRB Rule G-37 Q&A, Questions IV.2-3.

reason, we are not persuaded that an incumbent state or local official should be excluded from the definition solely because he or she is running for federal office.[151]

(3) Contributions

The rule's time out provisions are triggered by *contributions* made by an adviser or any of its covered associates.[152] A contribution is defined to include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such an election.[153] It also includes transition or inaugural expenses incurred by a successful candidate for state or local office.[154] The definition is the same as we proposed and as the one used in MSRB rule G-37.[155]

[151] Under certain circumstances, a state or municipal official running for federal office could remove herself from being an "official" for purposes of rule 206(4)-5 by eliminating her ability to influence the outcome of the hiring of an investment adviser. This might occur, for example, if she were to: (i) formally withdraw from participation in or influencing adviser hiring decisions; (ii) be leaving office, so that he or she could not participate in subsequent decision-making; and (iii) have held direct influence over the adviser hiring process (as opposed to, for example, having designated an appointee with such influence who would remain in a position to influence such hiring).

[152] Rule 206(4)-5(a)(1) makes it unlawful for covered investment advisers 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 of its covered associates. As suggested above, we are concerned that

contributions may be used "as the cover for what is much like a bribe: a payment that accrues to the private advantage of the official and is intended to induce him to exercise his discretion in the donor's favor, potentially at the expense of the polity he serves." *Blount*, 61 F.3d at 942 (describing the Commission's approval of MSRB rule G-37 as based on a wish to curtail this function).

[153] Rule 206(4)-5(f)(1).

[154] MSRB rule G-37 also covers payment of transition or inaugural expenses as contributions for purposes of its time out provision. *See* MSRB Rule G-37 Q&A, Question II.6. However, under neither rule does a contribution include the transition or inaugural expenses of a successful candidate for *federal* office. Contributions to political parties are not specifically covered by the definition and thus would not trigger the rule's two year time out unless they are a means to do indirectly what the rule prohibits if done directly (for example, the contributions are earmarked or known to be provided for the benefit of a particular political official). We also note that "contributions" are not intended to include independent "expenditures," as that term is defined in 2 U.S.C. 431 &

We received requests that we clarify the application of the rule to some common circumstances that may arise in the course of an adviser's relationship with a government client.[156] We would not consider a donation of time by an individual 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.[157] Similarly, we would not consider a charitable donation made by an investment adviser to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code,[158] or its equivalent in a foreign jurisdiction, at the request of an official of a government entity to be a contribution for purposes of rule 206(4)-5.[159]

441b (the federal statutory provisions limiting contributions and expenditures by national banks, corporations, or labor organizations invalidated by *Citizens United v. Federal Election Commission*, 130 S. Ct. 876 (2010) (holding that corporate funding of independent political broadcasts in candidate elections cannot be limited under the First Amendment)). Indeed, it is our intent that, under the rule, advisers and their covered associates "are not in any way restricted from engaging in the vast majority of political activities, including making direct expenditures for the expression of their views, giving speeches, soliciting votes, writing books, or appearing at fundraising events." *Blount*, 61 F.3d at 948.

[155] MSRB rule G-37(g)(i).

[156] *See, e.g.*, Caplin & Drysdale Letter; Callcott Letter I (volunteer activities); NASP Letter (charitable contributions); Sutherland Letter; IAA Letter (entertainment expenses and conference expenses). We address entertainment and conference expenses in section II.B.2(c) of this Release (which discusses the prohibition on soliciting or coordinating contributions from others).

[157] *See* Proposing Release, at n.91. A covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the adviser is not otherwise paying the employee's salary (*e.g.*, an unpaid leave of absence). *But see* rule 206(4)-5(d) (prohibiting an adviser from doing indirectly what the rule would prohibit if done directly). The MSRB deals similarly with this issue. *See* MSRB Rule G-37 Q&A, Question II.19.

[158] Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. 501(c)(3)) contains a list of charitable organizations that are exempt from federal income taxation.

[159] The MSRB deals similarly with this issue. *See* MSRB Rule G-37 Q&A, Question II.18. *But see* rule 206(4)-5(d) (prohibiting an adviser from doing indirectly what the rule would prohibit if done directly).

The few commenters that addressed the definition of "contribution" generally urged us to adopt a narrower version. Some, for example, recommended that contributions be expressly limited to political contributions and more explicitly exclude expenditures not clearly made for the purpose of influencing an election.[160] We are not narrowing our definition. We are instead adopting our definition as proposed due to our concern that "contributions" may also take the form of payment of election-related debts and transition or inaugural expenses. Further, our definition of "contribution" already requires that the payment be made for the purpose of influencing an election for a federal, state or local office.[161] We believe that the scope of our proposed definition is appropriate in light of the conduct we are seeking to address.

Commenters were divided as to whether contributions to PACs or local political parties should trigger the two-year time out.[162] Such contributions were not explicitly covered by the proposed rule and do not necessarily trigger the two-year time out in MSRB rule G-37.[163] In some cases, such contributions may effectively operate as a

[160] *See, e.g.*, National Organizations Letter; NASP Letter.

[161] Rule 206(4)-5(f)(1).

[162] *See*, *e.g.,* CalPERS Letter; NSCP Letter (should not apply to contributions to PACs or state or local parties, unless a particular candidate directly solicits contributions for those entities); Comment Letter of James J. Reilly (Aug. 24, 2009) ("Reilly Letter") (contributions to political parties should be included because in state and local elections contributions to political parties may effectively amount to contributions to an individual candidate); SIFMA Letter.

[163] *See, e.g.*, MSRB, *Payments to Non-Political Accounts of Political Organizations*, MSRB rule G-37 Interpretive Letter (Sept. 25, 2007), *available at* http://msrb.org/msrb1/rules/interpg37.htm (explaining that not all payments to political organizations that, in turn, make contributions to officials trigger Rule G-37's time out). With regard to solicitations from a PAC or a political party with no indication of how the collected funds will be disbursed, advisers should inquire how any funds received from the adviser or its covered associates would be used. For example, if the PAC or political party is soliciting funds for the purpose of supporting a limited number of government officials, then, depending upon the facts and circumstances, contributions to the PAC or payments to the political party might well result in the same prohibition on compensation

funnel to the campaigns of the government officials.[164] In other cases, however, they may fund general party political activities or the campaigns of other candidates.[165]

Therefore, we have decided not to explicitly include all such contributions among those that trigger the time out, although they may violate the provision of the rule, discussed below, which prohibits an adviser or any of its covered persons from indirect actions that would result in a violation of the rule if done directly.[166]

The MSRB rule G-37 definition of "contribution" has, in our view, proved to be workable. The types of contributions relevant to money managers and elected officials are unlikely to be different than those made to influence the awarding of municipal securities business by broker-dealers. On balance, we believe that the MSRB's definition of "contribution," which we mirrored in our proposal, achieves the goals of this rulemaking. Therefore, we are adopting the definition as proposed.

(4) Covered Associates

Contributions made to influence the selection process are typically made not by the firm itself, but by officers and employees of the firm who have a direct economic stake in the business relationship with the government client.[167] Accordingly, under the

for providing investment advisory services to a government entity as would a contribution made directly to the official. Our approach is consistent with the MSRB's. *See* MSRB Rule G-37 Q&A, Question III.5.

[164] *See, e.g.*, Reilly Letter.

[165] *See, e.g.*, Caplin & Drysdale Letter (explaining that "leadership PACs," for example, are commonly established by officeholders to donate to other candidates and issues).

[166] *See* section II.B.2(d) of this Release. For the MSRB's approach to this issue, see MSRB Rule G-37 Q&A, Question III.4. *But see* rule 206(4)-5(d) (noting that the rule's definition of "official" of a government entity includes any election committee for that person).

[167] Proposing Release, at section II.A.3(a)(4). Based on enforcement actions, we believe that such persons are more likely to have an economic incentive to make contributions to influence the advisory firm's selection. *See id*.

rule, contributions by each of these persons, which the rule defines as "covered associates," trigger the two-year time out.[168] A "covered associate" of an investment adviser is defined as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any of its covered associates.[169]

Owners. Contributions by sole proprietors are contributions by the adviser itself.[170] If the adviser is a partnership, the rule covers contributions by the adviser's general partners.[171] If the adviser is a limited liability company, the rule covers contributions made by managing members.[172] A contribution by an owner that is a limited partner or non-managing member (of a limited liability company) is not covered, however, unless the limited partner or non-managing member is also an executive officer or solicitor (or person who supervises a solicitor) covered by the rule, or unless the contribution is an indirect contribution by the adviser, executive officer, solicitor, or supervisor.[173] Similarly, if the adviser is a corporation, shareholder contributions are not covered unless the shareholder is also an executive officer or solicitor covered by the

[168] Rule 206(4)-5(a)(1).

[169] Rule 206(4)-5(f)(2).

[170] We note, however, that a sole proprietor may, in a personal capacity, avail herself or himself of the *de minimis* exceptions described in section II.B.2(a)(6) of this Release.

[171] Rule 206(4)-5(f)(2)(i).

[172] *Id.*

[173] *See* rule 206(4)-5(a)(1), (d) and (f)(2)(i)-(ii).

rule, or unless the contribution is an indirect contribution by the adviser, executive officer, solicitor, or supervisor.[174]

Executive Officers. Contributions by an executive officer of an investment adviser trigger the two-year time out.[175] Executive officers include: (i) the president; (ii) any vice president in charge of a principal business unit, division or function (such as sales, administration or finance); (iii) any other officer of the investment adviser who performs a policy-making function; or (iv) any other person who performs similar policy making functions for the investment adviser.[176] Whether a person is an executive officer depends on his or her function, not title; for example, an officer who is the chief executive of an advisory firm but whose title does not include "president" is nonetheless an executive officer for purposes of the rule.

The definition reflects changes we have made from our proposal that are designed to clarify the rule and to tailor it to apply to those officers of an investment adviser whose position in the organization is more likely to incentivize them to obtain or retain clients for the investment adviser (and, therefore, to engage in pay to play practices) while still achieving our objectives. We have clarified that "other executive officers" under the rule—*i.e.*, those other than the president and vice presidents in charge of principal business units or functions—include only those officers or other persons who perform a policy-making function for the investment adviser.[177] This limitation, which was

[174] *Id.*

[175] The definition of "covered associate" includes, among others, any executive officer or other individual with a similar status or function. Rule 206(4)-5(f)(2)(i).

[176] Rule 206(4)-5(f)(4).

[177] Rule 206(4)-2(f)(4). This modification also aligns the definition more closely with the definition of "executive officer" in our other rules. *See, e.g.,* rule 205-3(d)(4) under the Advisers Act [17 CFR 275.205-3(d)(4)] (defining executive officer for purposes of

recommended by commenters,[178] excludes persons who enjoy certain titles as a formal matter but do not engage in the kinds of activities that we believe should trigger the prohibitions in the rule.[179] We have also modified the definition to remove the limitation that the officer, as part of his or her regular duties, performs or supervises any person who performs advisory services for the adviser, or solicits or supervises any person who solicits for the adviser. We agree with the commenter who asserted that ". . . all of the adviser's executive officers should be included because the nature of their status alone

determinations of who is a qualified client exempting an adviser from the prohibition on entering into, performing, renewing or extending an investment advisory contract that provides for compensation on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, under the Advisers Act) and rule 3c-5(a)(3) [17 CFR 270.3c-5(a)(3)] under the Investment Company Act of 1940 [15 U.S.C. 80a] ("Investment Company Act") (defining executive officer for purposes of determinations of the number of beneficial owners of a company excluded from the definition of "investment company" by section 3(c)(1) of the Investment Company Act, and whether the outstanding securities of a company excluded from the definition of "investment company" by section 3(c)(7) of the Investment Company Act are owned exclusively by qualified purchasers, as defined in that Act). It also more closely aligns the definition to the MSRB approach. *See* MSRB rule G-37(g)(v).

[178] *See, e.g.*, Sutherland Letter.

[179] Several commenters urged us expressly to exclude from the definition the CEO, officers and employees of a parent company. *See, e.g.*, SIFMA Letter; ICI Letter; MFA Letter; Skadden Letter. Depending on facts and circumstances, there may be instances in which a supervisor of an adviser's covered associate (who, for example, engages in solicitation of government entity clients for the adviser) formally resides at a parent company, but whose contributions should trigger the two-year time out because they raise the same conflict of

interest issues that we are concerned about, irrespective of that person's location or title. In other words, whether a person is a covered associate ultimately depends on the activities of the individual and not his or her title. We recently considered a similar issue in a report addressing whether MSRB rule G-37 could include contributions by employees of parent companies as triggering that rule's time out provision, see *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: JP Morgan Securities, Inc.*, Exchange Act Release No. 61734 (Mar. 18, 2010), *available at* http://www.sec.gov/litigation/investreport/34-61734.htm ("This Report serves to remind the financial community that placing an executive who supervises the activities of a broker, dealer or municipal securities dealer outside of the corporate governance structure of such broker, dealer or municipal securities dealer does not prevent the application of MSRB Rule G-37 to that individual's conduct."). The MSRB also takes the view that it is an individual's activities and not his or her title that may render his or her contributions a trigger for that rule's time out provision. *See* MSRB Rule G-37 Q&A, Question IV.18.

creates a strong incentive to engage in pay to play practices."[180] Even if these senior officers are not directly involved in advisory or solicitation activities, as part of senior management, their success within the advisory firm is likely to be tied to the firm's success in obtaining clients.[181]

Employees who Solicit Government Clients. Contributions by any employee who solicits a government entity for the adviser would trigger the two-year time out. [182] An employee need not be primarily engaged in solicitation activities to be a "covered associate" under the rule.[183] We are also including persons who supervise employees who solicit government entities because we believe these persons are strongly incentivized to engage in pay to play activities to obtain government entity clients.[184] We

[180] *See* Fund Democracy Letter.

[181] Commenters also suggested that our definition exclude vice presidents in charge of business units, divisions or functions whose function is unrelated to investment advisory or solicitation activities. *See, e.g.,* IAA Letter. For the reasons described above, we do not believe such an exclusion is appropriate.

[182] We are not adopting the suggestion of several commenters that we treat third-party

solicitors the same way as employees. *See, e.g.*, 3PM Letter; Triton Pacific Letter; Comment Letter of Arrow Partners, Inc. Partner Ken Rogers (Sept. 2, 2009) ("Arrow Letter"). We explained in the Proposing Release that we determined not to propose this approach out of concern for the difficulties that advisers may have when monitoring the activities of their third-party solicitors. *See* Proposing Release, at nn.135 and accompanying text. Commenters did not persuade us that these concerns can reasonably be expected to be overcome. Therefore, whereas contributions by covered associates of the adviser trigger the two-year compensation time out, an adviser is prohibited from hiring third parties to solicit government business on its behalf unless the third party is a "regulated person." *See* section II.B.2(b) of this Release. Our approach is similar to MSRB's rule G-38, which restricts third-party solicitation activities differently from the two-year time out. *See* MSRB rule G-38.

[183] The MSRB also takes the approach that an associated person need not be "primarily engaged" in activities that would make his or her contributions trigger rule G-37's time out provision, particularly where he or she engages in soliciting business. *See* MSRB Rule G-37 Q&A, Question IV.8.

[184] Rule 206(4)-5(f)(2)(ii). The proposed rule would only have applied to *senior officers* who supervise employee solicitors. *See* proposed rule 206(4)-5(f)(4)(ii). MSRB rule G 37 also applies to supervisors of persons who solicit relevant business from government entities. *See* MSRB Rule G-37 Q&A, Question IV.14.

have revised this aspect of the definition to include *all* supervisors of those solicitors that solicit government entities because we believe the incentives to engage in pay to play exist for all such supervisors, not just those that have a certain level of seniority.

Rule 206(4)-5 defines "solicit" to mean, with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser.[185] Commenters asked us to provide further guidance on what we mean by "solicit."[186] The determination of whether a particular communication is a solicitation is dependent upon the specific facts and circumstances relating to such communication. As a general proposition any communication made under circumstances reasonably calculated to obtain or retain an advisory client would be considered a solicitation unless the circumstances otherwise indicate that the communication does not have the purpose of obtaining or retaining an advisory client. For example, if a government official asks an employee of an advisory firm whether the adviser has pension fund advisory capabilities, such employee generally would not be viewed as having solicited advisory business if he or she provides a limited affirmative response, together with either providing the government official with contact information for a covered associate of the adviser or informing the government official that advisory personnel who handle government advisory business will contact him or her. [187]

[185] Rule 206(4)-5(f)(10)(i). We are adopting this definition as proposed.

[186] *See, e.g.,* Skadden Letter.

[187] Similarly, if a government official is discussing governmental asset management issues with an employee of an adviser, the employee generally would not be viewed as having solicited business if he or she provides a limited communication to the government official that such alternative may be appropriate, together with either providing the government official with contact information for a covered associate or informing the

Political Action Committees. A covered associate includes a political action committee controlled by the investment adviser or by any of its covered associates.[188] Under the rule, we would regard an adviser or its covered associate to have "control" over a political action committee if the adviser or its covered associate has the ability to direct or cause the direction of the governance or operations of the PAC.[189] Two commenters asserted that we should narrow the definition of "covered associate" with respect to political action committees.[190] Specifically, they asserted that the definition should only include PACs controlled by the adviser and not those controlled by other covered associates, which could be a separate legal entity over which government official that advisory personnel who handle asset management for government clients will contact him or her. In these examples, however, if the adviser's employee receives compensation such as a finder's or referral fee for such business or if the employee engages in other activities that could be deemed a solicitation with respect to such business, the employee generally would be viewed as having solicited the advisory business. Our interpretation of what it means to "solicit" government business is consistent with the MSRB's. *See* MSRB, *Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), *available at* http://msrb.org/msrb1/rules/notg38.htm.

[188] Rule 206(4)-5(f)(2)(iii) (which we are adopting as proposed). One commenter suggested that we define a "political action committee," or PAC, as any organization required to register as a political committee under federal, state or local law. Caplin & Drysdale Letter. But we have not included this definition of PAC because we do not believe a definition linked to the registration status of a political committee would serve our purpose of deterring evasion of the rule as registration requirements vary among election laws. We note, however, that we would construe the term PAC to include (but not necessarily be limited to) those political committees generally referred to as PACs, such as separate segregated funds or non-connected committees within the meaning of the Federal Election Campaign Act, or any state or local law equivalent. *See* Federal Election Commission, Quick Answers to PAC Questions, *available at* http://www.fec.gov/ans/answers_pac.shtml#pac. Determination of whether an entity is a PAC covered by our rule would not, in our view, turn on whether the PAC was, or was required to be, registered under relevant law.

[189] One commenter suggested a similar interpretation of "control." Caplin & Drysdale Letter. For the MSRB's approach to this definition, see MSRB Rule G-37 Q&A, Question IV.24.

[190] SIFMA Letter; Sutherland Letter.

the adviser may have little influence.[191] We are not adopting this suggestion. As we discussed in the Proposing Release, PACs are often used to make political contributions.[192] The recommended changes would permit an executive of the adviser or another covered person of the adviser to use a PAC he or she controls to evade the rule. Even where the adviser itself does not control such PACs directly, we are concerned about their use to evade our rule where they are controlled by covered associates (whose positions in the organization, as we note above, are more likely to incentivize them to obtain or retain clients for the investment adviser).[193]

Other Persons. Several commenters urged that our definitions be broadened to encompass other persons whose contributions should trigger the two-year time out.[194] One urged that in some cases all employees should be covered associates because of the likelihood they could directly benefit from engaging in pay to play.[195] Another urged that the definition of covered associate include affiliates of the adviser that solicit government business on the adviser's behalf, any director of the adviser, and any significant owner of the adviser.[196] These suggestions would expand the rule to a range of persons that could

[191] *Id.*

[192] Proposing Release, at n.101.

[193] Advisers are responsible for supervising their supervised persons, including their covered associates. We have the authority to seek sanctions where an investment adviser, or an associated person, has failed reasonably to supervise, with a view to preventing violations of the federal securities laws or rules, a person who is subject to the adviser's (or its associated person's) supervision and who commits such violations. Sections 203(e)(6) and 203(f) of the Advisers Act [15 U.S.C. 80b-3(e)(6) and (f)].

[194] *See, e.g.*, Fund Democracy/Consumer Federation Letter; DiNapoli Letter (suggesting the rule also cover contributions from family members); Ounavarra Letter.

[195] Ounavarra Letter.

[196] Fund Democracy/Consumer Federation Letter.

engage in pay to play activities.[197] In our judgment, however, contributions from these types of persons are less likely to involve pay to play unless the contributions were made by these persons for the purpose of avoiding application of the rule, which could result in the adviser's violation of a separate provision of the rule.[198] We do not believe that the incremental benefits of capturing conduct of other individuals less likely to engage in pay to play based on the record before us today outweigh the additional burden such an expansion would impose.[199] Thus, we are not expanding the definition as these commenters have suggested.

Other commenters urged us to narrow our definition of "covered associate" to include fewer persons.[200] For example, one commenter recommended that the definition of "covered associate" expressly exclude all "support personnel."[201] Another suggested that we limit the definition to those who solicit government clients with a "major purpose" of obtaining that government client.[202] Expressly excluding all "support personnel" is unnecessary because, in almost all cases, such persons would not be

[197] *See, e.g.*, *supra* note 179 (discussing why we have chosen not to limit the definition of "executive officer" in other ways as suggested by some commenters).

[198] *See* Rule 206(4)-5(d). We also note that the MSRB takes a similar approach. *See, e.g.*, MSRB Rule G-37 Q&A, Question IV.9 (noting that the universe of those whose contributions above the *de minimis* level *per se* trigger the two-year time out is limited and does not include their consultants, lawyers or spouses). The MSRB also leaves contributions by affiliates and personnel beyond those identified as triggering the two year time out to be addressed by a provision prohibiting municipal securities dealers from doing indirectly what they are prohibited from doing directly under rule G-37. *See* MSRB Rule G-37(d).

[199] In this instance, as in others, we are sensitive to First Amendment concerns that further expansion of the scope of covered associates could broaden the rule's scope beyond what is necessary to accomplish its purposes.

[200] *See, e.g.*, T. Rowe Price Letter; NSCP Letter; Skadden Letter.

[201] T. Rowe Price Letter.

[202] Skadden Letter.

"covered associates," as that term is defined in the rule. We have not limited the definition to those who solicit government clients with a "major purpose" of obtaining that government client because we believe that our rule's definition of "solicit," as discussed above, adequately takes into account the purpose of the communication and adding an additional element of intent may exclude employees who have an incentive to engage in pay to play practices.

(5) "Look Back"

The rule attributes to an adviser contributions made by a person within two years (or, in some cases, six months) of becoming a covered associate of that adviser.[203] In other words, when an employee becomes a covered associate, the adviser must "look back" in time to that employee's contributions to determine whether the time out applies to the adviser.[204] If, for example, the contribution were made more than two years (or, pursuant to the exception described below for non-solicitors, six months) prior to the employee becoming a covered associate, the time out has run; if the contribution was made less than two years (or six months) from the time the person becomes a covered associate, the rule prohibits the adviser that hires or promotes the contributing covered associate from receiving compensation for providing advisory services from the hiring or

[203] Rule 206(4)-5(a)(1). The "look back" applies to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the rule. A person becomes a covered associate for purposes of the rule's look-back provision at the time he or she is hired or promoted to a position that meets the definition of "covered associate" in rule 206(4)-5(f)(2). For a discussion of the definition of "covered associate," see section II.B.2(a)(4) of this Release.

[204] Rule 206(4)-5(a)(1) (including among those covered associates whose contributions can

trigger the two-year time out a person who becomes a covered associate within two years after the contribution is made); Rule 206(4)-5(b)(2) (excepting from the two-year look back those contributions made by a natural person more than six months prior to becoming a covered associate of the investment adviser unless such person, after becoming a covered associate, solicits clients on behalf of the investment adviser).

promotion date until the two-year period has run.[205] The look-back provision, which is similar to that in MSRB rule G-37, is designed to prevent advisers from circumventing the rule by influencing the selection process by hiring persons who have made political contributions.[206]

We received many comments on our proposed look-back provision,[207] which would have applied the two-year look back with respect to all contributions of new covered associates.[208] One commenter asserted that such a provision is necessary to prevent advisers from circumventing the prohibitions on pay to play.[209] Most commenters, however, argued that the rule should not contain a look-back provision or should contain a shorter one because it could prevent advisers from hiring qualified

[205] In no case would the prohibition imposed by the rule be longer than two years from the date the covered associate makes a covered contribution. If, for example, a covered associate becomes employed by an investment adviser (and engages in solicitation activity for it) one year and six months after making a contribution, the new employer would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. We also note that the rule's exemptive process may be available in instances where an adviser believes application of the look-back provision would yield an unintended result. Rule 206(4)-5(e). For a discussion of the rule's exemptive provision, see section II.B.2(f) of this Release.

[206] Similarly, to prevent advisers from channeling contributions through departing employees, advisers must "look forward" with respect to covered associates who cease to qualify as covered associates or leave the firm. The covered associate's employer at the time of the contribution would be subject to the proposed rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate or remains employed by the adviser. Thus, dismissing a covered associate would not

relieve the adviser from the two-year time out. MSRB rule G-37 also includes a "look forward provision." *See* MSRB Rule G-37 Q&A, Question IV.17 (". . . any contributions by [an] associated person [who leaves the dealer's employ] (other than those that qualify for the *de minimis* exception under Rule G-37(b)) will subject the dealer to the rule's ban on municipal securities business for two years from the date of the contribution").

[207] *See, e.g.*, Fund Democracy/Consumer Federation Letter; ICI Letter; Davis Polk Letter; NY City Bar Letter; Fidelity Letter; Wells Fargo Letter; MFA Letter; IAA Letter; NASP Letter; American Bankers Letter; Comment Letter of Seward & Kissel LLP (Oct. 6. 2009) ("Seward & Kissel Letter"); Park Hill Letter; Dechert Letter; Skadden Letter.

[208] *See* Proposing Release, at section II.A.3(a)(5).

[209] Fund Democracy/Consumer Federation Letter.

individuals who have made unrelated political contributions,[210] or it could be disruptive to public pension plans seeking to hire qualified managers.[211] While some urged that we eliminate the look-back provision altogether,[212] most asked us to shorten the period to three to six months.[213] Others suggested alternative approaches to the look back, including adopting a higher contribution threshold to trigger the look-back provision[214] or permitting advisers to hire and promote persons to be covered associates who have made prohibited contributions, but not permitting them to solicit government clients or otherwise create firewalls between them and government clients.[215]

Upon consideration of the comments, we believe that applying the full two-year look back to all new covered associates may be unnecessary to achieve the goals of the rulemaking. We are adopting a suggestion offered by several commenters to shorten the look-back period with respect to certain new covered associates whose contributions are less likely to be involved in pay to play.[216] Under an exception to the rule, the two-year

[210] *See, e.g.*, ICI Letter; Davis Polk Letter; NY City Bar Letter; Fidelity Letter; Wells Fargo

Letter; MFA Letter.

[211] *See, e.g.*, Comment Letter of Connecticut Treasurer Denise L. Nappier (Sept. 10, 2009) ("CT Treasurer Letter"); CalPERS Letter.

[212] *See, e.g.*, IAA Letter; ICI Letter; Wells Fargo Letter; NASP Letter; American Bankers Letter; MFA Letter; Seward & Kissel Letter.

[213] *See, e.g.*, ICI Letter (three-month look back); IAA Letter (six-month look back); Park Hill Letter (six-month look back); Wells Fargo Letter (six-month look back); Davis Polk Letter (six-month look back); Dechert Letter (six-month look back); MFA Letter (six month look back).

[214] *See, e.g.*, Wells Fargo Letter; NSCP Letter.

[215] *See, e.g.*, Comment Letter of Strategic Capital Partners (Oct. 1, 2009) ("Strategic Capital Letter"); Comment Letter of B. Jack Miller (Oct. 3, 2009); Comment Letter of RP Realty Partners, LLC Chief Financial Officer Jerry Gold (Oct. 2, 2009); SIFMA Letter.

[216] *See, e.g.*, MFA Letter; Fidelity Letter; Dechert Letter; Wells Fargo Letter; Skadden Letter. The MSRB shortened the look-back period under MSRB rule G-37 to six months for certain municipal finance professionals in response to similar industry concerns about the impact on hiring. *See* MSRB, *Amendments Filed to Rule G-37 Concerning the*

time out is not triggered by a contribution made by a natural person more than six months prior to becoming a covered associate, unless he or she, after becoming a covered associate, solicits clients.[217] As a result, the two-year look back applies only to covered associates who solicit for the investment adviser.[218]

The potential link between obtaining advisory business and contributions made by an individual prior to his or her becoming a covered associate that is uninvolved in solicitation activities is likely more attenuated and therefore, in our judgment, should be subject to a shorter look back. We have modeled this shortened look-back period[219] on the MSRB's six-month look back for certain personnel, which it implemented as a result of feedback it received from dealers that indicated the two-year look back was negatively affecting in-firm transfers and promotions and "preclud[ing] them from hiring individuals

Exemption Process and the Definition of Municipal Finance Professional (Sept. 26, 2002), *available at* http://www.msrb.org/msrb1/archive/g%2D37902notice.htm.

[217] Rule 206(4)-5(b)(2). An adviser is subject to the two-year time out regardless of whether it is "aware" of the political contributions. Thus, statements by prospective employees regarding whether they have made relevant contributions are insufficient to inoculate the adviser, as some commenters urged (*see, e.g.*, IAA Letter; ICI Letter; NSCP Letter; Caplin & Drysdale Letter), to ensure that investment advisers are not encouraged to relax their efforts to promote compliance with the rule's prohibitions. Nonetheless, advisers who advise or are considering advising any government entity should consider requiring full disclosure of any relevant political contributions from covered associates or potential covered associates to ensure compliance with rule 206(4)-5. Advisers are required to request similar reports about securities holdings by Advisers Act rule 204A-1(b)(1)(ii) [17 CFR 275.204A-1(b)(1)(ii)], which requires each of a firm's "access persons" to submit an initial "holdings report" of securities he or she beneficially owns at the time he or she becomes an access person, even though the securities would likely have been acquired in transactions prior to becoming an access person. For a discussion of an adviser's recordkeeping obligations with regard to records of contributions by a new covered associate during that new covered associate's look-back period, see *infra* note 428.

[218] *See* rule 206(4)-5(f)(2) (defining covered associate of an investment adviser as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee).

[219] *See* rule 206(4)-5(b)(2).

who had made contributions, even though the contributions (which may have been relatively small) were made at a time when the individuals had no reason to be familiar with Rule G-37."[220] This approach balances commenters' concerns about the implications for their hiring decisions with the need to protect against individuals marketing to prospective investment adviser employers their connections to, or influence over, government entities those advisers might be seeking as clients.[221]

(6) Exceptions for De Minimis Contributions

Rule 206(4)-5 permits individuals to make aggregate contributions without triggering the two-year time out of up to $350, per election, to an elected official or candidate for whom the individual is entitled to vote,[222] and up to $150, per election, to

[220] MSRB, *Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Amendments to Rules G-37, on Political Contributions and Prohibitions on Municipal Securities Business, G-8, on Books and Records, Revisions to Form G-37/G-38 and the Withdrawal of Certain Rule G-37 Questions and Answers*, Exchange Act Release No. 47609 (April 1, 2003) [67 FR 17122 (Apr. 8, 2003)]. *See also* MSRB, *Self-Regulatory Organizations; Order Granting Approval of a Proposed Rule Change and Amendment No. 1 Thereto by the Municipal Securities Rulemaking Board Relating to Amendments to Rules G-37, on Political Contributions and Prohibitions on Municipal Securities Business, G-8, on Books and Records, Revisions to Form G-37/G-38 and the Withdrawal of Certain Rule G-37 Questions and Answers*, Exchange Act Release No. 47814 (May 8, 2003) [68 FR 25917 (May 14, 2003)] (Commission order approving amendments to MSRB rule G-37); MSRB rule G-37(b)(iii).

[221] We are not adopting the suggestion of commenters to exclude from the look-back provision contributions made before a merger or acquisition by an adviser by not attributing the contributions of the acquired adviser to the acquiring adviser. *See, e.g.,* Dechert Letter; ICI Letter. We believe that an acquisition of another adviser could raise identical concerns where the acquired adviser has made political contributions designed to benefit the acquiring adviser. Rule 206(4)-5 is not intended to prevent mergers in the investment advisory industry or, once a merger is consummated, to hinder the surviving adviser's government advisory business unless the merger was an attempt to circumvent rule 206(4)-5. Thus, the adviser may wish to seek an exemption from the ban on receiving compensation pursuant to rule 206(4)-5(a) from the Commission. The MSRB takes the same approach to this issue. *See* MSRB Rule G-37 Q&A, Question II.16.

[222] For purposes of rule 206(4)-5, a person would be "entitled to vote" for an official if the person's principal residence is in the locality in which the official seeks election. For example, if a government official is a state governor running for re-election, any covered

an elected official or candidate for whom the individual is not entitled to vote.[223] These *de minimis* exceptions are available only for contributions by individual covered associates, not the investment adviser itself.[224] Under both exceptions, primary and general elections would be considered separate elections.[225]

We proposed a $250 *de minimis* exception for contributions to candidates for whom a covered associate is entitled to vote,[226] which reflects the current *de minimis* exception in MSRB rule G-37.[227] Many commenters urged us to increase the *de minimis* amount (either to a larger number or by indexing it to inflation), arguing that a

associate of an adviser who resides in that state may make a *de minimis* contribution to the official without causing a ban on that adviser being compensated for providing advisory services for that government entity. In the example of a government official running for President, any covered associate in the country can contribute the *de minimis* amount to the official's Presidential campaign. The MSRB has issued a similar interpretation of what it means to be "entitled to vote" for purposes of MSRB rule G-37. *See MSRB Reports*, Vol. 16. No. 1 (January 1996) at 31-34.

223 *See* Rule 206(4)-5(b)(1) (excepting "*de minimis*" contributions to "officials" (*see supra* note 139 and accompanying text) from the rule's two-year time out provision).

224 *Id.* Under the rule, each covered associate, taken separately, would be subject to the *de minimis* exceptions. In other words, the limit applies per covered associate and is not an aggregate limit for all of an adviser's covered associates. *But see supra* note 170 (pointing out that a sole proprietor may, in a personal capacity, avail herself or himself of the *de minimis* exceptions even though his or her contributions are otherwise considered contributions of the adviser itself).

225 Accordingly, a covered person of an investment adviser could, without triggering the prohibitions of the rule, contribute up to the limit in both the primary election campaign and the general election campaign of each official for whom the person making the contribution would be entitled to vote. The MSRB takes the same approach of excepting from rule G-37's time out trigger contributions up to the rule's *de minimis* amount for *each* election (including a primary and general election). *See* MSRB Rule G-37 Q&A, Question II.8. *See also In the Matter of Pryor, McClendon, Counts & Co., Inc., et al.*, Exchange Act Release No. 48095 (June 26, 2003) (noting that contributions must be limited to MSRB rule G-37's *de minimis* amount *before* the primary, with the same *de minimis* amount allowed *after* the primary for the general election).

226 *See* Proposing Release, at section II.A.3(a)(6).

227 *See* MSRB rule G-37(b)(i).

contribution as large as $1,000 would be unlikely to influence the award of an advisory contract by a public pension plan.[228]

The $1,000 amount suggested by some commenters strikes us as a rather large contribution that could influence the hiring decisions, depending upon the size of the jurisdiction, the amount of campaign contributions to opposing candidates, and the competitiveness of the primary or prospective election. Instead, we are taking the suggestion of several commenters[229] that we should increase the *de minimis* amount to reflect the effects of inflation since the MSRB first established its $250 *de minimis* amount in 1994.[230] We may consider increasing the $350 amount in the future if, for example, the value of it decreases materially as a result of further inflation.

Commenters also urged us to eliminate the condition that a covered associate must be able to vote for the candidate.[231] They asserted that persons can have a legitimate interest in contributing to campaigns of people for whom they are unable to

[228] *See, e.g.*, SIFMA Letter; NASP Letter; Comment Letter of Philip K. Holl (Oct.5, 2009) ("Holl Letter"); NSCP Letter; Caplin & Drysdale Letter; Cornell Law Letter; ICI Letter; MFA Letter; Seward & Kissel Letter; Callcott Letter II; Comment Letter of the California State Teachers' Retirement System (Oct. 6, 2009) (adopted policies that limit contributions to board members by those seeking investment relationships with the fund to $1,000). Several commenters suggested our proposed *de minimis* limit could be subject to a challenge on constitutional grounds. For a discussion of, and response to, these comments, see *supra* note 72 and accompanying text.

[229] *See, e.g.*, Caplin & Drysdale Letter (recommending that we index the *de minimis* threshold for inflation); Cornell Law Letter (recommending that we index the *de minimis* threshold for inflation). *See also* Callcott Letter I.

[230] We multiplied the $250 *de minimis* amount that we proposed (which was adopted by the MSRB in 1994) by the annual consumer price index (a measure of inflation) change since 1994, as reported by the Bureau of Labor Statistics (*available at*

http://www.bls.gov/data/). The result was approximately $365 in 2009; we rounded it down to $350 for administrative convenience.

[231] *See, e.g.*, T. Rowe Price Letter; Dechert Letter; MFA Letter; NASP Letter; Callcott Letter I; Cornell Law Letter; IAA Letter.

vote.[232] We acknowledge that persons can have such an interest, such as in large metropolitan areas where a covered associate may work and live in different jurisdictions. But commenters did not confine their recommendations to such circumstances and we remain concerned that contributions by executives of advisers living in distant jurisdictions may be less likely to be made for purely civic purposes. Accordingly, we have added a *de minimis* exception for contributions of up to $150 to officials for whom a covered associate is not entitled to vote, which is lower than the *de minimis* exception of $350 for candidates for whom a covered associate is entitled to vote. We believe that $150 is a reasonable amount for the additional *de minimis* exception we are adopting because of the more remote interest a covered associate is likely to have in contributing to a person for whom he or she is not entitled to vote.

(7) Exception for Certain Returned Contributions

We are adopting, largely as proposed, an exception that will provide an adviser with a limited ability to cure the consequences of an inadvertent political contribution to an official for whom the covered associate making it is *not* entitled to vote.[233] The exception is available for contributions that, in the aggregate, do not exceed $350 to any one official, per election.[234] The adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution[235] and,

[232] *See, e.g.*, T. Rowe Price Letter; Dechert Letter; MFA Letter; NASP Letter; Callcott Letter

I; Cornell Law Letter.

233 Rule 206(4)-5(b)(3).

234 Rule 206(4)-5(b)(3)(i). We note that a contribution would not trigger the two-year ban at all to the extent it falls within the *de minimis* exception described in rule 206(4)-5(b)(1). *See* section II.B.2(a)(6) of this Release for a discussion of this exception.

235 *Id.*

within 60 days after learning of the triggering contribution, the contributor must obtain the return of the contribution.[236]

The scope of this exception is limited to the types of contributions that we believe are less likely to raise pay to play concerns. The prompt return of the contribution provides an indication that the contribution would not affect an official of a government entity's decision to award an advisory contract.[237] The relatively small amount of the contribution, in conjunction with the other conditions of the exception, suggests that it was unlikely to be made for the purpose of influencing the award of an advisory contract. Repeated triggering contributions suggest otherwise or that the adviser has not implemented effective compliance controls. Therefore, the rule limits an adviser's reliance on the exception to no more than two or three per 12-month period (based on the size of the adviser),[238] and no more than once for each covered associate,[239] regardless of the time period.[240]

236 Rule 206(4)-5(b)(3)(i).

237 The 60-day limit is designed to give contributors sufficient time to seek its return, but still

require that they do so in a timely manner. Also, this provision is consistent with MSRB rule G-37(j)(i). If the recipient will not return the contribution, the adviser would still have available the opportunity to apply for an exemption under paragraph (e) of the rule. Paragraph (e), which sets forth factors we would consider in determining whether to grant an exemption, includes as a factor whether the adviser has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution.

[238] Rule 206(4)-5(b)(3)(ii). The approach we have taken will generally create some

flexibility to accommodate a limited number of contributions by covered associates that would otherwise trigger the two-year time out. In a modification from our proposal that we believe is responsive to certain commenters' concerns (*see* note 251 and accompanying text below), "larger" advisers may avail themselves of three automatic exceptions, instead of two, in any calendar year. Rule 206(4)-5(b)(3)(ii). In contrast, our proposal would have permitted each adviser, regardless of its size, to rely on the automatic exception twice each year. The rule identifies a "larger" adviser for these purposes as any adviser who has reported in response to Item 5.A on its most recently filed Form ADV, Part 1A [17 CFR 279.1] that it has more than 50 employees. *Id.*

Investment Adviser Registration Depository (IARD) data as of April 1, 2010 indicate that

Commenters who addressed it generally supported our inclusion of an automatic exception provision,[241] although several suggested modifications.[242] Some urged us to eliminate the requirement that the contributor succeed in obtaining the return of the contribution.[243] We are not making this change, which could undermine our goals in adopting the rule if it led to contributors asking for the return of a contribution where such requests were expected to be refused by the government official. We would have to discern whether the contributor itself, who may (or whose employer may) be seeking to influence government officials, has tried "hard enough" to get the contribution back.

Other commenters recommended an alternative exception for inadvertent contributions that would not require that an otherwise-triggering contribution be

approximately 10 percent of registered advisers have more than 50 employees (and would therefore be limited to three "automatic" exceptions per calendar year instead of two). In particular, the data indicate that there are 11,607 registered investment advisers. Of those, 1,072 advisers (9.2% of the total) have indicated in their responses to Item 5.A of Part 1A of Form ADV that they have more than 50 employees. We chose the 50 employee cut-off because the number of employees is independently reported on Form ADV (and therefore cross-verifiable)—each adviser filing Form ADV must check a box indicating an approximation of the number of employees it has, choosing among 1-5, 6 10, 11-50, 51-250, 251-500, 501-1,000, or more than 1,000—and because we believe that inadvertent violations of the rule are more likely at advisers with greater numbers of employees. We think that the twice per year limit is appropriate for small advisers and the three times per year limit is appropriate for larger advisers. We do not believe it is appropriate for there to be greater variation in the number of times advisers may rely on the exception than that based either on their size or on other characteristics. We are seeking to encourage robust monitoring and compliance.

239 Rule 206(4)-5(b)(3)(iii). Once a covered associate has been made aware of an "inadvertent" violation, a justification for a second violation would be more questionable.

240 Although we have included different allowances for larger and smaller advisers (based on the number of employees they report on Form ADV), our approach otherwise generally tracks MSRB rule G-37's "automatic exemption" provision. *See* MSRB rule G-37(j).

241 *See, e.g.*, T. Rowe Price Letter; NSCP Letter; CT Treasurer Letter; Skadden Letter; ICI Letter; IAA Letter.

242 *See, e.g.*, NY City Bar Letter; Dechert Letter; IAA Letter.

243 *See, e.g.*, T. Rowe Price Letter; NSCP Letter; CT Treasurer Letter.

returned.[244] They contended that such an exception should be available to advisers with policies and procedures in place to prevent pay to play that include sanctions for employees violating the policies.[245] Such an approach excludes any objective indication that the contribution was inadvertent. As noted above, policies and procedures are required to ensure compliance with our rule. But policies and procedures alone, without critical objective criteria, such as obtaining a return of the contribution, are insufficient in our view to justify an exception to our prophylactic rule.

Some commenters urged us to modify or eliminate the requirement that the contribution be discovered by the adviser within four months.[246] We believe, however, that four months is the appropriate timeframe. We believe advisers should have a reasonable amount of time to discover contributions made by covered associates if, for example, their covered associates disclose their contributions to the adviser on a quarterly basis.[247] The absence of such a time limitation would encourage advisers not to seek to

[244] *See, e.g.*, IAA Letter (suggesting that we require, as a condition for such an exception, that "such contribution resulted in an inadvertent violation, meaning violations that are not reasonably known or condoned by the investment adviser and where the contributor lacked intent to influence the award of the advisory contract or violate the rule in making the contribution, as evidenced by the facts and circumstances surrounding such contribution").

[245] *See, e,g.*, IAA Letter; Dechert Letter; NY City Bar Letter.

[246] *See, e.g.*, T. Rowe Price Letter (arguing that, if an adviser has in place procedures to require covered associates to report all contributions no less frequently than quarterly, and an associate fails to report a contribution in violation of the procedures, the discovery of a prohibited contribution outside this four-month window should not preclude the use of this exception.). *But see* Fund Democracy/Consumer Federation Letter (urging us to consider shortening the time in which a contribution must be discovered for the exception to be available to one month).

[247] Quarterly compliance reporting is familiar to advisory personnel. *See, e.g.*, rule 204A-1 under the Advisers Act (requiring that, under an adviser's code of ethics, personnel report personal securities trading activity at least quarterly). We do not believe the exception should be available where it takes longer for advisers to discover contributions made by covered associates because they might enjoy the benefits of a contribution's potential

discover such contributions if they believed they could simply rely on the exception any time a contribution happened to come to light.

A number of commenters suggested the exception be allowed for *all* contributions regardless of dollar amount, while a few recommended raising the dollar amount to $1,000.[248] As we noted above, we view the limitation on the amount of such a contribution, in conjunction with the other conditions of the exception, important to the rule because it is more likely that the contribution was, in fact, inadvertent. We have modified this "automatic" exception from our proposal by raising the limit on contributions eligible for the exception to $350, the same amount we have adopted as a *de minimis* threshold for contributions to an official for whom a covered associate is entitled to vote.[249] In addition, at the suggestion of commenters who argued that our proposed limitation on the annual use of such exception failed to take into consideration the different size of advisers, [250] we have modified our proposal to permit use of the exception three times in any year by an adviser that has reported on its Form ADV

influence for too long a period of time. The condition that the contribution be discovered within four months is consistent with the MSRB's approach. *See* MSRB rule G-37(j)(i).

[248] *See, e.g.*, SIFMA Letter; NASP Letter; Holl Letter; NSCP Letter; ICI Letter; MFA Letter.

[249] Rule 206(4)-5(3)(i)(B). No automatic exception is available for any contributions to an official for whom the covered associate is entitled to vote that exceed the *de minimis* $350 amount. As explained above, we believe that $350 is the appropriate *de minimis* threshold for contributions to officials for whom a covered associate is entitled to vote and $150 is the appropriate *de minimis* threshold for contributions to officials for whom a covered associate it not entitled to vote. *See* section II.B(6) of this Release. Because these thresholds are different, we anticipate that covered associates could mistakenly make contributions up to the higher threshold under the mistaken belief that they are entitled to vote for an official when in fact they are not entitled to do so. So long as those contributions are returned and the other conditions of the exception are met, we believe they should be eligible for the automatic exception.

[250] *See, e.g.*, Skadden Letter; T. Rowe Price Letter; NSCP Letter; ICI Letter; IAA Letter.

registration statement that it had more than 50 employees who perform investment advisory functions.[251]

The exception is intended to provide advisers with the ability to undo certain mistakes. Because it operates automatically,[252] we believe it should be subject to conditions that are objective and limited in order to capture only those contributions that are unlikely to raise pay to play concerns.[253]

(b) Ban on Using Third Parties to Solicit Government Business

Rule 206(4)-5 makes it unlawful for any investment adviser subject to the rule or any of the adviser's covered associates to provide or agree to provide, directly or indirectly, payment[254] to any person to solicit[255] government clients for investment

[251] *See supra* note 238.

[252] The exception is "automatic" in the sense that an adviser relying on it may do so without notifying the Commission or its staff. However, we note that the recordkeeping obligations for registered advisers mandate specifically that an adviser maintain records regarding contributions with respect to which the adviser has invoked this exception. Rule 204-2(a)(18)(ii)(D). *See also* section II.D of this Release.

[253] As discussed below in section II.B.2(f) of this Release, in other circumstances, advisers can apply to the Commission for an exemption from the rule's two-year time out. *See* rule 206(4)-5(e).

[254] The term "payment" is defined in rule 206(4)-5(5)(f) as any gift, subscription, loan, advance, or deposit of money or anything of value. Depending on the specific facts and circumstances, payment can include *quid pro quo* arrangements whereby a non-affiliated person solicits advisory business for the adviser in exchange for being hired by the adviser to provide other unrelated services. This approach is consistent with the MSRB's with regard to MSRB rule G-38's third-party solicitor ban. *See* MSRB, *Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), *available at* http://msrb.org/msrb1/rules/notg38.htm. *But see infra* note 257 (discussing the provision of professional services by third parties).

[255] For the definition of what it means to "solicit" a client or prospective client to provide investment advisory services, which we are adopting as proposed, see text accompanying note 185. This definition is consistent with the definition the MSRB employs for similar purposes in rule G-38, the MSRB's rule that restricts third-party solicitation activity. MSRB rule G-38(b)(i).

advisory services on its behalf.[256] The prohibition is limited to third-party solicitors. Thus, the prohibition does not apply to any of the adviser's employees, general partners, managing members, or executive officers.[257] Contributions by these persons, however, may trigger the two-year time out. As discussed in more detail below, the prohibition also does not apply to certain "regulated persons" that themselves are subject to prohibitions against engaging in pay to play practices.[258]

We proposed to prohibit advisers from paying third parties in order to prevent advisers from circumventing the rule.[259] We observed in the Proposing Release that solicitors or "placement agents" have played a central role in actions that we and other authorities have brought involving pay to play schemes;[260] in several instances, advisers allegedly made significant payments to placement agents and other intermediaries in order to influence the award of advisory contracts.[261] We noted that government authorities in New York and other jurisdictions have prohibited or are considering

[256] Rule 206(4)-5(a)(2)(i). *See also* Proposing Release, at section II.A.3(b).

[257] Rule 206(4)-5(a)(2)(i). We note that, so long as non-affiliated persons providing legal, accounting, or other professional services in connection with specific investment advisory business are not being paid directly or indirectly by an investment adviser for communicating with a government entity (or its representatives) for the purpose of obtaining or retaining investment advisory business for the adviser—*i.e.*, they are paid solely for their provision of legal, accounting, or other professional services with respect to the business—they would not become subject to the ban on payments by advisers to third-party solicitors. This approach is similar to the MSRB's with regard to MSRB rule G-38's third-party solicitor ban. *See* MSRB, *Interpretive Notice on the Definition of Solicitation under Rules G-37 and G-38* (June 8, 2006), *available at* http://msrb.org/msrb1/rules/notg38.htm.

[258] This exception, which is responsive to commenters' concerns, is a modification of our proposal. As discussed below, we also eliminated an exception in our proposal that would have applied to "related persons" of the adviser and, if such "related person" were a company, an employee of the "related person." *See* Proposing Release, at section II.A.3(b).

[259] *See* Proposing Release, at section II.A.3(b).

[260] *Id*. at sections I and II.A.3(b).

[261] *Id.* at section II.A.3(b).

limiting or prohibiting the use of consultants, solicitors, or placement agents by investment advisers to solicit government business.[262] We considered the MSRB's experience with solicitors, which ultimately led it to ban municipal securities dealers from hiring consultants to solicit government clients after concluding that less restrictive approaches were ineffective to prevent circumvention of MSRB rule G-37.[263] We recalled comment letters we received in 1999 from advisers asserting that they should not

[262] *Id.* Since our proposal, a few state and local governments have undertaken actions to prohibit or regulate pay to play practices involving placement agents in response to concerns about to pay to play activities in their jurisdictions. For example, New York City Comptroller John C. Liu announced reforms relating to how the New York City pension funds make investments (including prohibitions on gifts and campaign contributions, strict rules on employees of the Office of New York City Comptroller, employees and trustees of the New York City pension systems, fund managers, and placement agents, and an expansion of the ban on private equity placement agents to include placement agents to other types of funds while providing an exclusion for legitimate placement agents who provide value-added services). *See* Office of the New York City Comptroller, *Comptroller Liu Announces Major Reforms to Pension Fund Investments*, Press Release, Feb. 18, 2010, *available at* http://www.comptroller.nyc.gov/press/2010_releases/pr10-02-022.shtm. A bill was introduced in California that would treat placement agents soliciting government entity clients as lobbyists and therefore restrict them from charging contingency fees. *See* Assem. B. 1743, 2009-10 Leg., Reg. Sess. (Cal. 2010), *available at* http://info.sen.ca.gov/pub/09-10/bill/asm/ab_1701 1750/ab_1743_bill_20100208_introduced.html. *See also* Cal. Gov't. Code §86205(f) (Deering 2010). Another law was passed in California on an emergency basis imposing

new disclosure obligations and prohibitions regarding placement agents. *See* Assem. B. 1854, 2009-10 Leg., Reg. Sess. (Cal. 2010) *available at* http://info.sen.ca.gov/pub/09 10/statute/ch_0301-0350/ch_301_st_2009_ab_1584. *See also* CalPERS, *CalPERS Releases Placement Agent Disclosures*, Press Release, Jan. 14, 2010, *available at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2010/jan/agent-disclosures.xml.

(discussing recent actions by CalPERS to make public more than 600 placement agent disclosures from the fund's external managers).

[263] *See* Proposing Release, at n.130 and accompanying text. *See also* MSRB Letter ("Due to

concerns regarding questionable practices by some consultants and a determination by the MSRB that it would be in the public interest to make the process of soliciting municipal securities business fully subject to the MSRB rules of fair practice and professionalism, the MSRB rescinded its original rule in 2005 and adopted new Rule G 38, on solicitation of municipal securities business, to prohibit dealers from using paid third-party consultants to obtain municipal securities business on their behalf.").

be held accountable for the political contributions of their third-party solicitors whom, they asserted, advisers lacked the ability to control.[264]

The record before us raised deeply troubling concerns about advisers' use of third-party solicitors to engage in pay to play activities.[265] We were concerned that a rule that failed to address the use of these solicitors would be ineffective were advisers simply to begin using solicitors and placement agents that have made political contributions or payments funded in part or in whole by the fees they receive from advisers.[266] Therefore, we proposed to prohibit advisers from engaging third parties to solicit government clients on their behalf.[267] In doing so, we requested comments on alternative approaches we

[264] In 1999, the Commission proposed a similar rule, which also would have been codified as rule 206(4)-5 under the Advisers Act, had it been adopted. *See Political Contributions by Certain Investment Advisers*, Investment Advisers Act Release No. 1812 (Aug. 4, 1999) [64 FR 43556 (Aug. 10, 1999)] ("1999 Proposing Release"). Comments on that proposal received electronically (comment file S7-19-99) are *available at* http://www.sec.gov/rules/proposed/s71999.shtml. Among the commenters on the 1999 Proposing Release who argued that advisers should not be held accountable for the political contributions of their third-party solicitors are: Comment Letter of Davis Polk (Nov. 1, 1999); Comment Letter of Legg Mason (Nov. 1, 1999); Comment Letter of MSDW (Nov. 1, 1999). At least one commenter on our 2009 proposal, although opposing the proposed third-party solicitor ban, took the same view. *See* MFA Letter ("We strongly agree with the SEC's comment in the Release that "covered associates" should not include employees of entities unaffiliated with an investment adviser, such as the employees of a third-party placement agent. An investment adviser would not have

the authority or capability to monitor and restrict political contributions made by individuals not employed by the adviser.").

265 *See* Proposing Release, at section I; section I of this Release. Moreover, "no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic." *Blount*, 61 F.3d at 945.

266 *See* Proposing Release, at section II.A.3(b). Some commenters have supported this approach. *See, e.g.*, Fund Democracy/Consumer Federation Letter ("Permitting advisers to circumvent pay-to-play restrictions by hiring solicitors would eviscerate the heart of the direct prohibition against advisers' bribing politicians in return for money management contracts."). We also noted commenters' concerns regarding the difficulties advisers face in monitoring the activities of their third-party solicitors. *See* Proposing Release, at section II.A.3(b).

267 *See* Proposing Release, at section II.A.3(b).

could take.[268] We wanted to know whether there might be a more effective means to accomplish our objectives, or means that would be less restrictive.

We received a large number of comments on this question. We received letters from the New York State Comptroller and New York City Comptroller that expressed strong support for the ban on using third parties to solicit government plans.[269] One commenter supporting the ban pointed out the key role that placement agents have played in pay to play practices.[270] It expressed concern that adopting the rule without the ban would exacerbate the problem by placing more pressure on advisers to pay "well connected" placement agents for access since the advisers will be limited in their contributions.[271] Another commenter expressed the view that "the most egregious violations of the public trust in this area have come from placement agents and those seeking finder's fees. The outright ban on their use to deter pay-to-play schemes is entirely appropriate."[272]

Most commenters, including many representing advisers, broker-dealers, placement agents and solicitors, and some government officials, however, strongly opposed the ban. Many asserted that solicitors, consultants and placement agents provide valuable services both for advisers seeking clients and for the public pension plans that

[268] *See id.*

[269] DiNapoli Letter; Thompson Letter (as indicated in note 262 above, NYC Comptroller Liu recently announced his office's approach to third-party solicitors).

[270] Fund Democracy/Consumer Federation Letter.

[271] *Id.*

[272] Common Cause Letter. *See also* Cornell Law Letter (generally supporting the prohibition on using third-party solicitors "given that third-party solicitors have played a central role in each of the enforcement actions against investment advisors that the Commission has brought in the past several years involving pay-to-play schemes.").

employ them and that banning their use would have several deleterious effects.[273] Several claimed that the rule would favor banks because banks are excluded from the definition of "investment adviser" under the Advisers Act and therefore are not subject to the Commission's rules, including rule 206(4)-5.[274] Others claimed the rule would favor larger investment advisers (which have internal marketing departments) over smaller firms.[275] Other commenters asserted the ban would harm smaller pension funds that do

[273] *See, e.g.*, Comment Letter of Senator Christopher J. Dodd (Feb. 2, 2010) ("Dodd Letter"); NY City Bar Letter; Dechert Letter; ABA Letter; Comment Letter of Teacher Retirement System of Texas (Oct. 12, 2009); Comment Letter of Bryant Law (Oct. 9, 2009) ("Bryant Law Letter"); Comment Letter of Probitas Partners (Oct. 6, 2009) ("Probitas Letter"); Comment Letter of Larry Simon (Oct. 6, 2009) ("Simon Letter"); Comment Letter of MarketCounsel, LLC (Oct. 6, 2009); ICI Letter; Comment Letter of Colorado Public Employees' Retirement Association (Oct. 6, 2009); Skadden Letter.

[274] *See* Advisers Act section 202(a)(11)(A) [15 U.S.C. 80b-2(a)(11)(A)] (excepting from the

definition of "investment adviser," and therefore from regulation under the Advisers Act, "a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company . . . ."). We discuss possible competitive effects of our rule's inapplicability to banks in section VI of this Release. We believe that the concerns the rule is designed to address, as discussed throughout this Release, warrant its adoption, notwithstanding these potential competitive effects.

275 *See, e.g.,* SIFMA Letter; IAA Letter; MFA Letter; Comment Letter of National

Conference on Public Employee Retirement Systems (Oct. 6, 2009) ("NCPERS Letter"); Comment Letter of European Private Equity & Venture Capital Association (Sept. 9, 2009) ("EVCA Letter"); Seward & Kissel Letter; Comment Letter of Sadis & Goldberg LLP (Oct. 2, 2009) ("Sadis & Goldberg Letter"); Comment Letter of State of Wisconsin Investment Board (Aug. 31, 2009) ("WI Board Letter"); Comment Letter of the Executive Director of Georgia Firefighters' Pension Fund, James R. Meynard, (Sept. 3, 2009) ("GA Firefighters Letter"); Comment Letter of Minnesota State Board of Investment (Sept. 8, 2009) ("MN Board Letter"); Comment Letter of Illinois Public Pension Fund Association (Sept. 29, 2009) ("IL Fund Association Letter"); Comment Letter of Melvyn Aaronson, Sandra March and Mona Romain, Trustees of the Teachers' Retirement System of the City of New York (Oct. 1, 2009) ("NYC Teachers Letter"); Comment Letter of the Texas Association of Public Employee Retirement Systems (Oct. 6, 2009) ("TX Public Retirement Letter"); Comment Letter of the Pennsylvania Public School Employees' Retirement Board (Oct. 6, 2009) ("PA Public School Retirement Letter"); Comment Letter of the California State Association of County Retirement Systems (Sept. 8, 2009) ("CA Assoc. of County Retirement Letter"); Caplin & Drysdale Letter; Comment Letter of Paul Ehrmann (Aug. 10, 2009) ("Ehrmann Letter"); Comment Letter of Joseph Finn (Aug. 10, 2009) ("Finn Letter"); Comment Letter of the Managing Partner of The Savanna Real Estate Fund I, LLP, Nicholas Bienstock (Aug. 11, 2009) ("Savanna Letter"); Comment Letter of Atlantic-Pacific Capital, Inc. (Aug. 12, 2009) ("Atlantic-Pacific Letter"); Comment Letter of Tricia Peterson (Aug. 14, 2009)

not have the resources to conduct a search for advisers on their own, and harm advisers that rely on the services that placement agents provide.[276] A number of commenters argued that the prohibition would reduce competition by reducing the number of advisers competing for government business,[277] and limit the universe of investment opportunities presented to public pension funds.[278]

Many of these commenters conceded that there is a problem with placement agents and other intermediaries, but asserted it is caused by a few bad actors, for which an entire industry should not be penalized.[279] A common theme among many

("Peterson Letter"); Comment Letter of Devon Self Storage Holdings (US) LLC (Aug. 21, 2009) ("Devon Letter"); Comment Letter of Thomas Capital Group, Inc. (Aug. 24, 2009) ("Thomas Letter"); Comment Letter of Stephen R. Myers (Aug. 26, 2009) ("Myers Letter"); Comment Letter of Chaldon Associates LLC (Aug. 26, 2009) ("Chaldon Letter"); Comment Letter of The Meridian Group (Aug. 26, 2009) ("Meridian Letter"); Comment Letter of Benedetto, Gartland & Company, Inc. (Sept. 30, 2009) ("Benedetto Letter"); Comment Letter of the Partners of CSP Securities, LP and Capstone Partners, LP (Sept. 17, 2009) ("Capstone Letter"); Comment Letter of Presidio Partners LLC Managing Partner Alan R. Braxton (Sept. 21, 2009) ("Braxton Letter"); Comment Letter of Littlejohn & Co., LLC (Sept. 14, 2009) ("Littlejohn Letter"); Comment Letter of Alta Communications (Sept. 18, 2009) ("Alta Letter"); Comment Letter of Charles River Realty Investors LLC (Sept. 23, 2009) ("Charles River Letter"); Comment Letter of W. Allen Reed (Sept. 19, 2009) ("Reed Letter"); Comment Letter of Glovista Investments LLC (Sept. 23, 2009) ("Glovista Letter"); Comment Letter of The Blackstone Group (Sept. 14, 2009) ("Blackstone Letter"); Park Hill Letter. Two commenters noted that the ban would result in less transparency as these services go "in-house." CalPERS Letter; Bryant Law Letter. Others commented on the effects on minority and women-owned firms. *See, e.g.*, NYC Teachers Letter, Myers Letter; GA Firefighters Letter; MN Board Letter; Blackstone Letter.

276 *See, e.g.*, Dodd Letter; NY City Bar Letter; Dechert Letter; ABA Letter; Probitas Letter; Seward & Kissel Letter; MFA Letter.

277 *See, e.g.*, Seward & Kissel Letter; Meridian Letter; NY City Bar Letter; Probitas Letter; Simon Letter; MFA Letter.

278 *See, e.g.*, SIFMA Letter; IAA Letter; Strategic Capital Letter; Alta Letter; Benedetto Letter; Comment Letter of Jim Glantz (Sept. 24, 2009) ("Glantz Letter"); Comment Letter of Venera Kurmanaliyeva (Sept. 15, 2009) ("Kurmanaliyeva Letter"); Park Hill Letter.

279 *See, e.g.*, Comment Letters of Brady Pyeatt (Aug. 4, 2009) & (Oct. 6, 2009); Comment Letter of Andrew Wang (Aug. 10, 2009); Comment Letter of Monomoy Capital Management, LLC (Aug. 25, 2009) ("Monomoy Letter"); Comment Letter of Ted Carroll

commenters was that the rule failed to distinguish "illegitimate" consultants and placement agents from the "legitimate" ones who provide an important service.[280]

We believe that many of the comments overstate the likely consequences of adoption of the rule. First, the rule will not prevent public pension plans from hiring their own consultants—*i.e.*, using their own resources—to assist them in their search for an investment adviser.[281] These consultants would have access to information about smaller advisers whose services may be appropriate for the plan. Many public pension plans already make—or are required to make—specific accommodations for so-called "emerging money managers" that otherwise may have difficulty getting noticed by public pension plans.[282] Second, these commenters failed to consider the potentially significant

(Aug. 4, 2009); Comment Letter of James C. George (Sept. 10, 2009) ("George Letter"); Comment Letter of Ariane Capital Partners LLC (Sept. 17, 2009); Blackstone Letter; Comment Letter of Nancy Fossland (Sept. 16, 2009); Comment Letter of Steven A. Friedmann (Sept. 14, 2009); Comment Letter of Keith P. Harney (Sept. 15, 2009); Comment Letter of Robert F. Muhlhauser III (Sept. 14, 2009); Comment Letter of XT Capital Partners, LLC (Sept. 30, 2009); CapLink Letter.

[280] *See, e.g.*, Bryant Law Letter; Comment Letter of Hedgeforce (Oct. 6, 2009) ("Hedgeforce Letter").

[281] *See* Fund Democracy/Consumer Federation Letter ("The proposed ban would "deny access" to nothing. There is nothing [in the proposed rule] preventing pension funds from retaining their own consultants whose sole responsibility is to the pension fund and its beneficiaries.").

[282] *See, e.g.*, Randy Diamond, *CalPERS CIO Joe Dear says Emerging Managers Don't Need Placement Agents*, PENSIONS & INVESTMENTS, Feb. 24, 2010, *available at* http://www.pionline.com/article/20100224/REG/100229965; Michael Marois, *CalPERS, Blackstone Clash over Placement Agent 'Jackpot' Fees*, BLOOMBERG (Apr. 7, 2010), available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acPNrTn1q7pw (quoting CalPERS CIO Joe Dear, "There's clear evidence in past practice that it's possible to develop an investment relationship with us by making a normal approach, without the assistance of a contingent-paid placement agent."); Ohio Pub. Employees Ret. Sys., *Ohio-Qualified and Minority Manager Policy* (May 2006), *available at* https://www.opers.org/pdf/investments/policies/Ohio-Qualified-Minority-Manager Policy.pdf; Teachers' Ret. Sys. of the State of Ill., Fiscal Year 2009 Annual Report on the use of Women, Minority and Disabled-Owned (W/MBE) Investment Advisors and Broker/Dealers (Aug. 31, 2009), *available at*

costs of hiring consultants and placement agents,[283] which already may make them unavailable to smaller advisers. Eliminating the cost of pay to play may, in fact, provide greater access to pension plans by those advisers which are unable to afford the costs of direct or indirect political contributions or placement agent fees.[284] We expect that prohibiting pay to play may reduce the costs to plans and their beneficiaries of inferior asset management services arising from adviser selection based on political contributions rather than investment considerations.[285] Finally, commenters failed to identify any

http://trs.illinois.gov/subsections/investments/minorityrpt.pdf; Md. State Ret. and Pension Sys., *Terra Maria: The Maryland Developing Manager Program*, *available at* http://www.sra.state.md.us/Agency/Investment/Downloads/TerraMariaDevelopingManagerProgram-Description.pdf; Thurman V. White, Jr., Progress Inv. Mgmt. Co., *Successful Emerging Manager Strategies for the 21st Century*, 3 (2008), *available at* http://www.progressinvestment.com/content/files/successful_emerging_manager_strategies.pdf (containing a "representative list of known U.S. Pension Plans that have committed assets to emerging manager strategies").

[283] One commenter made a similar point: "The proposed ban would simply replace the

indirect cost of placement agents incurred by pension plan sponsors with the direct cost of hiring their own placement agents—without the conflict of interest and potential for abuse that relying on advisers' placement agents creates. It is not the cost of independent advice that the Commission has not accounted for in its proposal, but the cost of conflicts that critics have failed to acknowledge in their analysis." Fund Democracy/Consumer Federation Letter.

[284] At least one commenter agreed. *See* Butler Letter ("[W]e find some evidence that the pay

to play practices by underwriters [before rule G-37 was adopted] distorted not only the fees, but which firms were allocated business. The current proposal mentions that pay to play practices may create an uneven playing field among investment advisers by hurting smaller advisers that cannot afford to make political contributions. We find evidence that is consistent with this view [in our research on pay to play by municipal underwriters].

During the pay to play era, municipal bonds were underwritten by investment banks with larger underwriting market shares compared to afterward. One interpretation of this result is that smaller underwriters were passed over in favor of larger underwriters (who presumably had deeper pockets for political contributions)."). As we indicated in the Proposing Release, pay to play practices may hurt smaller advisers that cannot afford the required contributions. Curtailing pay to play arrangements enables advisory firms, particularly smaller advisory firms, to compete on merit, rather than their ability or willingness to make contributions. *See* Proposing Release, at sections I and IV.

[285] *See* Tobe Letter (describing an under-performing money manager that was fired after the

commenter, a pension official, began to inquire into how it was selected); Weber Letter ("I have seen money managers awarded contracts with our fund which involved payments to individuals who served as middlemen, creating needless expense for the

meaningful way in which our rule might distinguish "legitimate" from "illegitimate" solicitors or placement agents. Even solicitors and placement agents that engage in pay to play may appear to operate "legitimately."[286]

Some commenters suggested alternatives to our proposed ban to address our concern that pay to play activities are often carried out through or with the assistance of third parties.[287] Several commenters, for example, suggested that we instead require greater disclosure by advisers of payments to solicitors.[288] Such an approach could be

fund. These middlemen were political contributors to the campaigns of board members who voted to contract for money management services with the companies who paid them as middlemen.").

[286] *See Blount*, 61 F.3d at 944 ("actors in this field are presumably shrewd enough to structure their relations rather indirectly").

[287] We note that, in addition to the alternatives discussed below, some commenters called for approaches outside the scope of our authority, such as an outright ban on all political contributions by third-party solicitors, the imposition of criminal penalties, or modification of the structure of pension boards. *See, e.g.*, Monomoy Letter (arguing that the Commission or the appropriate criminal authority should mandate jail time for public officials and intermediaries where the official gets a benefit from a public fund investment in a particular fund, that all managers of intermediaries who receive fees in such transactions should be banned from the financial services industry for life, and that all members of the general partner (manager) of the fund in which the investment is made be banned from the financial services industry for life); NCPERS Letter (arguing that the most effective method of eliminating pay to play is by having multiple trustees on public pension boards); Thomas Letter (suggesting that stronger internal control procedures, segregation of duties and dispersed or committee approval of granting pension business could help prevent pay to play activities, each of which historically has involved a complicit senior public plan fund official); Comment Letter of the Massachusetts Pension Reserves Investment Management Board (Aug. 26, 2009) ("PRIM Board Letter"); Preqin Letter I (acknowledging that it is outside the remit of the Commission, but arguing that there should be better oversight of public pension funds, and investment committees should consist of a minimum number of members in order to prevent a sole official being responsible for the investment-decision process); Triton Pacific Letter (arguing that the

Commission should adopt regulation of pension officials who are often responsible for initiating pay to play arrangements).

288 Several commenters urged us to require advisers to disclose to clients their payments to third-party solicitors and placement agents. *See, e.g.*, ABA Letter; 3PM Letter; ICI Letter; NY City Bar Letter; Comment Letter of Forum Capital Securities, LLC (Oct. 5, 2009) ("Forum Letter"); Jones Day Letter; CapLink Letter. Some asserted that existing disclosure requirements, such as those included in the Commission's investment adviser cash solicitation rule, are sufficient to address pay to play. *See, e.g.*, Comment Letter of

helpful to give plan fiduciaries information necessary for them to satisfy their legal obligations and uncover abuses,[289] but it would not be useful when plan fiduciaries themselves are participants in the pay to play activities.[290] In addition, as one commenter pointed out, the MSRB had already sought unsuccessfully to address the problem of placement agents and consultants engaging in pay to play activities on their principals' behalf through mandating greater disclosure.[291]

Steven Rubenstein (Aug. 17, 2009) ("Rubenstein Letter") (noting that Advisers Act rule 206(4)-3 [17 CFR 275.206(4)-3], the "cash solicitation rule," is adequate as is, but "just needs to be followed"); Thomas Letter (supporting "enforcement of existing disclosure rules"); Chaldon Letter (arguing that, in the scandals that have recently occurred, if the fee sharing arrangements had been disclosed to pension fund boards, no law or regulation would have been violated, and that third-party marketers should adhere to current law instead of banning a legitimate business practice); Comment Letter of Ray Wirta (Sept. 4, 2009) (arguing that all that is necessary is that penalties should be heightened, enforcement stepped up and results highly publicized); Arrow Letter (arguing that enforcement of the Advisers Act and FINRA requirements have ensured lawful and ethical business practices for decades); 3PM Letter (arguing that the rule's scope could be extended to include various additional disclosures). But we do not believe, for the reasons described above, that enforcement of existing obligations alone is sufficient to deter pay to play activities.

289 Some public pension plans have adopted policies requiring advisers they hire to disclose information about placement agents, including their political connections. *See, e.g.*, Cal. Pub. Employees Ret. Sys., *CalPERS Adopts Placement Agent Policy – Requires Disclosure of Agents, Fees*, Press Release (May 11, 2009), *available at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2009/may/adopts-placement agent-policy.xml.

[290] For examples of cases in which plan fiduciaries themselves have allegedly participated in pay to play activities involving placement agents, see *New York v. Henry "Hank" Morris and David Loglisci*, Indictment No. 25/2009 (NY Mar. 19, 2009) (a public official was alleged to be a beneficiary of the pay to play activities); *SEC v. Paul J. Silvester, et al.,* Litigation Release No. 16759, Civil Action No. 3:00-CV-19411 DJS (D. Conn. 2000) (former Connecticut State Treasurer was alleged to be a beneficiary of a pay to play scheme in which an investment adviser to a private equity fund had paid third-party solicitors to obtain public pension fund investments in the fund). *See also* Proposing Release, at n.49 (discussing additional reasons why we believe a disclosure approach would not effectively address our concerns regarding pay to play activities).

[291] Cornell Law Letter ("For example, after concluding that required disclosure was neither adequate to prevent circumvention nor consistently being made, the [MSRB] amended its own rules on pay-to-play practices in the municipal securities markets to impose a complete ban on the use of third-party consultants to solicit government clients." (citations omitted)). *See also* 3PM Letter (acknowledging that, although increased