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Part IV

Securities and Exchange Commission

17 CFR Part 275
Political Contributions by Certain Investment Advisers; Final Rule
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. Rovert, 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.


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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


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.


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.
publicly held companies and the securities markets. But most significantly, their management affects taxpayers and the beneficiaries of these funds, including the millions of present and future State and municipal retirees who rely on the funds for their pensions and other benefits. 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 deprive prospective clients of the consultation, services, known as “pay to play,” distort the process by which advisers are selected. 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.

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.” 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 to any 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, may be 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, or may appoint some or all of the board members who make the selection.

Numerous investigations 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. 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.

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. In 2009, for example, in one recent action we alleged that, in connection with a solicitation by 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 in exchange for 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).

10 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 to secure a client relationship with a public pension plan or an investment from one. 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 investment from the California public pension fund).

11 See also, e.g., 2 N.Y. Comp. Codes R. & Regs. tit. 2 § 320.2 (2009) (placement agents are required to provide a detailed description of any third-party solicitor’s involvement and a description of the payments to the solicitor).

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, fumneled through the former treasurer’s friends and political associates.\textsuperscript{19} Criminal authorities have in recent years brought cases in New York,\textsuperscript{20} New Mexico,\textsuperscript{21} Illinois,\textsuperscript{22} Ohio,\textsuperscript{23} Connecticut,\textsuperscript{24} and Florida,\textsuperscript{25} charging defendants with the same or similar conduct.

Allegations of pay to play activity involving State and municipal pension plans in other jurisdictions continue to be reported.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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—\textit{i.e.}, from participating in pay to play practices.\textsuperscript{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.\textsuperscript{30} We believe these rules have significantly curbed pay to play practices in the municipal securities market.\textsuperscript{31} investments in the fund). See also sources cited supra note 17.

\textsuperscript{22} 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 P. 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 would receive invitations to fundraising events for the new trustee with suggested donation amounts.”).


\textsuperscript{26} See Proposing Release, at n.23. See also infra note 101; Comment Letter of the Municipal...
Along the lines of MSRB rule G–37, 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. 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 borne by the adviser is providing or seeking government business. In addition, similar to MSRB rule G–38, our proposed rule would have prohibited the use of third parties to solicit government business. 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. Public pension plans and their officials were divided—some embraced the rule, including one that stated the rule is an important means to “increase transparency and public confidence in the investment activities of all public pension funds,” while others were critical, arguing, for example, that our proposal “may result in unintended hardships being placed upon public pension funds.” We received no letters from plan beneficiaries whom we sought to protect with the proposed rule, although two public interest groups supported it strongly. 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. Nonetheless, most of them objected to the Advisers Act of a rule similar to MSRB rules G–37 and G–38.

Most

34 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. 6, 2009). 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 encouraged sanctions to prohibit pay to play activities. AFSCME. Enhancing Public Retiree Pension Plan Security: Best Practice Policies for Trustees and Pension Systems (2010), available at http://www.afscme.org/docs/AFSCME-report-pension-best-practices.pdf.


36 See, e.g., Comment Letter of Ounavarra Capital, LLC (Aug. 28, 2009) (“Ounavarra Letter”) (noting the banning third-party solicitors and placing brokers of 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.

37 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.

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


39 See MSRB rule G–37(b). Our proposal, like MSRB rule G–37, was designed to address our concern that pay to play practices were “undermining the integrity” of the relevant market, in particular the market for the provision of investment advisory services to government entities. 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).

40 Proposing rule 206(4)–5(a)(1). See also MSRB rule G–37(b).

41 Proposing rule 206(4)–5(a)(2)(i). See also MSRB rule G–37(c).

42 See MSRB rule G–38(a).

43 Proposing rule 206(4)–5(a)(2)(ii).


46 Particular comments on the various aspects of our proposal are summarized in the corresponding sub-sections of section II of this Release.
or prospective client.” 47 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, acts and 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

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” 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 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 two respects. 58 First, government officials who participate may have an incentive to continue to accept contributions to support their campaigns because of 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

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51 S. Rep. No. 1760, 86th Cong., 2d Sess., 4 (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)–5; 275.206(4)–6; 275.206(4)–7; and 275.206(4)–8.
52 Section 206(4) was added to the Advisers Act in Public Law 86–750, 74 Stat. 885, at sec. 9 (1960).
53 See H.R. Rep. No. 2197, 86th Cong., 2d Sess., at 7–8 (1960) ("Because of the general language of section 206 and a number 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 of 1934 which applies to brokers and dealers."). See also S. Rep. No. 1760, 86th Cong., 2d Sess., at 8 (1960) ("This section (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, interpreted nearly identical language in section 14(e) of the Exchange Act to address similar conduct in that context.
55 Cf. Blount, 61 F.3d at 945 ("smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic").
56 See id. at 944 ("actors in this field are presumably shrewd enough to structure their relations rather indirectly").
57 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.
58 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 even if pay to play continues to be practiced").
59 For a discussion of concerns regarding our proposed rule that are similar to those raised regarding MSRB rule G–37, see section II.A of this Release.
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 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. 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.62 The restrictions inherent in

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 marginal restriction upon the contributor’s ability to engage in free communication.”63 Limitations on contributions are permissible if justified by a sufficiently important government interest that is closely drawn to avoid unnecessary abridgment of protected rights.64

Prevention of fraud is a sufficiently important government interest.65 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.66 The restrictions inherent in

rule 206(4)–5 are in the 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


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

Continued
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. 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.

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.

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. 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.

Fourth, the rule applies only to investment advisers that are registered with us, or unregistered in reliance on section 203(b)(3) of the Advisers Act, that have (or that are seeking) government clients. It applies only to the subset of the significantly broader 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 through investment pools.

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, and it covers only contributions to those governmental officials who would be the most likely targets of pay to play arrangements.

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).

73 Some commenters argued that the definition of de minimis, as used in the Proposing Release, was too narrow. We have clarified this definition to encompass the significant risks that may arise from contributions to officials of government entities. This does not limit the de minimis exceptions available to an adviser that solicits government clients, which is consistent with our regulatory purpose.

See also 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).

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

75 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, 559 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).

76 Some commenters expressed concern, for example, that rule 206(4)–5 may quell volunteering activities that lead to independent expenditures by corporate entities. See, e.g., Caplin & Drysdale Letter; NASP Letter. We have expressly clarified that volunteering activities, generally would not trigger the rule’s two-year time out provision and that employees running for office would not be subject to the contribution limitation. See infra notes 157 and 139, respectively.

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

78 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, 559 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).

79 Some commenters expressed concern, for example, that rule 206(4)–5 may quell volunteering activities that lead to independent expenditures by corporate entities. See, e.g., Caplin & Drysdale Letter; NASP Letter. We have expressly clarified that volunteering activities that do not involve the provision of services to a candidate for hire would not trigger the rule’s two-year time out provision and that employees running for office would not be subject to the contribution limitation. See infra notes 157 and 139, respectively.

80 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. As we noted 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. Therefore, our pay to play restrictions are intended to capture not only direct political contributions by advisers, but also other arrangements that may be designed to influence government officials to perform official acts.

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 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).

82 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).

83 Some commenters argued that the definition of de minimis, as used in the Proposing Release, was too narrow. We have clarified this definition to encompass the significant risks that may arise from contributions to officials of government entities. This does not limit the de minimis exceptions available to an adviser that solicits government clients, which is consistent with our regulatory purpose.

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

85 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, 559 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).

86 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. As we noted 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. Therefore, our pay to play restrictions are intended to capture not only direct political contributions by advisers, but also other arrangements that may be designed to influence government officials to perform official acts.

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.
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 is made. 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. 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. 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. This represents a modification from our proposal, which included a flat ban without an exception for any brokers or investment 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.

As discussed below, commenters persuad 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. 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 entities might 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. This provision in the rule we are adopting today is identical to our proposal. 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. This provision is substantially similar to our proposal, although we have made certain modifications described below.

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)). The rule would not, however, apply to most small advisers that are registered with State securities authorities instead of the Commission, or advisers that are unregistered in reliance on exemptions other than section 203(b)(3) of the Advisers Act.

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. Other commenters recommended that the rule apply more

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83 See section II.B.2(e) of this Release.
82 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.
84 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).
85 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. 80b–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. 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.
86 See Proposing Release, at section II.A.3(b).
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 Proposing Release, at section II.B.2(c).
89 See Proposing Release, at section II.A.3(d).
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 must 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. 80b–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. 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 internal 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 advisers. CalPERS supports application of the rule to investment advisers, as defined in the proposed rule.")
broadly to all advisers that may manage assets of government entities. 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. It is our understanding that few of these firms manage public pension plans or other public funds.

Accordingly, we have decided to adopt this provision as proposed.

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.” 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. 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.

We also 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.” Another agreed that the MSRB rules “provide an appropriate regulatory analogy for addressing [pay to play]

issues.” 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 inappropriate model on which to base an investment adviser pay to play rule. 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 for municipal securities dealers who are simply banned from obtaining “new” business as opposed to terminating a long-term relationship.

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.

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 repeated, if not ongoing, services, and the imposition of a two-year time out can have considerable

98 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”)).


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


102 Common Cause Letter.
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 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. Statutes requiring disclosure of political contributions are, in part, designed to inform voters about a candidate’s financial supporters; an informed electorate may then use the information to vote for or against a candidate. 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—namely, the public pension plans and their beneficiaries who are affected by pay to play practices. Disclosure to a plan’s trustees might be insufficient when 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. 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 a policy that prohibits contributions made for the purpose of influencing the selection of the adviser. Several commenters recommended, similarly, that we require advisers to adopt policies and procedures reasonably designed to prevent and detect contributions designed to influence the selection of an adviser. 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. 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.

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 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. 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.

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, investment advisers are best positioned to protect these clients by developing and enforcing robust 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. We have taken this approach to enable an adviser to act consistently with its fiduciary obligations, rather than may provide uncompensated services to other clients, including other government clients. Moreover, the fiduciary obligations of an adviser would not require it to provide uncompensated services indefinitely—rather, the adviser may need to continue to provide advisory services to other clients, including other government clients. Furthermore, the requirement to provide services for a reasonable period of time to allow the government client to replace the adviser. 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, while others argued that the prohibition on compensation was unreasonable and, in some cases, difficult or near impossible to implement. 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. 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 for an adviser to immediately cease providing services to a government client to claim or lose its assets. One asserted that it would be unreasonable to require advisers to provide uncompensated services altogether.

This approach, as a result of commenters’ assertions, we address this possibility in our cost-benefit analysis. See section IV of this Release.

We acknowledge that the rule will involve compliance costs and could adversely affect an adviser’s business. 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. 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 advisory services for a reasonable time, during which its client can seek to obtain advisory services from others.

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. We acknowledge that the rule will involve compliance costs and could adversely affect an adviser’s business. 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. 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 advisory services for a reasonable period of time during which its client can seek to obtain advisory services from others.

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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. 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

(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 have 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.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 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 costs.145 But State and municipal statutes vary substantially with respect to whom they entrust with the management of public 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

132 See, e.g., Dechert Letter; Fidelity Letter; KGI Letter; Day, Littauer & 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, e.g., DIVA Letter regarding contributions from pension funds, stating: “The awards generate lucrative fees and lend prestige that could help lure new clients.”); Louise Story, Quandrangle 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.”). 133 See 17 CFR 240.41029 Federal Register (rev. II.10 (May 24, 1994)).
134 See Proposed Release, at section II.A.3(a)(2).
135 See MSRB Rule G–37, Q&A.(5).
136 See Proposed Release, at section II.A.3(a)(2).
137 See, e.g., Kevin McCoy, Do Campaign Contributions Help Win Pension Fund Deals, USA Today, Aug. 8, 2009, available at http://www.usatoday.com/money/perfs/funds/2009-08-26- pension-fund-political-donations_N.htm (referring to advisory firms winning management contracts with profit increases derived directly from the management of government client assets.137)
138 See, e.g., Kevin McCoy, Do Campaign Contributions Help Win Pension Fund Deals, USA Today, Aug. 8, 2009, available at http://www.usatoday.com/money/perfs/funds/2009-08-26- pension-fund-political-donations_N.htm (referring to advisory firms winning management contracts with profit increases derived directly from the management of government client assets.137)
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140 See, e.g., Kevin McCoy, Do Campaign Contributions Help Win Pension Fund Deals, USA Today, Aug. 8, 2009, available at http://www.usatoday.com/money/perfs/funds/2009-08-26- pension-fund-political-donations_N.htm (referring to advisory firms winning management contracts with profit increases derived directly from the management of government client assets.137)
141 See Proposed Release, at section II.A.3(a)(2).
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
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 Proceedings (rev. Jun. 11, 2009), art. II, sec. 2.1, available at http://www.persrs.state.pa.us/board/policies/201001バイロワイス.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 generals and appointees of the State legislature serving on the board would be officials of the government entity. Conversely, a public official who is tasked with conducting 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. These definitions and their application are substantively the same as those in MSRB rule G–37. See MSRB rule G–37(iii) and (g)(v).
144 See, e.g., IAA Letter; NSCP Letter; Comment Letter of T. Rowe Price Associates, Inc. (“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 investments that 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 rule would undercut the purposes of the rule, not least because officials will be incentivized to offer such certifications liberally (and will presumably do so inappropriately) to encourage contributions. 146 Like us, the MSRB does not specify which officials have the authority to influence the granting
urged that triggering contributions should be limited to contributions to officials directly responsible for the selection of advisers. 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, while another contended that it should. 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 the office he or she currently holds. 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 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.

(3) Contributions

The rule's time out provisions are triggered by contributions made by an adviser or any of its covered associates. 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. It also includes transition or inaugural expenses incurred by a successful candidate for State or local office. The definition is the same as we proposed and as the one used in MSRB rule G–37.

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. 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 telephone, are not used. 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, 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.

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. 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.

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. 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. In some cases, such contributions may effectively operate as a funnel to the campaigns of the government officials. In other cases, however, they may fund general party political activities or the campaigns of other candidates. 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.

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 mirror 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. Accordingly, under the rule, contributions by each of these persons, which the rule defines as “covered associates,” trigger the two-year time out. 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.

Owners. Contributions by sole proprietors are contributions by the adviser itself. If the adviser is a partnership, the rule covers contributions by the adviser’s general partners. If the adviser is a limited liability company, the rule covers contributions made by managing members. 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.

Executive officers. Contributions by an executive officer of an investment adviser trigger the two-year time out. 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.

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. This is to limit the number of persons who can be considered by commenters. 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. We have

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 solicitation by 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 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.3.

164 See, e.g., Reilly Letter. See, e.g., Caplin & Drysdale Letter (explaining that “leadership PACs,” for example, are commonly established by ofﬁcials to donate to other candidates and issues). 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).

165 Proposing Release, at section II.A.3(a)(4).

166 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.

167 Rule 206(4)–5(a)(1).

168 Rule 206(4)–5(f)(2).

169 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.

170 Rule 206(4)–5(f)(2)(i).

171 Id.

172 See rule 206(4)–5(a)(1), (d) and (f)(2)(i)–(ii).

173 Id.

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 See, e.g., Sutherland Letter.

177 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 would trigger the two-year rule because they raise questions 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...
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 creates a strong incentive to engage in pay to play practices." 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.

Employees who Solicit Government Clients. Contributions by any employee who solicits a government entity for the adviser would trigger the two-year time out. An employee need not be associated to adequately depend on the activities of the individual as an officer 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., In the Matter of John Morgan, Proposed Rule 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.

Comments also suggested that our definition exclude senior management, 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.

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 did not 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 "qualified 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.

primarily engaged in solicitation activities to be a "covered associate" under the rule. 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. We 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. Commenters asked us to provide further guidance on what we mean by "solicit." 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.

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 solicitation or investment business. See MSRB Rule G–37 Q&A, Question IV.8.

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)(iv) ("MSRB’s rule would also apply to supervisors of persons who solicit relevant business from government entities. See MSRB Rule G–37 Q&A, Question IV.14.

Rule 206(4)–5(f)(10)(i). We are adopting this definition as proposed.

See, e.g., Skadden Letter.

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 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/msrb/rules/notg38.htm.

Rule 206(4)–5(f)(2)(iii) (which we are adopting as proposed). One commenter suggested that we define "political action committee," or PAC, as any organization required to register as a political committee under Federal, State or local law. Caplin & Drysdale Letter. We’ve 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 controlled by our rule would be made in our view, turn on whether the PAC was, or was required to be, registered under relevant law.

One commenter suggested a similar interpretation of "covered associate" for the SEC’s approach to this definition, see MSRB Rule G–37 Q&A, Question IV.24.

Id.

Proposing Release, at n.101.
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 the regulations 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 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

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 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) 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 See, e.g., Fund Democracy/Consumer Federation Letter.

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.

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).

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 employee 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 contribution 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; Weil 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).
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 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 altering the look-back period, including adopting a higher contribution threshold to trigger the look-back provision214 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 associations 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 time out is not triggered by a contribution 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 on the MSRB rule G–37.219

(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 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.\textsuperscript{225} We proposed a $250 de minimis exception for contributions to candidates for whom a covered associate is entitled to vote,\textsuperscript{226} which reflected the current de minimis exception in MSRB rule G–37.\textsuperscript{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 contribution as large as $1,000 would be unlikely to influence the award of an advisory contract by a public pension plan.\textsuperscript{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\textsuperscript{229} that we should increase the de minimis amount to reflect the effects of inflation since the MSRB first established its $250 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).\textsuperscript{230} 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 the primary or general election (including a primary and general election). See MSRB Rule G–37 Q&A, Question II.B. 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).

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.\textsuperscript{234} The exception is available for contributions that, in the aggregate, do not exceed $350 to any one official, per election.\textsuperscript{235} The adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution and, within 60 days after learning of the triggering contribution, the contributor must obtain the return of the contribution.\textsuperscript{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.\textsuperscript{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).\textsuperscript{238} and no more than once for

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\item 225 Id.
\item 226 Rule 206(4)–5(b)(3)(i).
\item 227 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(ii). 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.
\item 228 See 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 more open discussion from our proposal that we believe is responsive to certain commenters’ concerns (see note 251 and accompanying text below), “larger” advisers may warrant 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 50 or more employees. Id. Investment Adviser Registration Depository (IARD) data as of April 1, 2010 indicate that 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, 1,097 (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 verifiable)—each adviser filing Form ADV must check a box indicating an approximation of the
\end{itemize}
each covered associate, regardless of the time period. Commenters who addressed it generally supported our inclusion of an automatic exception provision, although several suggested modifications. Some urged us to eliminate the requirement that the contributor succeed in obtaining the return of the contribution. 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 returned. 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. 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. 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. The absence of such a time limitation would encourage advisers not to seek to 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. 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 threshold for contributions to an official for whom a covered associate is entitled to vote. In addition, at the suggestion of commenters who argued that our proposed limit on the annual use of such exception failed to take into consideration the different size of advisers, 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 registration statement that it had more than 50 employees who perform investment advisory functions.

The exception is intended to provide advisers with the ability to undo certain mistakes. Because it operates automatically, 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.

(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, 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 is 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. 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 I.I.D of this Release.

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).

We are not eliminar the requirement that the associate has been made aware of an inadvertent violation. As noted above, it is important to the rule because it is more likely to get the benefit of a contribution’s potential influence for too long a period of time. The four-month window should not preclude the covered associate 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.).

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 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(iii).

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 $150 amount. As explained above, we believe that $150 is the appropriate de minimis threshold for contributions to officials for whom a covered associate is 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. 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 I.I.D of this Release.

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).
payment to any person to solicit government clients for investment advisory services on its behalf. 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.

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.

We proposed to prohibit advisers from paying third parties in order to prevent advisers from circumventing the rule. 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; in several instances, advisers allegedly made significant payments to placement agents and other intermediaries in order to influence the award of advisory contracts. We noted that government authorities in New York and other jurisdictions have prohibited or are considering limiting or prohibiting the use of consultants, solicitors, or placement agents by investment advisers to solicit government business. 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. We recalled comment letters we received in 1999 from advisers asserting that they should not be held accountable for the political contributions of their third-party solicitors, whom, they asserted, advisers lacked the ability to control. The record before us raised deeply troubling concerns about advisers’ use of third-party solicitors to engage in pay to play activities. 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 pay they receive from advisers.

Therefore, we proposed to prohibit advisers from engaging third parties to solicit government clients on their behalf. In doing so, we requested comments on alternative approaches we could take. 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 City Comptroller and New York City Comptroller that expressed strong support for the ban on using third-party solicitors. In a press release on February 18, 2010, Comptroller Liu announced Major Reforms to increase pension funds’ transparency and to increase accountability of pension managers.

In 1999, the Commission proposed a similar rule, which also would have been codified as rule 204(4)–5 under the Advisers Act, had it been adopted. See Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 1816 (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 Lewis Dreyfus (Nov. 1, 1999); Comment Letter of Assembly Member, 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 Note 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.”).
parties to solicit government plans. Commenters supporting the ban pointed out the key role that placement agents have played in pay to play practices. 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. 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.

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 employ them and that banning their use would have several deleterious effects. 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.

Commenters questioned whether the Commission has brought in the past several solicitors have played a central role in each of the recent announced his office’s approach to third-party solicitors. The proposed ban would have several deleterious effects. A common theme among many commenters was that the rule failed to distinguish "illegitimate" consultants and placement agents from the "legitimate" ones who provide an important service.

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. 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.

The prohibition would reduce competition by reducing the number of advisers competing for government business and limit the universe of investment opportunities presented to public pension funds.

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. A common theme among many commenters was that placement agents provide valuable services both for advisers seeking clients and for the public pension plans that employ them and that banning their use would have several deleterious effects. 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.

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Second, these commenters failed to consider the potentially significant costs of hiring consultants and placement agents, 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. 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. Finally, commenters failed to identify any 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.”

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. Several commenters, for example, suggested that we instead require greater disclosure by advisers of payments to solicitors. Such an approach could be helpful to give plan fiduciaries information necessary for them to satisfy their legal obligations and uncover abuses, but it would not be useful when plan fiduciaries themselves are participants in the pay to play activities. 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.

285 See Tobe Letter (describing an underperforming money manager that was fired after the commenter, a pension official, began to inquire into how it was selected); "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 solicited for political contributions for the campaigns to the 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 ("Factors 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., Momoyoy Letter (arguing that the Commission or the appropriate criminal authorities 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 investment) is made be banned from the financial services industry for life); NPCERS Letter (arguing that the most effective method of eliminating pay to play is by having more than one pension board); 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”); Pregin Letter I (acknowledging that it is outside the remit of the Commission, but arguing that there should be better oversight of third-party pension fund investment committees should consist of a minimum number of members in order to prevent a sole official being responsible for authorizing investment process); Triton Pacific Letter (arguing that the Commission should adopt regulation of pension officials who are often responsible for initiating pay to play arrangements).

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; ICJ Letter; NY City Bar Letter; Comment Letter of the Forum for Financial Services with the Companies who paid them as middlemen.

291 Cornell Law Letter (noting that Advisers Act rule 206(4)–3 [17 CFR 270.206(4)–3], the “rule adequate as is, but “just needs to be followed”); Thomas Letter (supporting “enforcement of existing disclosure rules”); Chaldon Letter (arguing that, in the scandal that have occurred, the fee-sharing arrangements had been disclosed to pension fund boards, no law or regulation would have been violated, and that third-party market should adhere to current law instead of adopting 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 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. Silbert, et al., Litigation Release No. 16759, Civil Action No. 3:00–CV–19411 DJJ (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).

290 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 transparency by all parties involved in the investment process who might have the ability to exert influence, including advisers, third-party...
we rely on voluntary industry codes of conduct.292 But we believe, in light of the growing body of evidence of advisers’ use of third-party solicitors to engage in pay to play activities we describe above, that voluntary actions are insufficient to deter pay to play, which may yield lucrative management contracts.293 As we discuss above, pay to play involves a “collective action” problem that is unlikely to be resolved by voluntary actions.294 Elected officials who accept contributions from State contractors may believe they have an advantage over their opponents who forego the contributions, and firms that do not “pay” may fear that they will lose government business to those that do.295

Other commenters recommended that we amend our rules to require that advisers amend their codes of ethics to monitor contributions by third-party solicitors.296 But advisers using third-party solicitors to circumvent pay to play restrictions are well aware of these payments, and are unlikely to be deterred by a monitoring requirement. In addition, adviser codes of ethics are unlikely to be a sufficient means to induce third-party solicitors to be transparent about their own pay to play activities.

Instead of suggesting alternative approaches, other commenters urged us to apply the rule more narrowly by exempting from the ban solicitors that are registered broker-dealers or associated persons of broker-dealers.297 Some were concerned that the rule would interfere with the distribution of mutual funds and private funds, which are generally distributed by registered broker-dealers that may be compensated by the adviser in some form.298 Many argued that registration as a broker-dealer generally legitimizes placement agents that provide “legitimate” services from those that merely offer political influence.299 Others expressed concern that some broker-dealer firms that rely on placement agent business could be harmed.300 We recognize that services that commenters have identified as beneficial would typically require broker-dealer registration. But registration under the Exchange Act does not preclude a broker-dealer from participating in pay to play practices—MSRB rules G–37 and G–38 do not apply, for example, to broker-dealers soliciting investments on behalf of investment companies or private funds.301 Thus, amending our rule to limit third parties soliciting governments to broker-dealers registered under the Exchange Act would not achieve the prophylactic purpose of this rulemaking. We believe that our approach is appropriate in light of the concerns we are seeking to address.302

Several commenters proposed that we achieve our goals by permitting advisers to engage solicitors and placement agents that are registered broker-dealers and subject to rules similar to those adopted by the MSRB.303 One asserted that such rules would be “a logical extension of the already-existing regulatory scheme governing broker-dealers.”304 Another agreed, arguing that such rules would be consistent with the approach the MSRB took when it adopted MSRB rule G–38, the effect of which was to sweep “all solicitors of municipal business (underwriting, sales and advisory) into the broker-dealer registration regime” where they would be subject to oversight of a registered broker-dealer and are required to conform their municipal securities activities to applicable MSRB rules.

298 See, e.g., SFIMA Letter; NY City Bar Letter; Monomoy Letter; IAA Letter. Mutual fund distribution fees are typically paid by the fund pursuant to a 12b–1 plan, and therefore generally would not constitute payment by the fund’s adviser. As a result, such payments would not be prohibited by rule 206(4)–5 by its terms. Where an adviser pays for the fund’s distribution out of its “legitimate profits,” however, the rule would generally be implicated. For a discussion of a mutual fund adviser’s use of “legitimate profits” for fund distribution, see Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (Oct. 28, 1980) [45 FR 73896 (Nov. 7, 1980)] (emphasizing the prohibition on the indirect use of fund assets for distribution, unless pursuant to a 12b–1 plan, “[t]hroughout, under the rule there is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources” * * * . Profits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the [Investment Company Act].”). For private funds, third parties are often compensated by the adviser or its affiliated general partner and, therefore, the “placement fees” are subject to the rule. Structuring such a payment to come from the private fund for the purpose of evading the rule would violate the rule. See Rule 2606(4)–5(d).
300 Comment Letter of the National Association of Independent Broker-Dealers (Oct. 5, 2009).
301 At least one commenter suggested that there are “inherent” safeguards in the broker-dealer regulatory regime sufficient to protect against pay to play practices. See, e.g., ABA Letter. But the broker-dealer regulatory regime does not specifically address pay to play activities, as demonstrated by the MSRB’s adoption of rules G–37 and G–38.
302 We acknowledge that there are costs associated with our rule. For further analysis of these, along with the benefits, see sections I and IV of this Release.

303 Skadden Letter (“The Commission and FINRA could directly impose and enforce restrictions on such broker-dealers.”); Davis Polk Letter (“Registered broker-dealers that provide legitimate placement agent services could be required by the Commission to comply with “pay-to-play” restrictions”); Credit Suisse Letter (preclude an investment adviser from using a placement agent that is not subject to pay to play restrictions, analogous to rule G–37); Comment Letter of the President of M Advisory Group J. Daniel Vogelzang (Sept. 18, 2009) (“M Advisory Letter”) (treat [all] placement agents, investment advisers and consultants * * * exactly the same regarding prohibited political contributions; i.e., a two-year ban on doing business with any governmental agency to which a prohibited political contribution is made.”). See also Comment Letter of Hudson Capital Management (NY), L.P. (Oct. 5, 2009) (suggesting Commission take measures to properly discipline and regulate third-party solicitors); SFIMA Letter (“The pay-to-play and political activity of registered placement agents involved in soliciting government investment could * * * be directly regulated under the Exchange Act.”). We believe our rule, as adopted, which allows certain regulated third parties to solicit government clients on their behalf, addresses these concerns.
304 Davis Polk Letter.
including MSRB Rule G–37.\textsuperscript{305} Others suggested that we could similarly achieve our goals by permitting advisers to engage as solicitors registered investment advisers that are themselves subject to pay to play restrictions under an Advisers Act rule.\textsuperscript{306}

We are persuaded by these comments and have decided to revise the proposed rule to permit advisers to make payments to certain “regulated persons” to solicit government clients on their behalf.\textsuperscript{307} As described in more detail below, “regulated persons” include certain broker-dealers and registered investment advisers that are themselves subject to prohibitions against participating in pay to play practices and are subject to our oversight and, in the case of broker-dealers, the oversight of a registered national securities association, such as FINRA.\textsuperscript{308} As one commenter observed, “the Commission would have the direct authority to determine these restrictions as well as the oversight, control and enforcement of penalties over any violations. The restrictions could be tailored to operate with the same underlying purpose and effect on [solicitors] as the “pay-to-play” restrictions imposed on investment advisers.”\textsuperscript{309} We believe that the application of such rules would provide an effective deterrent to these solicitors or placement agents from participating in pay to play arrangements because political contributions or payments would subject solicitors to similar consequences, as discussed below.\textsuperscript{310}

Because rule 206(4)–5 prohibits an adviser from compensating a registered adviser solicitor for solicitation activities if that adviser solicitor does not meet the definition of “regulated person,” the adviser that hired the solicitor must immediately cease compensating a solicitor that no longer meets these conditions.\textsuperscript{311}

In light of our decision to permit advisers to make payments to certain “regulated persons,” described below, to solicit government clients on their behalf, we no longer believe that our proposed exception from the prohibition on advisers paying third-party solicitors for payments to related persons and employees of related person companies of the adviser is necessary.\textsuperscript{312} We have therefore proposed the exception to enable advisers to compensate these persons for government entity solicitation activities because we recognized there may be efficiencies in allowing advisers to rely on these particular types of persons to assist them in seeking clients. We requested comment regarding whether the exception would undermine the rule’s efficacy by allowing advisers to compensate certain employees of related person companies whose contributions would not have triggered the two-year time out. Although we did not receive comment specifically addressing our concern,\textsuperscript{313} we believe the approach we are adopting that allows advisers to pay “regulated persons” to solicit government entities on their behalf will still allow advisers to use employees of certain related companies—i.e., of those related companies that qualify as “regulated persons”—as solicitors.\textsuperscript{314}

(1) Registered Broker-Dealers

Registered national securities association rules of similar scope and consequence as the rule we are today adopting could sufficiently satisfy the concerns that led us to propose to prohibit advisers from paying brokers to solicit potential government clients. Advisers could not easily use placement agents covered by such rules to circumvent rule 206(4)–5. Under this approach, placement agents would be deterred from engaging in pay to play directly on account of the registered national securities association’s rules. There would be no need for the Commission to prove in an enforcement action that a contribution by a placement agent amounted to an indirect contribution by the investment adviser because the placement agent itself could be charged with violating the registered national securities association’s rules. Therefore, as adopted, rule 206(4)–5 allows an adviser to compensate “regulated persons,” which includes registered brokers subject to a registered national securities

\textsuperscript{305} SIFMA Letter (“Although Rule G–38(a) specifically prohibits a municipal dealer from paying a fee to a nonaffiliated person for solicitation of municipal securities business, the policies underlying Rule G–38 were to bring solicitors within the purview of the Federal securities laws—not to exclude the involvement of registered broker-dealers, including those registered broker-dealers not affiliated with advisers and private funds.”). See also Monument Group Letter (“We believe that MSRB Rule G–38 is not analogous to the proposed rule. Rule G–38 applies only to broker-dealers that are affiliated with an issuer to market that issuer’s securities to a public pension plan or any other investor. Proposed Rule 206(4)–5(a)(2)(i) prevents this and seeks to intermediate the process between the issuer of a security and the ultimate investor.”); Credit Suisse Letter (“[W]e strongly believe that a more complete analogy to the MSRB Pay-to-Play Rules would not preclude regulated broker-dealers from performing placement agent services in the context of municipal issuers, as the Proposed Rule would do. Notably, the MSRB Pay-to-Play Rules do not preclude SEC-registered broker-dealers from acting as placement agents to municipal issuers. Instead, the MSRB Pay-to-Play Rules subject such placement agents to “pay-to-play” restrictions and prevent them from retaining unregulated third-party finders and solicitors.”).\textsuperscript{306} See, e.g., IAA Letter.

\textsuperscript{307} See Rule 206(4)–5(a)(2)(i).

\textsuperscript{308} Rule 206(4)–5(f)(9). See supra note 85 (noting that, in this Release, we will refer directly to FINRA, currently the only registered national securities association). As noted below, under the definition of “regulated persons” as it applies to brokers, the Commission must find, by order, that a registered national securities association’s pay to play rule applicable to such brokers imposes substantially equivalent or more stringent restrictions on them than rule 206(4)–5 imposes on investment advisers and that such rule is consistent with the objectives of rule 206(4)–5. Rule 206(4)–5(f)(9)(ii)(B).

\textsuperscript{309} Davis Polk Letter.

\textsuperscript{310} Another group of commenters argued that third-party solicitors should be treated as covered associates—that is, their contributions should trigger the two-year ban for advisers that hire them. See, e.g., ABA Letter; IP Letter; IC Letter; NY City Bar Letter; Forum Letter; Jones Day Letter. In explaining our rejection of this approach in the Proposed Release, we noted that this approach—which we included in our 1999 pay to play proposal—was consistent with the advice of counsel at that time. See Proposing Release, at section I.A.3(b). They primarily argued that it was unfair to impute the activities of third parties to advisers, especially given what they perceived as the harsh consequences caused by triggering a contribution—i.e., a two-year time out imposed on the adviser. See id. They further argued that an approach in which contributions by third-party solicitors triggered a two-year time out for an adviser would create over-burdensome compliance challenges because the adviser could not meaningfully control the contribution activities of such third parties. See id. We continue to be sympathetic to these concerns and believe that an approach in which a contribution by a third party triggered a two-year time out for the adviser that hires the third party as a solicitor could lead to unfair consequences. See, e.g., Capitol Stone Letter; Monument Group Letter; Park Hill Letter. For example, if a solicitor gives a triggering contribution in order to assist one client, we are concerned about the harsh result that such a contribution could have on all of the solicitor’s other clients seeking to assist the same prospective government entity client.

\textsuperscript{311} It would be a violation of the rule for an adviser to compensate a third party for solicitation of government entity clients at any time that third party did not meet the definition of “regulated person,” regardless of whether the “regulated person” failed to meet the definition at the time it was hired or subsequently.

\textsuperscript{312} See Proposing Release, at section I.A.3(b).

\textsuperscript{313} One commenter asked that we clarify the proposed exception for related parties (Rutherford Letter) and another recommended a case-by-case determination of whether independent contractors may be eligible for the exception, due to concern for life insurance agents who may not technically have qualified as “employees” for purposes of the exception (Skadden Letter). As noted, however, we have eliminated this exception in favor of allowing advisers to pay “regulated persons” to solicit government clients on their behalf.

\textsuperscript{314} We acknowledge that some advisers may have to bear certain additional costs of hiring outside parties as a result of our elimination of our proposal’s “related person” exception, which would have allowed advisers to compensate related persons that are not registered broker-dealers or advisers for solicitation services. We anticipated discussion of costs relating to the rule, see section IV of this Release. But, we also note that the rule, as adopted, does not favor an adviser with affiliates (which our proposal would have allowed) over an adviser who uses the same third party to solicit on its behalf another adviser without affiliates. Instead, our rule, as adopted, allows an adviser to pay a “regulated person” affiliated or not, to solicit on its behalf.
An adviser may engage a registered broker to solicit government clients on its behalf so long as the broker continues to meet the definition of “regulated person” throughout its engagement as a solicitor by the adviser.

For a broker-dealer to be a “regulated person” under rule 206(4)–5, the broker-dealer must be registered with the Commission and be a member of a registered national securities association that has a rule: (i) That prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made; and (ii) that the Commission finds both to impose substantially equivalent or more stringent restrictions on broker-dealers than rule 206(4)–5 imposes on investment advisers and to be consistent with the objectives of rule 206(4)–5.316 We have included the requirement that a broker-dealer, in order to qualify as a regulated person, be subject to a pay to play rule of a registered national securities association or rule of which it is a member so that brokers seeking to act as placement agents for investment advisers are, in turn, adequately deterred from engaging in pay to play activities on behalf of those advisers by such a rule.

FINRA has informed us that it is preparing rules for consideration that would prohibit its members from soliciting advisory business from a government entity on behalf of an adviser unless they comply with requirements prohibiting pay to play activities.317 FINRA has said its rule would impose regulatory requirements on member brokers “as rigorous and as expansive” as would be imposed on investment advisers by rule 206(4)–5, and that in developing its proposal it intends to “draw closely upon all of the substantive and technical elements of the SEC’s proposal as well as our regulatory expertise in examining and enforcing the MSRB rules upon which the SEC’s proposal is based.”319 The rules, including any recordkeeping requirements, would be enforced by FINRA, which has substantial experience enforcing MSRB rules G–37 and G–38.320 For the Commission to adopt a rule prohibiting advisers from using placement agents until FINRA adopts a rule could impose substantial hardships on a significant number of advisers and solicitors that wrote to us. It could also disrupt pension funds’ investment opportunities. Therefore, as we discuss in more detail below, we are delaying application of the prohibition on compensating third-party solicitors for one year from the effective date of this rule, in part to give FINRA time to propose such a rule.321

(2) Registered Investment Advisers

We are also permitting advisers covered by the rule to pay solicitors for government clients that are registered investment advisers subject to similar limitations.322 Under the rule, a “regulated person” includes (in addition to a registered broker subject to the conditions described above), an investment adviser that is registered with the Commission under the Advisers Act, provided that the solicitor and its covered associates have not, within two years of soliciting a government entity: (i) Made a contribution to an official of that government entity (other than a de minimis contribution, as permitted by the rule); or (ii) coordinated, or solicited any person (including a PAC) to make, any contribution to an official of a government entity to which the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services, or payment to a political party of a State or locality where the investment adviser that hired the solicitor is providing or seeking to provide investment advisory services to a government entity.323

We received comments urging us to permit advisers to compensate registered investment advisers for soliciting government officials, subject to rules or amendments to which the Commission could adopt under the Advisers Act.324 We believe such an allowance is appropriate for similar reasons to those for permitting advisers to compensate broker-dealers subject to pay to play rules we have determined meet our objectives under rule 206(4)–5. We have direct oversight authority over investment advisers registered with us. Accordingly, we believe it is appropriate to allow them to act as third-party solicitors for other advisers. Therefore, the rule, as adopted, limits the advisers that an investment adviser may pay to solicit government entities on its behalf to those advisers that are registered with the Commission325 and that have neither made the types of political contributions that would not trigger the two-year time out nor otherwise engaged in activities (e.g., bundling of contributions) that the adviser could not engage in under the rule326.

315 Rule 206(4)–5(a)(2)(i) (which prohibits advisers and their covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party other than a regulated person to solicit a government entity for investment advisory services on behalf of such investment adviser). Rule 206(4)–5 defines a “regulated person” to include a “broker,” as defined in section 3(a)(4) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)(4)] or a “dealer,” as defined in section 3(a)(5) of that Act [15 U.S.C. 78c(a)(5)], that is registered with the Commission, and is a member of a registered national securities association registered under section 15A of that Act [15 U.S.C. 78t(a)]. Provided that (A) the rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and (B) the Commission finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers than rule 206(4)–5 imposes on investment advisers and that such rules are consistent with the objectives of rule 206(4)–5. The rule’s definition of “regulated person” also includes certain investment advisers. See infra text accompanying note 323.

316 Rule 206(4)–5(0)(9)(ii)(I).

317 See Letter from Richard G. Ketchum, Chairman & Chief Executive Officer, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (Mar. 15, 2010), available at http://www.sec.gov/comments/s7-18-09/s71809-252.pdf (“Ketchum Letter”). (“We believe that a regulatory scheme targeting improper pay to play practices by broker-dealers acting on behalf of investment advisers is * * * a viable solution to a ban on certain third-party placement agents serving as legitimate function”). See also Letter from Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Richard G. Ketchum, Chairman & Chief Executive Officer, FINRA (Dec. 18, 2009), available at http://www.sec.gov/comments/s7-18-09/s71809-252.pdf.

318 As used in this Section, “broker” means a “broker” or “dealer,” as each term is defined in section 3(a) of the Securities Exchange Act of 1934 [15 U.S.C. 78c(a)].

319 Ketchum Letter.

320 See MSRB, Enforcement of Board Rules, available at http://msrb.org/msrb1/whatsnew/default.asp (“Responsibility for examination and enforcement of Board rules is delegated to the Financial Industry Regulatory Authority for all securities firms, and to the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Comptroller of the Currency, and the Offices of Insurance and Finance of the Banks.”)

321 For a discussion of transition issues, see section III of this Release.

322 Rule 206(4)–5(a)(2)(i) (which prohibits advisers and their covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party other than a regulated person to solicit a government entity for investment advisory services on behalf of such investment adviser).
Advisers compensating other advisers that qualify as “regulated persons” for soliciting government entities must adopt policies and procedures reasonably designed to prevent a violation of the rule.327 Such policies and procedures should include, among other things, a careful vetting of candidates and ongoing review of “regulated person” investment advisers acting as solicitors currently being used. Such review would need to determine whether the adviser (and its covered persons) acting as a solicitor has made political contributions or otherwise engaged in conduct that would disqualify it from the rule definition of “regulated person” and thereby preclude the hiring adviser from paying it for the solicitation activity.

(c) Restrictions on Soliciting and Coordinating Contributions and Payments

Rule 206(4)–5 prohibits advisers and covered persons from coordinating or soliciting328 any person or PAC to make the rules that apply to the services it is performing, rather than complying with both investment adviser and broker-dealer pay-to-play requirements. The Exchange Act generally defines brokers and dealers to register with the Commission and become members of at least one self-regulatory organization. Exchange Act sections 15(a), 15(b)(8) [15 U.S.C. 78o(a), (b)(8)]. Section 3(a)(4)(A) of the Exchange Act generally defines “broker” as any person engaged in the business of effecting transactions in securities for the account of others [15 U.S.C. 78c(a)(4)(A)]. See, e.g., Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 44291, at n.124 (May 11, 2001) [66 FR 27759 (May 18, 2001)] (“Solicitation is one of the most relevant factors in determining whether a person is effecting transactions.”); Strengthening the Commission’s Requirements Regarding Auditor Independence, Exchange Act Release No. 47265, at n.82 (Jan. 28, 2003) [68 FR 6006 (Feb. 5, 2003)] (noting that a person may be “engaged in the business,” among other ways, by receiving compensation tied to the successful completion of a securities transaction). See also Persons Deemed Not to Be Brokers, Exchange Act Release No. 22172, at sec. I.A [Jun. 27, 1985] [50 FR 27561, 27567 (July 9, 1985)] (noting that attorneys, accountants, insurance brokers, financial service organizations and financial consultants are engaged in the business of effecting transactions in securities for others if they are retained by an issuer specifically for the purpose of selling securities to the public and receive transaction based-compensation for their services).

327 See Advisers Act Rule 206(4)–7 [17 CFR 275.206(4)–7 (requiring advisers to adopt and implement compliance policies and procedures). 328 Rule 206(4)–5(i)(10)(ii) (defining “solicit,” with respect to a contribution or payment, as communicating, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment). Some commentators requested that we provide guidance regarding when an adviser would be deemed to be contributing for purposes of the rule. See, e.g., Caplin & Drysdale Letter. An adviser that consents to the use of its name on fundraising literature for a candidate would be soliciting contributions for that candidate.

(i) any contribution 329 to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services,330 or (ii) any payment 331 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.332 These restrictions are intended to prevent advisers from circumventing the rule’s prohibition on direct contributions to certain elected officials such as by “bundling” a large number of small employee contributions to influence an election, or making contributions (or payments) indirectly through a State or local political party.333 We received only a few comments on this provision. One supporter of our proposal asserted that it “would close an important gap in which contributions might be made indirectly to government officials for the purpose of influencing their choice of investment advisers.”334 Most commenters that addressed the provision focused on the prohibition relating to contributions and payments to State and local political parties where the adviser is providing, or seeking to provide, advisory services. One State official suggested that this prohibition would unfairly affect states with strict limitations on individual contributions to candidates as they are now more reliant on party money for campaigns.335 Another State official, however, explained the importance of the provision by pointing out that it is often difficult or impossible to differentiate between individuals seeking an office and the political party, which often merely passes contributions it receives on to the candidate, and may direct successful candidates to place pension business with contributors.336 We are adopting this provision, as proposed. These restrictions on soliciting and coordinating or seeking to provide advisory services to a government entity in that locality. In these circumstances, the rule would, however, prohibit an adviser from soliciting the payment to a local political party as a means to indirectly make payments to the State party. See rule 206(4)–5(d).

333 See note 68.

334 Cornell Law Letter.

335 CT Treasurer Letter. In upholding restrictions targeted at a particular industry, courts have found that the loss of contributions from a small segment of the electorate “would not significantly diminish the universe of funds available to a candidate” and “would not impede the 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”); On DeLisle, 529 F. Supp. 2d 119, 128 (S.D.N.Y. 2008); aff’d 553 F.3d 105, 110 (2d Cir. 2009).
contributions and payments close what would otherwise be a potential gap in the rule as advisers could circumvent its limitations on direct contributions through soliciting and coordinating others to make contributions to influence an election or a government official’s investment adviser selection process.337 We disagree that this prohibition would unfairly affect candidates in states that limit individual contributions, because the rule is non-discriminatory and would affect contributions (and payments) to all candidates equally that were being bundled or made through a gatekeeper for the benefit of an investment adviser seeking or doing business with the State or local government.

(d) Direct and Indirect Contributions or Solicitations

Rule 206(4)–5(d) prohibits acts done indirectly, which, if done directly, would violate the rule.338 As a result, an adviser and its covered associates could not funnel payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the adviser as a means to circumvent the rule.339 We emphasize, however, that contributions by these other persons would not otherwise trigger the rule’s two-year time out.340 We received no comments on this aspect of the proposed rule and are adopting it as proposed.

(e) Covered Investment Pools

Rule 206(4)–5 includes a provision that applies each of the prohibitions of rule 206(4)–5 to an investment adviser that manages assets of a government entity through a hedge fund or other type of pooled investment vehicle (“covered investment pool”).341 For example, a political contribution to a government official that would, under the rule, trigger the two-year time out from providing advice for compensation to the government entity would also trigger a two-year time out from the receipt of compensation for the management of those assets through a covered investment pool. This provision extends the protection of the rule to public pension plans that increasingly access the services of investment advisers through hedge funds and other types of pooled investment vehicles they sponsor or advise.

This provision will generally affect two common types of arrangements in which a government official is in a position to influence investment of funds in pooled investment vehicles. The first is the investment of public funds in a hedge fund or other type of pooled investment vehicle. The other is the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a “529 plan.”342 An adviser that makes political contributions to steer assets to a pooled investment vehicle that advises or facilitates fraud by implementing a government official’s “quid pro quo” scheme.343 Public pension plan beneficiaries are harmed when a government official violates the public trust, for example, by failing to disclose that the government official has directed the investment of the plan’s assets in a pooled investment vehicle not because of the vehicle’s financial merits but rather because the official has received a political contribution.344 By engaging in such conduct, the adviser engages in a scheme to defraud the beneficiaries of the government plan or program.345 Additionally, an investment adviser to a pooled investment vehicle that is an investment option in a government plan or program may prepare information about the pooled investment vehicle that may be used by plan officials to evaluate the vehicle and by pension plan beneficiaries to decide whether to allocate assets to the vehicle. Such an adviser engages in or facilitates an act, practice, or course of business which is fraudulent, deceptive, or manipulative when the adviser does not disclose that it made a contribution for the purpose of inducing an investment by the government officials and that the

337 We note that a direct contribution to a political party by an adviser or its covered associates would not violate the rule, unless the contribution was a means for the adviser to do indirectly what the rule would prohibit if done directly (for example, if the contribution was earmarked or known to be provided for the benefit of a particular government official). See section II.B.2(d) of the Release. The MSRB amended Rule G–37 in 2005 to expand its prohibition on soliciting others to make, and on coordinating, payments to State and local political parties to close what the MSRB identified as a gap in which contributions were being made indirectly to officials through payments to political parties for the purposes of influencing their choice of municipal securities dealers. The MSRB had not previously been able to deter this misconduct, despite issuing informal guidance in both 1996 and 2003. See Rule G–37: Request for Comments on Draft Amendments to Rule G–37(c) Relating to Prohibiting Solicitation and Coordination of Payments to Political Parties, and Draft Question and Answer Guidance Concerning Indirect Rule Violations, MSRB Notice 2005–11, available at http://www.msrb.org/msrb1/archive/2005/2005–11.asp (“Both the 1996 Q&A guidance and the 2003 Notice were intended to alert dealers and [municipal finance professionals] to the realities of political fundraising and guide them toward developing procedures that would lead to compliance with both the letter and the spirit of the rule. The MSRB continues to be concerned, however, that dealer [municipal finance professional], and affiliated persons’ payments to political parties, including “housekeeping”, “conference” or “overhead” type accounts, can in some cases be at least the appearance that dealers may be circumventing the intent of Rule G–37.”); Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Approving Proposed Rule Change Concerning Solicitation and Coordination of Payments to Political Parties and Question and Answer Guidance Related to Rule G–37(d) on Indirect Violations, Exchange Act Release No. 52496 (Sept. 22, 2005) (SEC order approving change to MSRB G–37 to prohibit soliciting or coordinating payments to political parties).

338 Paragraph (d) of the rule is substantially similar to section 208(d) of the Advisers Act [15 U.S.C. 80b–8(d)], which states, “It shall be unlawful for any person indirectly, or through or by any other

339 This provision would also cover, for example, situations in which contributions by an adviser are made, directed or funded through a third party with an expectation that the contributions, another contribution is likely to be made by a third party to an “official of the government entity,” for the benefit of the adviser. Contributions made through gatekeepers thus would be considered to be made “indirectly” for purposes of the rule. In approving MSRB rule G–37, the Commission stated: “[rule G–37(d)] is intended to prevent dealers from funneling funds to other persons or entities to circumvent the [rule’s] requirements. For example, a dealer would violate the [rule] if it does business with a fund or contributions were made to an issuer official from or by associated persons, family members of associated persons, consultants, lobbyists, attorneys, other dealers, dealers’ agents, PACs, or other persons or entities as a means to circumvent the rule. A dealer also would violate the rule by doing business with an issuer after providing money to any person or entity when the dealer knows that the money will be given to an official of an issuer who could not receive the contribution directly from the dealer without triggering the rule’s prohibition on business.” 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)].

340 Like MSRB rule G–37(d), rule 206(4)–5(d) requires a showing of intent to circumvent the rule in order for such contributions to trigger the time out. See Blount, 61 F.3d at 948 (“In short, according to the SEC, the rule restricts such gifts and contributions only when they are intended as end-runs around the direct contribution limitations.”).

341 See rule 206(4)–5(c). We discuss the types of pooled investment vehicles that are “covered investment pools” below in section II.B.2.e(1) of this release.

342 We note that if an adviser is selected by a government entity to advise a government-sponsored plan (regardless of whether the plan selects one of the pools that advises or manages as an option available under its plan), the prohibitions of the rule directly apply. See rule 206(4)–5(a)(1) and (a)(2).

343 SEC v. Dibello, 587 F.3d 553, 568 (2d Cir. 2009).

344 Id. at 566.

345 See id. at 568–69; section 206(4) of the Advisers Act. See also Exchange Act rule 10b–5 [17 CFR 240.10b–5].
government officials sponsoring the plan chose the vehicle as an investment option for beneficiaries not solely on the basis of its merits, but rather as the consequence of improper *quid pro quo* payments. The rule also operates to prevent an adviser from engaging in pay to play practices indirectly through an investment pool that it would not be permitted to do if it directly managed (or sought to directly manage) the assets of a government entity. Although a few commenters asserted that the rule or parts of it should not apply to pooled investment vehicles, none made a persuasive argument that the problems the rule is designed to address are not present in the management of public pension plan and other public monies invested in pooled investment vehicles. As we discussed in the Proposing Release, when a decision to invest public funds in a pooled investment vehicle is based on campaign contributions, the public pension plan may make inferior investment choices and may pay higher fees. And plans may invest in pooled investment vehicles that pay substantially higher advisory fees and assume significantly greater risks than other investment alternatives.

We find nothing in the structure of pooled investment vehicles or the variety of investment strategies they employ that suggests a reason for treating advisers to pooled investment vehicles differently from advisers to separately managed advisory accounts, except as we discuss below, registered investment companies to which we apply a more limited version of the rule. That an investment in a pooled investment vehicle may not involve a direct advisory relationship with a government sponsored plan does not change the nature of the fraud or the harm that may be inflicted as a consequence of the adviser’s pay to play activity.

Indeed, many of our recent enforcement cases alleged political contributions or kickbacks designed to induce public officials to invest public pension plan assets in pooled investment vehicles. We are concerned that our failure to apply the rule to advisers who manage assets through these vehicles would ignore an area where there has been considerable growth, both in the amount of public assets invested in such pooled investment vehicles and allegations of pay to play activity involving public pension plans. We believe a failure to apply the rule in this area could, in some cases, even encourage the use of covered investment pools as a means of avoiding application of the rule.

Nonetheless, as described in more detail below, we have made several changes from the proposal to more narrowly tailor the applicability of the rule to pooled investment vehicles in order to achieve our regulatory purpose while reducing compliance burdens that commenters brought to our attention. In addition, we have made certain clarifying changes to the rule, as described below.

(1) Definition of “Covered Investment Pool”

Under the rule, a “covered investment pool” includes: (i) Any investment company registered under the Investment Company Act of 1940 that is an investment option of a plan or program of a government entity; or (ii) any company that would be an investment company but for section 3(a) of that Act but for the exclusion provided from that definition by section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act. Accordingly, it includes such unregistered pooled investment vehicles as hedge funds, private equity funds, venture capital funds and collective investment trusts. It also

CalPERS, Blackstone Clash over Placement Agent ‘Jackpot’ Fees, Bloomberg (Apr. 7, 2010), available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPNtTr1q7tpw (noting that placement agents working for private equity, hedge funds, venture capital and real estate firms typically earn the equivalent of 0.5 percent to 3 percent of the money they place under the management of their client, quoting California State Treasurer Bill Lockyer, a member of the CalPERS board: “The contingency fees are too much of a jackpot for the placement agents * * * [they] invite corrupt practices”).

One commenter questioned the Commission’s authority to apply the rule in the context of covered investment pools in light of the opinion of the Court of Appeals for the District of Columbia Circuit in Goldstein v. SEC, 431 F.3d 873 (D.C. Cir. 2006). Sutherland Letter. That case created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act [15 U.S.C. 80b–2(a)(11)(A)]. A non-bank adviser that provides advisory services with respect to a collective investment trust in which a government entity invests, however, would be subject to the rule’s prohibitions with respect to all of its government entity clients, including the collective investment trust in which a government entity invests, unless another exemption is available.

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includes registered pooled investment vehicles, such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.359 These plans or programs may include college savings plans like “529 plans”357 and retirement plans like “403(b) plans”358 and “457 plans”359 that typically allow participants to select among pre-established investment “options,” or particular investment pools (often invested in registered investment companies or funds of funds, such as target date funds), that a government official has directly or indirectly selected to include as investment choices for participants.360

We proposed to include in the definition of “covered investment pool” the types of pooled investment vehicles that are likely to be used as funding vehicles for, or investments of, government-sponsored savings and retirement plans. We explained that we included registered investment companies because of the significant growth in government-sponsored savings plans in recent years, which increasingly use these funds as investment options,361 and the increased competition among advisers for selection of their fund as an investment option for these plans.362 We were concerned that advisers to pooled investment vehicles, including registered investment companies, may make political contributions to influence the decision by government officials to include their funds as options in such plans.

We recognized in our proposal, however, that an adviser to a registered investment company might have difficulty in identifying when or if a government investor was a fund shareholder for purposes of preventing the adviser (or its covered associates) from making contributions that would trigger a two-year time out.363 Therefore, we proposed to only include publicly offered registered investment companies in the definition of covered investment pool for purposes of the two-year time out provision to the extent they were investments or investment options of a program of a government entity where the participant selects a fund or portfolio (such as an age-based investment option of a 529 plan) and the government entity selects the specific underlying registered investment company or companies in which the portfolio’s assets are invested.

We proposed rule 206(4)–5 under this authority.364 Rule 206(4)–5(b).

357 A 529 plan is a “qualified tuition plan” established under section 529 of the Internal Revenue Code of 1986 [26 U.S.C. 529], States generally establish 529 plans as State trusts which are considered instrumentalities of States for Federal securities laws purposes. As a result, the plans themselves are generally not regulated under the Federal securities laws and many of the protections of the Federal securities laws do not apply to investors in them. Section 2(b) of the Investment Company Act [15 U.S.C. 80a–2(b)] and section 2(a) of the Advisers Act [15 U.S.C. 80b–2(a)] (exempting State-owned entities from those statutes). However, the Federal securities laws do generally apply to, and the Commission does generally regulate, the brokers, dealers, and municipal securities dealers that effect transactions in interests in 529 plans. See generally sections 15(a)(1) and 15B of the Exchange Act [15 U.S.C. 78a–15(a)(1) and 15B]. A bank effecting transactions in 529 plan interests may be exempt from the definition of “broker” or “municipal securities dealer” under the Exchange Act if it can rely on an exception from the definition of broker in the Exchange Act. In addition, State sponsors of 529 plans may hire third-party investment advisers either to manage 529 plan assets on their behalf or to act as investment consultants to the agency responsible for managing plan assets. These investment advisers qualify for a specific exemption from registration under the Advisers Act, are generally required to be registered with the Commission as investment advisers and would therefore be subject to our rule.

358 A 403(b) plan is a tax-deferred employee benefit retirement plan established under section 403(b) of the Internal Revenue Code of 1986 [26 U.S.C. 403(b)].

359 A 457 plan is a tax-deferred employee benefit retirement plan established under section 457 of the Internal Revenue Code of 1986 [26 U.S.C. 457].

360 We would consider a registered investment company to be an investment option of a plan or program of a government entity.364 Several commenters asserted that an adviser to a publicly offered investment company would have similar difficulties in identifying government investors in registered investment companies for purposes of complying with other provisions of the rule.365 One opposed application of the rule to registered investment companies “even if the [company] is not included in a plan or program of a government entity,”366 although several generally urged us to exclude registered investment companies from the rule altogether.367 Another commenter urged us to apply the rule’s recordkeeping requirements (discussed below) prospectively and after a period of time that would be adequate to enable funds to redesign their processes and systems to capture information about whether an investor is a “government entity,” which would be necessary to comply with the rule and our proposed amendment to the Act’s recordkeeping rule.368 Some noted that identifying government investors would be particularly challenging when shares were held through an intermediary.369

We continue to believe for the reasons discussed above370 and in the Proposing Release, that advisers to registered investment companies should be subject to the rule. In response to comments, we have modified our

359 See supra note 352 and accompanying text.

360 See, e.g., Charles Paikert, TIAA–CREF Stages Comeback in College Savings Plans, Crain’s New York Bus., Apr. 23, 2007 (depicting TIAA–CREF’s struggle to remain a major player in managing State 529 plans because of increasing competition from the industry’s heavyweights); Beth Healy, Investment Giants Battle for Share of Exploding College-Savings Market, Boston Globe, Oct. 29, 2000, at F1 (describing the increasing competition between investment firms for State 529 plans and increasing competition to market their plans nationally). See also Anna Maria Andriotis, 529 Plan Fees Are Dropping, SmartMoney, Dec. 16, 2009, available at http://www.smartmoney.com/personal-finance/college-planning/529-plan-fees-are-dropping-but-for-how-long/?page=1 (“Costs on these plans are falling for a few reasons, and the biggest one has little to do with the State of the economy: The nature of their contracts creates competition that therefore has to be subject to our rule. Costs on these plans are falling for a few reasons, and the biggest one has little to do with the State of the economy: The nature of their contracts creates competition that therefore has to be subject to our rule.”). We proposed rulemaking text.

361 See supra note 352 and accompanying text.


363 See T. Rowe Price Letter.

364 Fidelity Letter; ICI Letter; NSCAP Letter; SIFMA Letter. We disagree that registered investment companies should be excluded from our rule. Pay to play activity is fraudulent, regardless of whether it occurs in the context of a pooled investment vehicle or a separately managed account. One commenter asserted that the existence of a regulatory regime applicable to investment companies precludes the need for pay to play prohibitions with respect to these pools. See ICI Letter. However, existing laws and regulations applicable to investment companies do not specifically address pay to play practices.

365 ICI Letter. See also section 1D.3 of this Release.

366 See T. Rowe Price Letter; ICI Letter; Fidelity Letter.

367 See supra notes 361–362 and accompanying text.
proposal to include a registered investment company in the definition of covered investment pool, for purposes of all three of the rule’s pay to play prohibitions, but only if it is an investment option of a plan or program of a government entity.\textsuperscript{371} We believe this approach strikes the right balance between applying the rule in those contexts, discussed in the Proposing Release,\textsuperscript{372} in which advisers to registered investment companies may be more likely to engage in pay to play conduct, while recognizing the compliance challenges relating to identifying government investors in registered investment companies\textsuperscript{373} that may result from a broader application of the rule. When an adviser’s investment company is an investment option in a participant-directed government plan or program, we believe it is reasonable to expect the adviser will know (or can reasonably be expected to acquire information about) the identity of the government plan.\textsuperscript{374} We recognize that when shares are held through an intermediary, an adviser may have to take additional steps to identify a government entity.\textsuperscript{375} Therefore, we have provided advisers to registered investment companies with additional time to modify current systems and processes.\textsuperscript{376}

We have also made several minor changes from our proposal intended to clarify and simplify application of the rule. First, at the suggestion of commenters,\textsuperscript{377} we are clarifying that an adviser to a registered investment company is only subject to the rule—\textit{i.e.}, the investment company is only considered a covered investment pool—if the investment company is an investment option of a plan or program of a government entity that is \textit{participant-directed}.\textsuperscript{378} This change reflects our intent, as demonstrated by the examples we give in the definition (\textit{i.e.}, 529 plans, 403(b) plans, and 457 plans) that the definition is intended to encompass those covered investment pools that have been pre-selected by the government sponsoring or establishing the plan or program as part of a limited menu of investment options from which participants in the plan or program may allocate their assets. We have also added, as additional examples to the definition of “government entity,” a defined benefit plan and a State general fund to better distinguish these pools of assets from a plan or program of a government entity.\textsuperscript{379} We have also made minor organizational changes within the definition of government entity from our proposal to make clear that such pools are not “plans or programs of a government entity.” Finally, we have simplified the definition of “covered investment pool” as it applies to registered investment companies. The definition as adopted includes investment companies registered under the Investment Company Act that are an option of a plan or program of a government entity, regardless of whether, as proposed, their shares are registered under the Securities Act of 1933 (“1933 Act”). As discussed above, under the rule as adopted an adviser to a registered investment company is only subject to the rule if the company is an investment option of a plan or program. As a result, we believe it is unnecessary to distinguish between registered types of plans. We also understand that it is not uncommon for contributions of 403(b) and 457 plans to be commingled into an omnibus position that is forward funded, making it more challenging for an adviser to distinguish government entity investors from others.\textsuperscript{377}

Application of the Rule

Under rule 206(4)–5 (and as proposed) an investment adviser is subject to the two-year time out if it manages a covered investment pool in which the assets of a government entity are invested.\textsuperscript{380} The rule does not require a government entity’s withdrawal of its investment or cancellation of any commitment it has made. Indeed, the rule prohibits advisers not from providing advice subsequent to a triggering political contribution, but rather from receiving compensation for providing advice. If a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year “time out” is made, the adviser must forgo any compensation related to the assets invested or committed by that government entity.\textsuperscript{381}

Application of the two-year time out may present different issues for covered investment pools than for separately managed accounts due to various structural and legal differences. Having made a contribution triggering the two-year time out, the adviser may have multiple options available to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. For instance, in the case of a private pool, the adviser could seek to cause the pool to redeem the investment of the government entity.\textsuperscript{382}

\textsuperscript{371} Rule 206(4)–5(i)(3).

\textsuperscript{372} Proposing Release, at nn.185–87 and accompanying text. See also supra notes 352 and 362 and accompanying text (describing the growth in government-sponsored savings plans in recent years and the increased competition for an adviser’s fund to be selected as an investment option of such plans). \textsuperscript{373} Identifying government investors in other types of covered investment pools does not generally present similar compliance challenges. See, e.g., rule 2(a)(31) under the Investment Company Act (defining “qualified purchaser,” as that term is used in section 3(c)(7) of that Act); Rule 501(a) of Regulation D under the Securities Act of 1933 (“Securities Act”). \textsuperscript{374} With respect to a 529 plan, for example, an adviser would know that its investment company is an investment option of the plan and will know the identity of the government entity investor because a 529 plan can only be established by a State, which generally establishes a trust to serve as the direct investor in the investment company, while plan participants invest in various options offered by the 529 trust. The rule does not require an adviser to identify plan participants, only the government plan or program. See rule 206(4)–5(f)(5)(iii) (defining a “government entity” to include a plan or program of a government entity. The definition does not include the participants in those plans or programs). \textsuperscript{375} For example, while 403(b) plans and 457 plans are generally associated with retirement plans for government employees, they are not used exclusively for this purpose. For instance, certain non-profit or tax-exempt entities can establish these investment companies based on whether their shares are registered under the 1933 Act, although we understand that those shares will typically be registered where the fund is an option in a plan or program of a government entity. (2) Application of the Rule

Under rule 206(4)–5 (and as proposed) an investment adviser is subject to the two-year time out if it manages a covered investment pool in which the assets of a government entity are invested.\textsuperscript{380} The rule does not require a government entity’s withdrawal of its investment or cancellation of any commitment it has made. Indeed, the rule prohibits advisers not from providing advice subsequent to a triggering political contribution, but rather from receiving compensation for providing advice. If a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year “time out” is made, the adviser must forgo any compensation related to the assets invested or committed by that government entity.\textsuperscript{381}

Application of the two-year time out may present different issues for covered investment pools than for separately managed accounts due to various structural and legal differences. Having made a contribution triggering the two-year time out, the adviser may have multiple options available to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. For instance, in the case of a private pool, the adviser could seek to cause the pool to redeem the investment of the government entity.\textsuperscript{382}
Such redemptions may be relatively small matters in the case of, for example, a highly liquid private pool. Commenters pointed out to us that, for some private pools, such as venture capital and private equity funds, a government entity’s withdrawal of its capital or cancellation of its commitment may have adverse implications for other investors in the fund.

In such cases, the adviser could instead comply with the rule by waiving or rebating the portion of its fees or any performance allocation or carried interest determined on the same basis as the adviser fee, or permit the government entity to continue to pay its portion of the advisory fee, but require the adviser to rebate that portion of the fee to the fund as a whole. We believe either approach would meet the requirements of the rule we are adopting today.

(3) Subadvisory Arrangements

A number of commenters urged that we exclude from the rule subadvisers to covered investment pools because, being in a subordinate role to the adviser, they may have no involvement in the adviser’s solicitation activities including any ability to identify government entities being solicited, and therefore should not be held accountable for the adviser’s actions. None of these commenters, however, indicated that a subadviser could not obtain from the adviser the information necessary to comply with the rule. Additionally, no commenter provided us with a basis to distinguish advisers from subadvisers that would be adequate to avoid undermining the prophylactic nature of our rule. “Subadviser” is not defined under the Act, and significant variation exists in subadvisory relationships. There is no readily available way to draw meaningful distinctions between advisers and subadvisers by, for example, looking at who controls marketing and solicitation activities, who has an advisory contract directly

approach, while another commenter suggested we could, alternatively, permit the government entity to continue to pay its portion of the advisory fee, but require the adviser to rebate that portion of the fee to the fund as a whole. We believe either approach would meet the requirements of the rule we are adopting today.

with the government client, or other factors. In addition, subadvisers generally have the same economic incentives as advisers to obtain new business and increase assets under management. We are concerned that under the approaches suggested by commenters, an adviser that sought to avoid compliance with the prophylactic provisions of our rule and engage in pay to play could organize itself to operate as a subadviser in such an arrangement. We therefore believe it is not appropriate to exclude subadvisers from the rule.

We are, however, providing some guidance that may assist advisers in subadvisory and fund of funds arrangements in complying with the rule. First, by the terms of the rule, if an adviser or subadviser makes a contribution that triggers the two-year time out from receiving compensation, the subadviser or adviser, as applicable, that did not make the triggering contribution could continue to receive compensation from the government entity, unless the arrangement were a means to do indirectly what the adviser or subadviser could not do directly under the rule. Second, advisers to underlying funds in a fund of funds arrangement are not required to look through the investing fund to determine whether a government entity is an investor in the investing fund unless the investment were made in that manner as a means for the adviser to do indirectly

memorandum, prospectus or other disclosure document to current and prospective investors in such a fund. See, e.g., Rule 502 of Regulation D under the Securities Act [17 CFR 230.502] (addressing disclosure obligations for non-accredited investors who purchase securities in a limited offering pursuant to rules 505 or 506 of Regulation D under the Securities Act [17 CFR 230.505 or 17 CFR 230.506]).

We understand that other types of pooled investment vehicles, including private equity and venture capital funds, already have special withdrawal and transfer provisions related to the regulatory and tax considerations applicable to certain types of investors, such as those regulated by the Employee Retirement Income Security Act of 1974 (“ERISA”) [29 U.S.C. 18]. See generally James M. Schell, Private Equity Funds—Structure and Operations (Law Journal Press 2000) (2010).

See Abbott Letter; ICI Letter; NY City Bar Letter.

As we noted in the Proposing Release, some commenters to our 1999 Proposal asserted that a performance fee waiver raises various calculation issues. See Proposing Release, at n.192. An adviser making a disqualifying contribution could comply with rule 206(4)–5 by waiving a performance fee or carried interest determined on the same basis as the fee or carried interest is normally calculated—e.g., on a mark-to-market basis. For arrangements like those typically found in private equity and venture capital funds where the fee or carry is calculated based on realized gains and losses and mark-to-market calculations are not feasible, advisers could use a straight-line method of calculation which assumes that the realized gains and losses were invested over the life of the investment.

See Proposing Release, at n.193 and accompanying text. See, e.g., rule 18f–3 under the Investment Company Act [17 CFR 270.18f–3]. Moreover, other regulatory considerations, such as those we noted in Part II A, may impact these arrangements with respect to collective investment trusts.

This may also be done at the class level or series level for private funds organized as corporations.
what it could not do directly under the rule.\textsuperscript{398}

(f) Exemptions

An adviser may apply to the Commission for an order exempting it from the two-year compensation ban.\textsuperscript{399} Under this provision, which we are adopting as proposed, we can exempt advisers from the rule’s time out requirement where the adviser discovers contributions that trigger the compensation ban only after they have been made, and when imposition of the prohibition is unnecessary to achieve the rule’s intended purpose. This provision will provide advisers with an additional avenue by which to seek to cure the consequences of an inadvertent violation by the adviser that falls outside the limits of the rule’s de minimis exception and exception for returned contributions,\textsuperscript{400} such as when a disgruntled employee makes a greater than \$350 contribution as he or she exits the firm. In determining whether to grant an exemption, we will take into account the specific facts and circumstances that each application presents. Among other factors, we will consider: (i) whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Advisers Act; (ii) whether the investment adviser, (A) before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of rule 206(4)–5; (B) prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and (C) after learning of the contribution, (1) 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; and (2) has taken such other remedial or preventive measures as may be appropriate under the circumstances; (iii) whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment; (iv) the timing and amount of the contribution which resulted in the prohibition; (v) the nature of the election (e.g., Federal, State or local); and (vi) the contributor’s apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.\textsuperscript{401} We intend to apply these factors with sufficient flexibility to avoid consequences disproportionate to the violation, while effecting the policies underlying the rule.

We received limited comment on this provision. A few commenters suggested that the operation of the rule should toll until a decision is made about an applicant’s request.\textsuperscript{402} We are concerned that such an approach could encourage frivolous applications and encourage applicants to delay the disposition of their applications. As we explained in the Proposing Release, an adviser seeking an exemption could place into an escrow account any advisory fees earned between the date of the contribution triggering the prohibition and the date on which we determine whether to grant an exemption.\textsuperscript{403} Some commentators recommended that we build-in a specified length of time for the Commission to respond to requests for relief.\textsuperscript{404} We recognize that applications for an exemptive order will be time-sensitive and will consider such applications expeditiously. We note that the escrow arrangements discussed above may lessen the hardship on advisers.

D. Recordkeeping

We are adopting amendments to rule 204–2 to require registered investment advisers that have government clients, or that provide investment advisory services to a covered investment pool in which a government entity investor invests, to make and keep certain records that will allow us to examine for compliance with new rule 206(4)–5.\textsuperscript{405}

\textsuperscript{398} See rule 206(4)–5(d).

\textsuperscript{399} Rules 0–4, 0–5, and 0–6 under the Advisers Act [17 CFR 275.0–4, 0–5, and 0–6] provide procedures for filing applications under the Act, including applications under the rule 206(4)–5.

\textsuperscript{400} See sections II.B.2(a)(5) and (7) of this Release, describing exceptions to the two-year time out prohibition of the rule.

\textsuperscript{401} See Rule 206(4)–5(f)(v)(e). These factors are similar to those considered by FIRNA and the appropriate bank regulators in determining whether to grant an exemption under MSRB rule G–37(i).

\textsuperscript{402} ICI Letter; Skadden Letter.

\textsuperscript{403} See Proposing Release, at n.199. The escrow account would be with the adviser if the Commission grants the exemption. If the Commission does not grant the exemption, the fees contained in the account would be returned to the government entity client. In contrast, MSRB rule G–37, on which rule 206(4)–5 is based, does not permit a municipal securities dealer to continue to engage in municipal securities business with an issuer while an application is pending. See MSRB Rule G–37 Q&A, Question V.1.

\textsuperscript{404} IAA Letter; ICI Letter; NASP Letter (each suggesting all applications be granted if they are not acted upon in 30 days); Skadden Letter (suggesting a 45-day deadline).

\textsuperscript{405} Rule 204–2(a)(18) and (b)(1). An adviser is required to make and keep these records only if it provides investment advisory services to a government entity or if a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services. Advisers that solicit government clients on behalf of other advisers are also subject to the amended recordkeeping requirements. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act, however, are not subject to the recordkeeping requirements under amended 204–2 unless they do register with us, although as discussed earlier, supra note 92 and accompanying text, they are subject to rule 206(4)–5. Advisers keeping substantially the same records under rules adopted by the MSRB are not required to keep duplicate records. Rule 204–2(b)(1).

\textsuperscript{406} MSRB rule G–8(a)(xvi). The MSRB also requires certain records to be made and kept in accordance with disclosure requirements that our rule does not contain.
plan. An investment adviser, regardless of whether it currently has a government client, must also keep a list of the names and business addresses of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity on its behalf. The amended rule reflects several changes from our proposal, which we describe below.

First, in response to comments,413 we have limited the rule to provide that only records of contributions,414 not payments, must be maintained by an adviser. In this way, an adviser is not required to maintain records of payments to PACs.417 Although those payments do not require, as proposed, advisers to maintain records of payments to PACs.417 Although those payments do not trigger application of the two-year time out, payments to PACs can be a means for an adviser or covered associate to funnel contributions to a government official without directly contributing. We are, therefore, adopting the amendment to require advisers to keep records of payments to PACs as these records will allow our staff to identify situations that might suggest an intent to circumvent the rule.

Second, an investment adviser to a registered investment company must maintain records identifying government entity investors only if the investments are made as part of a plan or program of a government entity or provide participants in the plan or program with the option of investing in the fund.419 This change would narrow the records required to those necessary to support the rule as modified from our proposal, and we believe addresses commenters’ concerns regarding the ability of advisers to registered investment companies to identify government entity investors.420 As discussed above, we believe it is reasonable to expect advisers to know the identity of the government entity when a registered fund they advise is part of a plan or program. In addition, as commenters suggested, we are providing a substantial transition period for advisers to registered investment companies that should allow these advisers to make the necessary changes to account documents and systems to allow them to identify government entities that provide one or more of the investment companies they advise as an investment option.421

Third, the amended rule requires an adviser to maintain a list of only those government entities to which it provides, or has provided in the past five years, investment advisory services.422 We are not requiring, as proposed, a list of government entities the adviser solicited for advisory business.423 Some commenters expressed concerns about the potential scope of this requirement and noted that solicitation does not trigger rule 206(4)–5’s two-year time out, rather it is providing advice for compensation that does so.424 In light of these concerns, and the record before us today, we are not requiring advisers to maintain lists of government entities solicited that do not become clients.

Fourth, as discussed above, rule 206(4)–5 permits an adviser to use certain third parties to solicit on its behalf. We are, therefore, requiring that advisers that provide or agree to provide, directly or indirectly, payment to advisers or broker-dealers registered with the Commission that act as regulated persons under rule 206(4)–5 to maintain a list of the names and business addresses of each such regulated person.425 These records will enable the Commission’s staff to review and compare the regulated person’s records to those of the adviser that hired the regulated person.

Finally, the amendments require advisers to make and keep records of their covered associates, and their own and their covered associates’ contributions, only if they provide advisory services to a government client.426 Commenters had expressed concerns that requiring advisers with no government business to make and keep these records could be unnecessarily intrusive to employees and burdensome on advisers.427 In light of those concerns, and the record before us today, we are not requiring advisers with no government business to make and keep these records.428 As a consequence, an adviser with no government clients would not have to require employees to report their political contributions.

E. Amendment to Cash Solicitation Rule

We are adopting, as proposed, a technical amendment to rule 206(4)–3 under the Advisers Act, the “cash solicitation rule.” That rule makes it

413 Amended rule 204–2 does not require an adviser to a covered investment plan that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. See supra note 374. Consistent with changes we have made to the definition of covered investment pool, we note that an adviser’s recordkeeping obligations with respect to a registered investment company apply only if such an investment company is an option of a plan or program of a government entity. See section II.B.2(e) of this Release.

414 Rule 204–2(a)(18)(ii)(D).

415 Fidelity Letter; IAA Letter; SIFMA Letter.

416 See supra note 153 and accompanying text (defining “covered associates”).

417 See supra note 331 (defining “PAC”).

418 Rule 204–2(a)(18)(ii)(C).

419 See, e.g., IAA Letter; SIFMA Letter.

420 Accordingly, as part of a strong compliance program, an adviser or covered associate that receives a general solicitation to make a contribution to a PAC should consider inquiring about how the collected funds would be used to determine whether the PAC is closely associated with a government official to whom a direct contribution would subject the adviser to the two-year time out. See section II.B.2(d) of this Release and rule 206(4)–5(d). The MSRB takes a similar approach regarding whether a payment to a PAC is an indirect contribution to a government official. See MSRB Rule G–27 Q&A, Questions III.4 and III.5.

421 Rule 204–2(a)(18)(ii)(B). Amended rule 204–2 does not require an adviser to a covered investment plan that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. For a discussion of the application of the rule to a covered investment pool that is an option of a government plan or program, see supra note 371 and accompanying text. Consistent with changes we have made to the definition of covered investment pool, we note that an adviser’s recordkeeping obligations with respect to a registered investment company apply only if such an investment company is an option of a plan or program of a government entity. See section II.B.2(e) of this Release.

422 Advisers to covered investment pools that are relying on Investment Company Act exclusions in sections 3(c)(11), 3(c)(7) and 3(c)(11) must identify government entities regardless of whether they are an investment option of a plan or program of a government entity. Rule 204–2(a)(18)(ii)(B).

423 See section II.B.2(e) of this Release.

424 Dechert Letter; SIFMA Letter; Skadden Letter.

425 Rule 204–2(a)(18)(ii)(D). If an adviser does not specify which types of clients the regulated person should solicit on its behalf (e.g., that it should only solicit government entity clients), the adviser could satisfy this requirement by maintaining a list of all of its regulated person solicitors. Supra note 412.

426 Rule 204–2(a)(18)(iii).

427 IAA Letter; Dechert Letter; SIFMA Letter.

428 Although advisers that do not have government entity clients are not required to maintain records under the amendments, the look-back requirements of rule 206(4)–5 continue to apply. As a result, an adviser that has maintained records of the firm’s and its covered associates’ contributions would have to determine whether any contributions by the adviser, its covered associates, and any former covered associates would subject the firm to the two-year time out prior to accepting compensation from a new government entity client. The same applies to newly-formed advisers. The record developed during this determination process, would fall under the adviser’s obligation to maintain records of all direct or indirect contributions made by the investment adviser or its covered associates to an official of a government entity, or payments to a political party of a State or political subdivision thereof, or to a political action committee. Rule 204–2(a)(18)(ii)(C).
unlawful, except under specified circumstances and subject to certain conditions, for an investment adviser to make a cash payment to a person who directly or indirectly solicits any client for, or refers any client to, an investment adviser.\(^429\) Paragraph (iii) of the cash solicitation rule contains general restrictions on third-party solicitors that cover solicitation activities directed at any client, regardless of whether it is a government entity client. New paragraph (e) to rule 206(4)–3 alerts advisers and others that special prohibitions apply to solicitation activities involving government entity clients under rule 206(4)–5.\(^{430}\)

### III. Effective and Compliance Dates

Rule 206(4)–5 and the amendments to rules 204–2 and 206(4)–3 are effective on September 13, 2010. 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.\(^{431}\) Advisers to registered investment companies that are covered investment pools must comply with the rule by September 13, 2011.\(^{432}\) 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.

#### A. Two-Year Time Out and Prohibition on Soliciting or Coordinating Contributions

We are providing advisers with a six month transition period to give them time to identify their covered associates and current government entity clients and to modify their compliance programs to address new compliance obligations under the rule.\(^{433}\) Accordingly, rule 206(4)–5’s prohibition on providing advisory services for compensation within two years of a contribution will not apply to, and the rule’s prohibition on soliciting or coordinating contributions will not be triggered by contributions made before March 14, 2011.\(^434\) We believe that the length of the transition period should address commenters’ concerns that advisers have sufficient time to implement policies and procedures regarding contributions to avoid violations of the rule and that the rule not affect the 2010 elections for which some advisory personnel may already have committed to make political contributions.\(^{435}\)

#### B. Prohibition on Using Third Parties To Solicit Government Business and Cash Solicitation Rule Amendment

Advisers must comply with the new rule’s prohibition on making payments to third parties to solicit government entities for investment advisory services on September 13, 2011.\(^{436}\) Before this compliance date, advisers are not prohibited by the rule from making payments to third-party solicitors regardless of whether they are registered as broker-dealers or investment advisers.\(^{437}\) We have provided an extended transition period to provide advisers and third-party solicitors with sufficient time to conform their business practices to the new rule, and to revise their compliance policies and procedures to prevent violation of the new rule. In addition, the transition period will provide an opportunity for a registered national securities association to propose a rule that would meet the requirements of rule 206(4)–5(f)(9)(ii)(B) and for the Commission to consider such a rule. If, after one year, a registered national securities association has not adopted such rules, advisers would be prohibited from making payments to broker-dealers for distribution or solicitation activities with respect to government entities, but would be permitted to make payments to registered investment advisers that meet the definition of “regulated person” under the rule.\(^{438}\) We understand from our staff, however, that FINRA plans to act within the timeframe; if they do not, we will consider whether we should take further action.

Finally, the compliance date for the technical amendment to the cash solicitation rule, rule 206(4)–3, which is intended to alert advisers that rule 206(4)–5 is applicable to solicitations of a government entity, is one year from the effective date, as the amendment to the cash solicitation rule need only be operative when rule 206(4)–5’s third-party solicitor provisions are in effect.

#### C. Recordkeeping

As discussed above, the amendments to rule 204–2 apply only to investment advisers with clients who are government entities. Such advisers must comply with the amended rule on March 14, 2011 except as noted below. By March 14, 2011, these advisers must begin to maintain records of all persons who are covered associates under the rule and keep records of political contributions they make on and after that date. Advisers must also make and keep a record of all government entities that they provide advisory services to on and after March 14, 2011. Advisers are not, however, required to look back for the five years prior to the effective date to identify former government clients. Advisers that pay regulated persons to solicit government entities for advisory services on their behalf must make and keep a list of those persons beginning on and after September 13, 2011.\(^{439}\)

#### D. Registered Investment Companies

Advisers to registered investment companies that are “covered investment pools” under the rule\(^{440}\) must comply with rule 205(4)–5 with respect to those covered pools September 13, 2011. During the transition period, contributions by the adviser or its employees to government entity clients that have selected an adviser’s registered investment company as an investment option of a plan or program will not trigger the prohibitions of rule 206(4)–5.\(^{441}\)
We have provided for an extended compliance date to respond to concerns expressed by commenters that an adviser to a registered investment company may require additional time to identify government entities that have selected that registered investment company as an investment option when shares of the fund are held through omnibus arrangements such that the identity of the fund investor is not readily available to the adviser.\textsuperscript{442} The changes we have made to the proposed rule that limit the application of the two-year time out with respect to registered investment companies to those that are options in a plan or program of a government entity,\textsuperscript{443} together with this extended compliance date should provide advisers to registered investment companies sufficient time to put into place those system enhancements or business arrangements, such as those with intermediaries, that may be necessary to identify those government plans or programs in which the funds serve as investment options.\textsuperscript{444}

As noted above, we are providing for an extended compliance date for advisers that manage registered investment companies that are covered investment pools under the rule, which we are applying, for the same reasons, to recordkeeping obligations that arise as a result of those covered investment pools. Thus, advisers to these covered investment pools must make and keep a record of all government entity investors on and after September 13, 2011.\textsuperscript{445}

\section*{IV. Cost-Benefit Analysis}

We are sensitive to the costs and benefits imposed by our rules, and understand that there will be costs associated with compliance with rule 206(4)–5 and the amendments to rule 204–2.\textsuperscript{446} We recognize that the rule and amendments will place burdens on advisers that provide or seek to provide advisory services to government entities, and that advisers may in turn choose to limit the ability of certain persons associated with an adviser to make contributions to candidates for certain offices and to solicit contributions from certain candidates and payments to political parties. We believe there are practical, cost-effective means to comply with the rule without an adviser imposing a blanket ban on political contributions by its covered associates. We have closely drawn the rule, and modified it based on comments received, to achieve our goal of addressing adviser participation in pay to play practices, while seeking to limit the burdens imposed by the rule.

The rule and rule amendments are designed to address pay to play practices by investment advisers that provide advisory services to government entity clients and to certain covered investment pools in which a government entity invests. The rule 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 rule also prohibits an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party that is not a “regulated person” for a solicitation of advisory business from a government entity, or for a solicitation of a government entity to invest in certain covered investment pools, on behalf of such adviser.

Additionally, the rule prevents an adviser from coordinating or soliciting from others contributions to certain elected officials or candidates or payments to certain political parties. The rule applies both to advisers registered with us (or required to be registered) and those that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b–3(b)(3)). Our amendment to rule 204–2 requires a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees, as well as records of the regulated persons the adviser pays or agrees to pay to solicit government entities on the adviser’s behalf.

In the Proposing Release, we requested comment on the effects of the proposed rule and rule amendments on pension plan beneficiaries, participants in government plans or programs, investors in pooled investment vehicles, investment advisers, the advisory profession as a whole, government entities, third party solicitors, and political action committees.\textsuperscript{447} We requested that commenters provide analysis and empirical data to support their views on the costs and benefits associated with the proposal. For example, we requested comment on the costs of establishing compliance procedures to comply with the proposed rule, both on an initial and ongoing basis and on the costs of using compliance procedures of an affiliated broker-dealer that the broker-dealer established as a result of MSRB rules G–37 and G–38. In addition, we requested data regarding our assumptions about the number of unregistered advisers that would be subject to the proposed rule, and the number of covered associates of these exempt advisers.

Finally, in the context of the objectives of this rulemaking, we sought comments that address whether these rules will promote efficiency, competition and capital formation, and what effect the rule would have on the market for investment advisory services and third-party solicitation services.

We received approximately 250 comment letters on the proposal. Almost all of the commenters agreed that pay to play is a serious issue that should be addressed. One commenter stated that “the benefits derived from the application of pay to play limitations to public sector advisory services will far outweigh any temporary dislocations that may occur as private and public sector professionals make the necessary adjustments to their activities to transition to the Commission’s new standards.”\textsuperscript{448} Many, however, expressed concern about costs,\textsuperscript{449} particularly those related to the proposed ban on payments to third parties. Some suggested that the

\textsuperscript{442} See IC\textsuperscript{I} Letter; T. Rowe Price Letter.\textsuperscript{443} See section II.B.2(a) of this Release.\textsuperscript{444} A few commenters recommended that the rule apply only to new government investors in registered investment companies after the effective date of the rule. See IC\textsuperscript{I} Letter; T. Rowe Price Letter. We do not believe this would be appropriate because pay to play can be just as troubling in the context of an adviser renewing an advisory contract (or including a registered investment company as an investment option in a plan or program) as one that is endeavoring to obtain business for the first time.

\textsuperscript{445} Amended rule 204–2 does not require an adviser to a covered investment pool that is an option of a government plan or program to make and keep records of participants in the plan or program, but only the government entity. See supra note 411.

\textsuperscript{446} As proposed, we are also making a conforming technical amendment to rule 206(4)–3 to address potential areas of conflict with proposed rule 206(4)–5. We do not believe that this technical amendment affects the costs associated with the rulemaking. It will benefit advisers because it provides clarity about the application of our rules when they potentially overlap.

\textsuperscript{447} Proposing Release, at section III.C.

\textsuperscript{448} MSRB Letter. See also Thompson Letter; Common Cause Letter; Fund Democracy/Consumer Federation Letter (each identifying benefits of the rule).

\textsuperscript{449} See, e.g., Davis Polk Letter (generally commenting that any benefits of the proposed rule were outweighed by its likely costs). See also IC\textsuperscript{I} Letter; Monument Group Letter.
Commission underestimated the costs of compliance with the rule and rule amendments. As discussed below, many of the commenters who did comment specifically on the costs and benefits of the proposal did not provide empirical data to support their views.

A. Benefits

As we discuss extensively throughout this Release, we expect that rule 206(4)-5 will yield several important direct and indirect benefits. Overall, the rule is intended to address pay to play relationships that interfere with the legitimate process by which advisers are chosen based on the merits rather than on their contributions to political officials. The potential for fraud to invade the various, intertwined relationships created by pay to play arrangements is without question. We believe that rule 206(4)-5 will reduce the occurrence of fraudulent conduct resulting from pay to play and thus will achieve its goals of protecting public pension plans, beneficiaries, and other investors from the resulting harms. One commenter who agreed with us commended the proposed rule as a “strong start in controlling corruption, balancing the rights of the advisors and their executives with the very real detriment to the public which the numerous cases of pay-to-play involving public pension funds and other public entities have caused.”

Addressing pay to play practices will help protect public pension plans and investments of the public in government-sponsored savings and retirement plans and programs by addressing situations in which a more qualified adviser may not be selected, potentially inferior management, diminished returns or greater losses. One commenter who agreed, observed, “[w]hen lucrative investment contracts are awarded to those who pay to play, public pension funds may end up receiving substandard services and higher fees, resulting in lower earnings.” One public official commenter detailed the role of pay to play arrangements in the selection of public pension fund managers and the harm it can inflict on the affected plans, while other officials wrote to us explicitly expressing support for a Commission rule. By addressing pay to play practices, we will help level the playing field so that the advisers selected to manage retirement funds and other investments for the public are more likely to be selected based on the quality of their advisory services. These benefits, although difficult to quantify, could result in substantial savings and better performance for the public pension plans, their beneficiaries, and participants. Two commenters noted that the rule would promote the interests of plan beneficiaries.

By leveling the playing field among advisers competing for State and local government business, the rule will help minimize or eliminate manipulation of the market for advisory services provided to State and local governments. For example, direct political contributions or payments made to third-party solicitors as part of pay to play practices create artificial barriers to competition for firms that cannot, or will not, make those contributions or payments. They also increase costs for firms that may feel they have no alternative but to pay to play. The rule addresses a collective action problem created by this dynamic analogous to the one identified in the Blount opinion. One commenter emphasized the importance of restoring public confidence in the investment activities of all public pension funds. Indeed, at its core, the rulemaking addresses practices that undermine the integrity of the market for advisory services, as underscored by another commenter.

Allocative efficiency is enhanced when government clients award advisory business to advisers that compete based on price, performance and service and not the influence of pay to play, which in turn enables advisory firms, particularly smaller advisory firms, to compete on merit, rather than their ability or willingness to make contributions. In addition, taking into account the effects of analogous practices in the underwriting of municipal securities prior to MSRB rule G-37, we believe a merit-based competitive process may result in the allocation of public pension money to different advisers who may well deliver better investment performance and lower advisory fees than those advisers...

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450 See, e.g., SIFMA Letter (“While SIFMA believes that addressing practices that potentially undermine the merit-based selection of investment advisers is an important and laudable effort, the SEC appears to have underestimated the compliance costs the Proposed Rule will impose on covered entities.”); ICI Letter ([I]n relying on the estimates for compliance with the MSRB rules, the Commission significantly understates the compliance and recordkeeping burdens associated with the proposed rule”); Davis Polk Letter (“We believe that the Commission may have substantially underestimated the number of investment advisers that will be affected by the Proposed Rule and its costs and market effects in concluding that many of the aspects of the Rule would impose only minimal additional costs and burdens on investors and investment advisers.”). The commenters who addressed our estimates, however, did so in general terms and did not provide specific suggestions as to how they should be modified. See the discussion below regarding changes from the proposed rule that we believe mitigate some of the costs.

451 Common Cause Letter.

452 Bloomberg Letter.

453 See supra note 453.

454 See Blount, 61 F.3d at 945–46 (discussing the harms of pay to play: “Moreover, there appears to be a collective action problem tending to make the misallocation of resources persist.”).

455 According to the most recently available US census data, as of 2008, there are 2,550 State and local government employee retirement systems. See supra note 291–294 of this release. Collective action problems are a class of market failures calling for a regulatory response, and 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.

456 See DiNapoli Letter (noting applause for efforts “to stop the ‘pay-to-play’ practice which only serves to undermine public trust in investment advisers and regulators”).

457 One commenter cited a study containing evidence that before rule G-37 was adopted, underwriters’ pay to play practices distorted underwriting fees as well as which firms were hired by government issuers. See Butler Letter.

458 See supra note 453.

459 See Blount.
our rule is closely modeled. The MSRB rules have prohibited municipal securities dealers from participating in pay to play practices since 1994.467 As we have stated previously, we believe these rules have significantly curbed pay to play practices in the municipal securities market, and are likely to be similarly effective in deterring pay to play activities by investment advisers.468

Applying the rule to government entity investments in certain pooled investment vehicles or where a pooled investment vehicle is an investment option in a government-sponsored plan or program will extend the same benefits regardless of whether an adviser subject to the rule is providing advice directly to the government entity or is managing assets for the government entity indirectly through a pooled investment vehicle. By addressing distortions in the process by which investment decisions are made regarding public investments, we are providing important protections to public pension plans and their beneficiaries, as well as participants in other important plans or programs sponsored by government entities. Other investors in a pooled investment vehicle also will be better protected from, among other things, the effects of fraud that may result from an adviser’s participation in pay to play activities, such as higher advisory fees.

Finally, the amendments to rule 204–2 will benefit the public plans and their beneficiaries and participants in State plans or programs as well as supervisors of such plans by helping to uncover or resist acts and practices that keep the required records. The public pension plans, beneficiaries, and participants will benefit from these amendments because the records required to be kept will provide Commission staff with information to review an adviser’s compliance with rule 206(4)-5 and thereby may promote improved compliance. Advisers will benefit from the amendments to the recordkeeping rule as these records will assist the Commission in enforcing the rule against, for example, a competitor whose pay to play activities, if not uncovered, could adversely affect the competitive position of a compliant adviser.

B. Costs

We acknowledge that the rule and rule amendments will impose costs on advisers that provide or seek to provide advisory services to government clients directly, or indirectly through pooled investment vehicles. We discuss these costs below, along with a number of modifications we have made to the proposed rule and proposed amendments that will reduce costs.

1. Compliance Costs Related to Rule 206(4)-5

Rule 206(4)-5 requires an adviser with government clients to incur costs to monitor contributions made by the adviser and its covered associates and to establish procedures to comply with the rule. The initial and ongoing compliance costs imposed by the rule will vary significantly among firms, depending on a number of factors. Our estimated compliance costs, discussed below, take into account different ways a firm might comply with the rule. These factors include the number of covered associates of the adviser, the degree to which compliance procedures are automated (including policies and procedures that could require pre-clearance), the extent to which an adviser has a pre-existing policy under its code of ethics or compliance program, and whether the adviser is affiliated with a broker-dealer firm that is subject to MSRB rules G–37 and G–38. A smaller adviser, for example, will likely have a small number of covered associates, and thus expend less resources to comply with the rule and rule amendments than a larger adviser. Although a larger adviser is likely to spend more resources to comply with the rule, based on staff observations, a larger adviser is more likely to have an affiliated broker-dealer that is required to comply with MSRB rules G–37 and G–38.470 As we learned from a broker-

464 Commenters, both on the Proposing Release and our 1999 proposal, argued that treating third-party solicitors as covered associates would create significant compliance challenges because these solicitors were not controlled by advisers. See supra note 264 and accompanying text.

465 See supra note 55 and accompanying text.

466 See Kozel Letter (supporting the Commission’s proposal and asserting that the persons who engage in pay to play practices know that any shortfall will be covered by taxpayers); Bloomberg Letter (“Because the City is legally obligated to make up any short fall in the pension system assets to ensure full payment of pension benefits, pay to play practices can potentially harm all New Yorkers.”). See also Common Cause Letter; 1997 Survey, supra note 8 (“[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.”)

467 MSRB rule G–37 was approved by the Commission and adopted by the MSRB in 1994. See supra note 66.

468 See supra notes 101–107 and accompanying text.

469 One commenter stated that many investment advisers already have pay to play policies and procedures in place within the framework of their codes of ethics. See IIA Letter (advocating for regulation that would address pay to play practices through an adviser’s code of ethics, as an alternative to the approach taken in proposed rule 206(4)-5).

470 According to registration information available from Investment Adviser Registration Depository (“IARD”) as of April 1, 2010, there are 1,332 SEC-registered investment advisers (or 11.48% of the total 11,607 registered advisers) that indicate in Item 5.D.(9) of Form ADV that they have State or municipal government clients. Of those 1,332 advisers, 113 (or 8.50%) of the largest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. 204 of the largest 20% (or 76.7%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. Conversely, only 40 (or 30.1%) of the smallest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer; and only 67 of the smallest 20% (or 25.2%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer; and only 67 of the smallest 20% (or 25.2%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. With respect to broker-dealer affiliates, however, we note that our IARD data does not indicate whether the affiliated broker-dealer is a municipal securities dealer subject to MSRB rules.
dealer with an investment adviser affiliate that commented on our 1999 proposal, “the more the Rule mirrors G–37, the more firms can borrow from or build upon compliance procedures already in place.” Accordingly, we believe some advisers with broker-dealer affiliates may spend fewer resources to comply with the rule and rule amendments. We recognize, as some commenters pointed out, that MSRB rules G–37 and G–38 compliance systems may not be easily extensible in all cases, and we acknowledge that the range of efficiencies created in these circumstances will vary. A prominent concern of these commenters related to a proposed recordkeeping amendment which would have required advisers to keep records of solicitations—something that is not required under MSRB recordkeeping rule G–8. As previously discussed, we are not adopting that proposed amendment, which may address the concern noted by commenters.

We anticipate that advisory firms subject to rule 206(4)–5 will develop compliance procedures to monitor the political contributions made by the adviser and its covered associates. We estimate that the costs imposed by the rule will be higher initially, as firms establish and implement procedures and systems to comply with the rule and rule amendments. We expect that compliance expenses would then decline to a relatively constant amount in future years, and annual expenses are likely to be lower for small advisers as the systems and processes should be less complex than for a large adviser.

We estimate that approximately 1,697 investment advisers registered with the Commission may be affected by the rule and rule amendments.

474 Of the 1,697 advisers, we estimate that approximately 1,271 advisers have fewer than five covered associates that would be subject to the rule (each, a “smaller firm”); approximately 304 advisers have between five and 15 covered associates (each, a “medium firm”); and approximately 122 advisers have more than 15 covered associates that would be subject to the prohibitions of the rule (each, a “larger firm”).

475 This estimate is based on registration information from IARD as of April 1, 2010, applying the same methodology as in the Proposing Release. As previously noted, according to responses to Item 5.D(9) of Part 1 of Form ADV, 1,332 advisers have clients that are State or municipal government entities, which indicate that 11.48% of all advisers registered with us. 10,275 advisers have not responded that they have clients that are State or municipal government entities. Of those, however, responses to Item 5.D of Form ADV indicate that 2,486 advisers have clients that are other pooled investment vehicles. Estimating that the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—i.e., 11.48%. 285 of these advisers would be subject to the rule (2,486 x 11.48% = 285). Out of the 10,275 that have not responded that they have clients that are State or municipal government entities, after backing out the 2,486 which have clients that are other pooled investment vehicles, responses to Item 5.D(9) of Form ADV indicate that 699 advisers have some clients that are registered investment companies. Estimating that roughly the same percentage of these advisers advise pools with government entity investors as advisers that have direct government entity clients—i.e., 11.48%. 80 of these advisers would be subject to the rule (699 x 11.48% = 80). Although we limited the application of rule 206(4)–5 with respect to registered investment companies to those that are investment options of a plan or program of a government entity, we continue to estimate that 80 advisers would comply with the recordkeeping provisions because of the difficulty in further delineating this estimated number. Therefore, we estimate that the total number of advisers subject to rule 206(4)–5 would be 1,332 advisers with State or municipal clients + 285 advisers with other pooled investment vehicle clients + 80 advisers with registered investment company clients = 1,697 advisers subject to rule. We expect certain additional advisers may incur compliance costs associated with rule 206(4)–5. We anticipate some advisers may be subject to the rule because they solicit government entities on behalf of other investment advisers. Additionally, some advisers that do not currently have government clients may seek to obtain them in the future. In doing so, they likely would conduct due diligence to confirm they would not be prohibited from receiving compensation for providing investment advisory services to the government client.

476 This estimate is based on registration information from IARD as of April 1, 2010. These estimates are based on IARD data, specifically the responses to Item 5.B(1) of Form ADV, that 997 (or 74.9%) of the 1,332 registered investment advisers that have government clients have fewer than five employees who perform investment advisory functions, 239 (or 17.9%) have five to 15 such employees, and 96 (or 7.2%) have more than 15 such employees. We then applied those percentages to the 1,697 advisers we believe will be subject to the proposed rule for a total of 1,271 smaller, 304 medium and 122 larger firms.

477 Investment advisers registered with the Commission 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 rule 206(4)–7.

478 The amendments to rules 204–2 and 206(4)–3, however, only apply to adviser that are registered, or required to be registered, with the Commission.

479 This number is based on our review of registration information on IARD as of April 1, 2010, IARD data from the peak of hedge fund adviser registration in 2005, and a distillation of...
principles we used with respect to registered investment advisers, we estimate that 230 of those advisers manage pooled investment vehicles in which government client assets are invested and would therefore be subject to the rule.\textsuperscript{480} For purposes of this analysis, it is assumed that each unregistered advisory firm that would be subject to the rule would either be a smaller firm or a medium firm in terms of number of covered associates because it is unlikely that an adviser that operates outside of public view and is limited to the number of clients that would have a large number of advisory personnel that would be covered associates. One commenter agreed that most of these unregistered advisers would be small, although the commenter based its assessment on assets under management, not on the adviser’s likely number of covered associates.\textsuperscript{482}

Some commenters asserted that our estimated number of advisers subject to the proposed rule was too low.\textsuperscript{483} One claimed that the number of advisory firms exempted from registration in reliance on Section 203(b)(3) may be “over two times our estimate,” but provided statistics about the number of unregistered pooled investment vehicles, not the number of advisers to those pools.\textsuperscript{484} Other commenters did not provide empirical data or suggest alternative formulas by which to recalculate our estimate. Additionally, another seemed to misunderstand our estimates.\textsuperscript{485}

As we stated in the Proposing Release,\textsuperscript{486} although the time needed to comply with the rule will vary significantly from adviser to adviser, as discussed in detail below, the Commission staff estimates that firms with government clients will spend between 8 hours and 250 hours to establish policies and procedures to comply with the rule. Commission staff further estimates that ongoing compliance with the rule will require between 10 and 1,000 hours annually. In addition, advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the rule. These costs would vary widely among firms. Small advisers may not incur any system costs if they determine a system is unnecessary due to the limited number of employees they have or the limited number of government entity clients they have. Large firms likely already have devoted significant resources into automatic compliance systems. We estimate that the hiring and the new rule could result in enhancements to these existing systems. We believe such system costs could range from the tens of thousands of dollars for simple reporting systems, to hundreds of thousands of dollars for complex systems used by the large advisers.

Initial compliance procedures would likely be designed, and ongoing administration of them performed, by compliance managers and compliance clerks. To establish and implement adequate compliance procedures, we estimate that the rule would impose initial compliance costs of approximately $2,352 per smaller firm,\textsuperscript{488} approximately $29,407 per medium firm,\textsuperscript{489} and approximately $58,813 per larger firm.\textsuperscript{490} It is estimated that the rule would impose annual, ongoing compliance expenses of approximately $2,940 per smaller firm,\textsuperscript{491} $17,625 per medium firm,\textsuperscript{492} and $235,250 per larger firm.\textsuperscript{493}

In establishing these estimates, which are calculated in the same manner as those we included in the Proposing Release, we took into consideration comments in 1999 that suggested our cost estimates were too low.\textsuperscript{494} Our staff, in developing the estimates contained in the Proposing Release, also engaged in conversations with industry professionals in the number of hours compliance with rules G–37 and G–38 and representatives of investment advisers that have pay to play policies in place.\textsuperscript{495} We significantly increased our cost estimates from the 1999 proposal as a result. Some commenters on the proposed rule asserted that our projected costs are too low, but did not provide empirical data or formulas for us to review.\textsuperscript{496} One commenter indicated that, “as a practical matter, although there may be significant differences in the number of hours dedicated to ongoing annual compliance between firms of different sizes, the estimated number of hours needed to develop initial compliance procedures will be similar for all firms, regardless of size. The initial effort of designing and implementing new policies and procedures and educating personnel will require similar effort and upfront fixed costs.”\textsuperscript{497} We disagree. Although there are some aspects of implementing hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he/she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for larger firms would take 187.5 hours of compliance manager time, at $294 per hour (or $55,125), and 62.5 hours of clerical time, at $59 per hour (or $3,688), for a total estimated cost of $58,813.

\textsuperscript{487}Our hourly wage rate estimate for a compliance manager and compliance clerk is based on data from the Securities Industry Financial Markets Association’s Management & Professional Earnings in the Securities Industry 2009, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 (in the case of compliance managers) or 2.93 (in the case of compliance clerks) to account for time devoted to ongoing compliance and other duties.\textsuperscript{497} We disagree. Although there are some aspects of implementing hours to develop initial compliance procedures, and such a firm would likely have support staff. We also anticipate that a compliance manager would do approximately 75% of the work because he/she is responsible for implementing the policy for the entire firm. Accordingly, the per firm cost estimate is based on our estimate that development of initial compliance procedures for larger firms would take 187.5 hours of compliance manager time, at $294 per hour (or $55,125), and 62.5 hours of clerical time, at $59 per hour (or $3,688), for a total estimated cost of $58,813.

\textsuperscript{491}The per firm cost estimate is based on our estimate that ongoing compliance procedures for smaller firms would take 10 hours of compliance manager time, at $294 per hour, for a total estimated cost of $2,940 per year.

\textsuperscript{493}The per firm cost estimate is based on our estimate that ongoing compliance procedures for larger firms would take 75 hours of compliance manager time, at $294 per hour (or $8,550), and 25 hours of clerical time, at $59 per hour (or $1,475), for a total estimated cost of $35,250 per year.

\textsuperscript{494}See Proposing Release, at n.226 and accompanying text.

\textsuperscript{495}Id. at section III.B.

\textsuperscript{496}See, e.g., ICI Letter; MFA Letter; SIFMA Letter.

\textsuperscript{497}See Davis Polk Letter.
a compliance program that would be similar among all firms regardless of their number of covered associates, we expect most costs will vary significantly among firms of different sizes as they engage in such activities as developing and monitoring reporting mechanisms to track covered associate contributions, revising their codes of ethics, training their employees, and performing routine quality control tests.

In the Proposing Release, we estimated that 75% of larger advisory firms, 50% of medium firms, and 25% of smaller firms that are subject to the rule may also engage outside legal services to assist in drafting policies and procedures, based on staff observations. In addition, we also estimated the cost associated with such an engagement would include fees for approximately three hours of outside legal review for a smaller firm, 10 hours for a medium firm, and 30 hours for a larger firm. One commenter suggested that we had underestimated both the percentage of advisers that would engage outside counsel and the number of hours that outside counsel would spend lending their assistance, but did not provide alternative estimates.498 Based on our staff’s experience administering the compliance program rule, we continue to believe that our estimates for the number of firms that will retain outside counsel for review of policies and procedures are appropriate. Based on this comment, however, we have revisited the number of hours we estimated outside counsel would spend reviewing policies and procedures and have increased these estimates. We now estimate the cost associated with such an engagement would include fees for approximately eight hours of outside legal review for a smaller firm, 16 hours for a medium firm, and 40 hours for a larger firm, at a rate of $400 per hour.499 Consequently, for a smaller firm we estimate a total of $3,200 in outside legal fees for each of the estimated 318 advisers that would seek assistance, for a medium firm we estimate a total of $6,400 for the estimated 152 advisers that would seek assistance, and for each of the 92 larger firms we estimate a total of $16,000. Thus, we estimate that approximately 562 investment advisers will incur these additional costs, for a total cost of $3,462,400 among advisers affected by the rule amendments.500

One commenter suggested that, due to the complexity of, and variation among, State and local laws, it might be more difficult than we had accounted for in the proposal for an adviser to determine with certainty who could be a covered official, and as a result, a greater number of advisers would seek the help of outside counsel to make this determination than we estimated.501 Although the commenter did not provide an estimate of how many firms might seek such assistance, we believe that the additional guidance we have provided in the discussion of officials will address this commenter’s concerns and result in fewer consultations with outside counsel than anticipated. In addition, it is our understanding from discussions with those involved in advising on compliance with MSRB rules G–37 and G–38 that a small percentage of persons subject to the rule seek legal assistance to make these determinations. Our rule uses substantially similar definitions of “official” of a “government entity” to those used in the MSRB rules; therefore we expect that the percentage of advisory firms that would retain legal counsel to make these determinations would be similarly small. Moreover, we anticipate that the advisers that are most likely to need assistance identifying officials of government entities are larger advisers, whose businesses tend to be national in scope and whose clients are located throughout the country. If all 122 of the larger advisory firms we estimate are subject to the rule retain legal counsel at a rate of $400 per hour, for approximately 20 hours per year, those advisers would incur an estimated total of $976,000 in legal fees.502

In the Proposing Release, we estimated that approximately five advisers annually would apply to the Commission for an exemption from the rule, based on staff discussions with the FINRA staff responsible for reviewing exemptive applications submitted under MSRB rule G–37, and that outside counsel would spend 16 hours preparing and submitting an application. We received criticism that these approximations were too low.504 Given that the advisory industry is much larger than the municipal securities industry, and in light of the number of comment letters we received that expressed concern about inadvertent violations of the rule that would not qualify for the exception for returned contributions, our staff estimates that approximately seven advisers annually would apply to the Commission for an exemption from the rule. Although we may initially receive more than seven applications a year for an exemption, over time, we expect the number of applications we receive will significantly decline to an average of approximately seven annually. We continue to believe that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, but based on commenters concerns have raised the number of hours counsel will spend preparing and submitting an application from 16 hours to 32 hours, at a rate of $400 per hour.505 As a result, each application will cost approximately $12,800, and the total estimated cost for seven applications annually will be $89,600.

2. Other Costs Related to Rule 206(4)–5

The prohibitions of the rule may also impose other costs on advisers, covered associates, third-party solicitors, and political officials.

(a) Two-Year Time Out

An adviser that becomes subject to the prohibitions of the rule would no longer be eligible to receive advisory fees from its government client. This would result in a direct loss to the adviser of revenues and profits relating to that government client, although another adviser that the government client subsequently chose to retain would see an increase in revenues and profits. The two-year time out could also limit the number of advisers able to provide services to potential government entity clients. An adviser that triggers the two-year time out may be obligated to provide (uncompensated) advisory services for a reasonable period of time until the government client finds a successor to ensure its withdrawal did not harm the client, or the contractual arrangement between the adviser and the government client might obligate the adviser to continue to perform under the contract at no fee. An adviser that

498 Id.
499 In the Proposing Release we estimated the hourly cost of outside counsel to be $400 based on our consultation with advisers and law firms who regularly assist them in compliance matters. We did not receive comment on this estimate and continue to believe that it is an accurate estimate.
500 (316 × $3,200 = $1,017,600) + (152 × $6,400 = $972,800) = (52 × $16,000 = $1,328,000) = $3,462,400.
501 One commenter asserted that a greater number of firms would seek assistance of counsel, regardless of size, but did not provide data to support its assertion. Davis Polk Letter.
502 Caplin & Drysdale Letter. See also IAA Letter; MFA Letter.
503 $400 × 20 = $8,000, and $8,000 × 122 = $976,000.
504 See Davis Polk Letter; ICI Letter.
505 The hourly cost estimate of $400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.
provides uncompensated advisory services to a government client would, at a minimum, incur the direct cost of providing uncompensated services, and may incur opportunity costs if the adviser is unable to pursue other business opportunities for a period of time.

Advisers to government clients, as well as covered associates of the adviser, also may be less likely to make contributions to government officials, including candidates, potentially resulting in less funding for these officials. Under the rule, advisers and covered associates will be subject to new limitations on the amounts and to whom they can contribute without triggering the rule’s time out provision. In addition, these same persons will be prohibited from soliciting others to contribute or from coordinating contributions to government officials, including candidates, or payments to political parties in certain circumstances. These limitations and prohibitions, including if a firm chooses to adopt policies or procedures that are more restrictive than the rule, could be perceived by the individuals subject to them as costs imposed on their ability to express their support for certain candidates or elected office and government officials. In addition to these costs, the rule’s impact on advisers’ and employees’ contributions will introduce some inefficiency into the allocation of contributions to candidates and officials as the rule impacts contributions regardless of whether they are being made for the purpose of engaging in pay to play.

We have made several modifications to the rule from the proposal that will reduce these costs or burdens. We are creating a new exception to the two-year time out for contributions 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 on behalf of the investment adviser. This modification will decrease the burdens on both employees and employers in terms of tracking and limiting employee contributions prior to becoming employed or promoted by an investment adviser. In terms of narrowing the scope of “covered investment pools,” we included a registered investment company in the definition of covered investment pool, for purposes of all three of the rule’s pay to play prohibitions, only if it is an investment option of a plan or program of a government entity. As noted above, we believe this approach strikes the right balance between applying the rule in those contexts in which advisers to registered investment companies are more likely to engage in pay to play conduct while recognizing the compliance challenges and costs that may result from a broader application of the rule. We are also broadening the exception to the rule’s time out provision in several respects that should further decrease the compliance costs associated with the two-year time out and will lower any perceived costs on covered associates’ ability to express their support for candidates. We are increasing the aggregate contribution amount eligible for the exception for certain returned contributions from $250 to $350 to any one official per election, and we are increasing the number of times an adviser is permitted to rely on the returned contributions exception from two to three per calendar year for advisers with more than 50 employees. Furthermore, we are making the same adjustment from $250 to $350 for contributions eligible for the de minimis exception, and we are adopting a de minimis exception for contributions not exceeding $150 made by individuals who are not entitled to vote for the candidate.

Several commenters highlighted the costs of the two-year time out to the adviser and government entity client, as well as pension fund beneficiaries, stating that the time out could force termination of long-standing relationships and may result in a permanent termination of the advisory relationship. We acknowledge that advisers subject to the time out may lose a government client’s business beyond the two-year period and are sensitive to the concerns of commenters regarding the operation of the rule on public pension funds, including the burdens they may face in replacing managers and the possibility that some managers may no longer seek to manage public plan assets as a result of the rule. We believe that these costs are necessary to accomplish our goal of addressing pay to play and are justified by the benefits of rule 206(4)–5. As discussed above, rule 206(4)–5 is modeled on the pay to play rules adopted by the MSRB, which have significantly curbed pay to play practices in the municipal securities market. We believe that adopting a two-year time out similar to the time out applicable under the MSRB rules is appropriate, and that the fiduciary relationship advisers have with public pension plans argues for a strong prophylactic rule. Finally, while we have designed the rule to reduce its impact, investment advisers are best positioned to protect government clients by developing and enforcing robust compliance programs designed to prevent contributions from triggering the two-year time out.

Commenters also noted, particularly, the potential harm of the two-year time out to government clients and to other investors in a fund that holds illiquid securities when a government investor redeems its interests in the fund as a result of the fund adviser’s triggering contribution. As we note above, however, our rule does not require an adviser that has triggered the time out to redeem the interests of a government investor or cancel its commitment. The adviser may have multiple options available from which to select to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. The adviser could instead comply with the rule by waiving or rebating the portion of its fees or any performance allocation or carried interest attributable to the government client. Most of the comments we received about the costs of this aspect of the proposed rule, however, focused on the costs of an inadvertent violation.

We understand that there will be costs, sometimes quite significant, as a result of an inadvertent violation. However, we believe that these costs are necessary to accomplish our goal of addressing pay to play and are justified by the benefits of rule 206(4)–5. As discussed above, rule 206(4)–5 is modeled on the pay to play rules adopted by the MSRB, which have significantly curbed pay to play practices in the municipal securities market. We believe that adopting a two-year time out similar to the time out applicable under the MSRB rules is appropriate, and that the fiduciary relationship advisers have with public pension plans argues for a strong prophylactic rule. Finally, while we have designed the rule to reduce its impact, investment advisers are best positioned to protect government clients by developing and enforcing robust compliance programs designed to prevent contributions from triggering the two-year time out.

Commenters also noted, particularly, the potential harm of the two-year time out to government clients and to other investors in a fund that holds illiquid securities when a government investor redeems its interests in the fund as a result of the fund adviser’s triggering contribution. As we note above, however, our rule does not require an adviser that has triggered the time out to redeem the interests of a government investor or cancel its commitment. The adviser may have multiple options available from which to select to comply with the rule in light of its fiduciary obligations and the disclosure it has made to investors. The adviser could instead comply with the rule by waiving or rebating the portion of its fees or any performance allocation or carried interest attributable to the government client.
of inadvertent violations. However, with these potential costs in mind, we have taken additional steps to decrease the likelihood of inadvertent violations of the rule. First, as discussed above, we shortened the look back with respect to most covered associates. We expect this new exception will provide an additional mechanism for advisers to avoid the cost of a time out as a result of an inadvertent violation and will largely address commenters’ concerns about the screening burdens for new or promoted employees that this aspect of the proposal would have imposed on advisers.514 Second, as discussed above, we are increasing to $350 the amount eligible for an exception for certain returned contributions from what we had proposed, we are increasing the number of times an adviser is permitted to rely on the returned contributions exception, and we are also adopting an additional de minimis exception for certain contributions not exceeding $150. Last, we note that an adviser’s implementation of a strong compliance program will reduce the likelihood, and therefore costs, of inadvertent violations.

One commenter asserted that the proposed rule would put advisers at a competitive disadvantage to other providers of advisory services to government plans that would not be subject to it, such as banks and insurance companies.515 As we stated earlier, we believe that the concerns that we are trying to address with the rule justify its adoption, notwithstanding the potential competitive effects that advisers may face as a result of the limits on our jurisdiction. We also do not view competition by means of engaging in practices such as pay to play as an interest that we need to protect.

(b) Third-Party Solicitor Ban

Under our proposal, advisers would have been prohibited from compensating any third party to solicit government entities for advisory services, other than “related persons.”520 As a result, advisers that rely on third-party solicitors to obtain government clients would have had to bear the expense of hiring and training in-house staff in order to continue their solicitation activities,521 a result that commenters said would be particularly costly for small and new investment advisers.522 In addition, third-party solicitors might also have experienced substantial negative consequences under the proposed rule.523 We heard from many commenters on this issue, offering various perspectives on how the costs would outweigh the benefits of the proposed prohibition.524 A few commenters asserted that this proposal would have a significant adverse effect on efficient capital formation in that it would make it more difficult for private equity and venture capital managers to obtain funding that in turn can invest in portfolio companies.525 As other commenters pointed out, this aspect of our proposed rule might also have placed a significant burden on public pension plans, particularly smaller plans because third-party solicitors provide services that plans may value, including serving as placement agent for alternative investments and serving a screening function with respect to those investments presented to the pension plan.527

Indian Harbor Partner Robert W. Stone (Aug. 13, 2009) (“Indian Harbor Letter”); Kurmanaliyeva Letter; M Advisory Letter; NCPERS Letter; NYC Teachers Letter; PA Public School Retirement Letter; Myers Letter; TX Public Retirement Letter; WI Board Letter; Credit Suisse Letter (“Moreover, by performing these functions, placement agents enable investment advisers to focus on their core expertise, investment management, and to avoid the necessity of developing the costly in-house resources necessary to raise capital directly.”).522 See, e.g., Managers that engage placement agents, particularly small and offshore managers, would lose the ability to market their services to government clients or incur significantly higher costs to hire internal marketing personnel; and managers that hire internal personnel could spend substantial amounts to register as a broker-dealer.). See also SIFMA Letter; IAA Letter; Seward & Kissel Letter; Sadis & Goldberg Letter; WI Board Letter; GA Firefighters Letter; MN Board Letter; IL Fund Association Letter; NYC Teachers Letter; TX Public Retirement Letter; FA Public School Retirement Letter; Boenning Letter; Finn Letter; Savanna Letter; Atlantic-Pacific Letter; Peterson Letter; Devon Letter; Chaldon Letter; Meridian Letter; Benedetto Letter; Capstone Letter; Braxton Letter; Littlejohn Letter; Alfa Letter; Charles River Letter; Reed Letter; Glovista Letter; Blackstone Letter; Park Hill Letter.

Proposing Release, at 89. See also Thomas Letter (“The ban would very likely cripple many legitimate placement agents—most of whom are currently regulated by the SEC and FINRA—as the public pension plans are the largest source of capital for alternative investments.”); Comment Letter of the Managing Partner of Bridge 1 Advisors, LLC Robert G. McGroarty (Sept. 24, 2009) (“Bridge 1 Letter”); SIFMA Letter.524 See, e.g., Dawes Folk Letter (“While we strongly support the underlying purpose of the Proposed Rule, we believe that this ban on all third-party solicitors is overly expansive and the costs inflicted on both investment advisers and government clients from lack of access to the valuable services provided by most third-party solicitors outweigh any expected benefits to be gained from its adoption.”); Comment Letter of Hampshire Real Estate Companies (Sept. 29, 2009) (“Placement agents are a vital component of the investment management industry as a whole will incur “dramatic job losses”; Parenteau Letter.525 Alta Letter; Benedetto Letter; Comment Letter of Berkshire Property Advisors, LLC (Sept. 29, 2009) (“Berkshire Letter”); Bridge 1 Letter; Comment Letter of Hampshire Real Estate Companies (Sept. 29, 2009); Comment Letter of Thomas J. Mizon on behalf of HFF Securities L.P. (Sept. 24, 2009); M Advisory Letter; Monument Group Letter; Comment Letter of Pisol Group Managers, LLC (Sept. 28, 2009).

See, e.g., Park Hill Letter (“The Commission has commented that if the Placement Agent Ban is adopted, Public Pension Investors can seek to engage placement agents themselves in order to continue to have access to their services in helping to find the best Fund Sponsors. However, that would impose costs on Public Pension Investors that they do not currently incur. Moreover, as the Commission has acknowledged in its cost-benefit analysis, if the Placement Agent Ban were adopted, Fund Sponsors who do not have in-house marketing staffs would be disproportionately disadvantaged relative to larger firms that have those internal resources in place and that obtain access to Public Pension investors and other institutional investors.”); Thomas Letter (“A ban on placement agents would have significant unintended consequences for public pension plans. * * * [For instance] the incremental effort by investment staffs to perform due diligence on promising but possibly ill-prepared investment managers will raise the cost and lessen the overall pension fund portfolio performance.”); Comment Letter of Austin F. Whitman (Sept. 21, 2009) (“Without access to placement agents, government pensions would be significantly disadvantaged relative to their private sector peers, with limited access (and benefit from) the services described above.”); ABA Letter. But see Fund Democracy/ Consumer Federation Letter that 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 relies on advisers’ placement agents creates.”).

See, e.g., Ogburn Letter; Schmitz Letter (highlighting the valuable function of placement agents, especially in light of pension funds’ budgetary pressures and lean staffs); Savanna Letter (discussing the “pre-screening” effect that reputable placement agents can provide for pension professionals); Atlantic-Pacific Letter; Indian Harbor Letter; Peterson Letter; Rubenstein Letter; Comment Letter of Réal Desrochers (Aug. 20, 2009) (highlighting the valuable function of placement agents, especially in light of pension funds’ budgetary pressures and lean staffs).
Others argued, for similar reasons as those expressed above, that it would also harm public pension plans to ban payments to third parties because it would decrease competition by reducing the number of advisers competing for government business and limit the universe of investment opportunities presented to public pension funds.

We believe our decision to modify the proposed rule to permit advisers to make payments to certain “regulated persons” to solicit government clients on the one hand and to eliminate certain registration, recordkeeping, and reporting requirements as described in more detail above, should alleviate many of these concerns, including those from private equity and venture capital managers on capital formation.

In particular, we believe the concerns expressed by private equity and venture capital managers regarding the effects of the rule on capital formation have been substantially addressed by the modification for payments to “regulated persons.” We expect advisers that engage the services of regulated-person solicitors will incur limited costs to initially confirm and subsequently monitor the solicitor’s eligibility to be a “regulated person.” Nevertheless, we expect this exception to the third-party solicitor ban will substantially reduce the costs associated with this aspect of the proposal. We acknowledge, however, that the third-party solicitor ban will nonetheless have a substantial negative impact on persons who provide third-party solicitation services that are not regulated persons, including State-registered advisers. If their businesses consist solely of soliciting government entities on behalf of investment advisers, the rule could result in these persons instead being employed directly by regulated persons, shifting the focus of their solicitation activities, seeking to change their business model to shift their source of payment from investment advisers to pension plans, or going out of business.

In addition, we acknowledge that the third-party solicitor ban may adversely affect both competition and allocative efficiency in the market for advisory services where third-party solicitors that are not regulated persons participate. We have carefully considered these effects. As discussed above, however, we do not have regulatory authority to oversee the activities of State-registered advisers through examination and our recordkeeping rules. Nor do we have authority over the states to enforce their rules, as we do with FINRA. As a result, we have not included State-registered advisers in the definition of regulated person.

In addition, some commenters suggested that the third-party prohibition could have a negative impact on the efficient allocation of capital for government plans, particularly small ones, and advisers that seek to manage these assets directly (not through a covered investment pool).

These small government plans may, as a result of the rule’s ban on payments to third parties, have fewer managers to select from to the extent that larger advisers choose not to participate in this market. In addition, both government plans and advisers that seek these government clients may have to hire internal staff, respectively, to identify potential advisers and potential government clients to the extent these functions are not internalized. However, these commenters did not discuss the potentially significant costs that exist today of hiring third-party solicitors, and that eliminating the cost of pay to play may, in fact, provide greater access to pension plans by those advisers that are currently unable to afford the costs of direct or indirect political contributions or third-party solicitor fees.

We expect that prohibiting pay to play will reduce the costs to plans and their beneficiaries that may result when adviser selection is based on political contributions rather than investment considerations.

3. Costs Related to the Amendments to Rule 204–2

The amendments to rule 204–2 require SEC-registered advisers with government clients to maintain certain records of campaign contributions by certain advisory personnel and records of the regulated persons the adviser pays or agrees to solicit government entities on its behalf. Records are a critical complement to rule 206(4)–5. In particular, such records are necessary for examiners to inspect advisers for compliance with the terms of the rule.

As described below, for purposes of the Paperwork Reduction Act of 1995 (“PRA”), we have estimated that Commission-registered advisers would incur approximately 3,394 additional hours annually to comply with the rule.

532 As we note above, State-registered advisers are not subject to the recordkeeping rules we are adopting today. We expect that prohibiting pay to play will reduce the costs to plans and their beneficiaries that may result when adviser selection is based on political contributions rather than investment considerations.

533 At least one commenter agreed. See Butler Letter (“We 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).”].

534 See supra note 452 & 453 and accompanying text (describing commenters’ observations about some of the pay to play costs to plans and their beneficiaries).

535 Unregistered advisers that would be subject to rule 206(4)–5 would not be subject to the amendments to rule 204–2.

536 See supra note 452 & 453 and accompanying text (describing commenters’ observations about some of the pay to play costs to plans and their beneficiaries).

537 See supra note 452 & 453 and accompanying text (describing commenters’ observations about some of the pay to play costs to plans and their beneficiaries).
amendments to rule 204–2.540 Based on this estimate, we anticipate that advisers would incur an aggregate cost of approximately $200,246 per year for the total hours advisory personnel would spend in complying with the recordkeeping requirements.541 In addition, we expect advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the amendments to rule 204–2. For purposes of the PRA, we have estimated that some small and medium firms will incur start-up costs, on average, of $10,000, and larger firms will incur, on average, $100,000. As a result, the amendments to rule 204–2 are estimated to increase the PRA non-labor cost burden by $20,080,000.542

We received a number of specific comments on this aspect of the proposal, many of which included assertions about cost burdens associated with maintaining records related to unsuccessful solicitations, and urged us to reconsider the benefits to be gained from such a requirement in light of the costs.543 We were persuaded by these commenters to eliminate provisions of the proposed amendments to the recordkeeping rule that would have required advisers to maintain a list of government entities that the adviser solicits.544 Instead, an adviser must only retain records of existing government entity clients and investors as well as records of regulated persons that the adviser pays or agrees to pay to solicit government entities on its behalf for a five-year period. Additionally, we have narrowed the scope of the amended rule to apply only to advisers with government entity clients; an adviser is only required to make and keep these records if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services.545 We have also limited the rule to provide that only records of contributions, not payments, to government officials and candidates are required to be kept under the rule. Additionally, because rule 206(4)–5 applies to an adviser to a registered investment company only if it is an investment option of a participant-directed plan or program of a government entity,546 such investment advisers will only have to identify government entities that provide plan or program participants the option of investing in the fund, which addresses many commenters’ concerns about recordkeeping burdens that would have been imposed on advisers to registered investment companies under the proposed rule.547

We anticipate that commenters’ general concerns that we may have underestimated the burdens we presented in our proposal will be offset by what we believe will be a reduction in burdens as a result of the various modifications from our proposal described above. In addition, we have revised the rule to require advisers to maintain a list of regulated persons that solicits on an adviser’s behalf, but expect advisers to already have this information in the normal course of business, including in some instances, to comply with existing requirements of rule 206(4)–3.

V. Paperwork Reduction Act

A. Rule 204–2

The amendment to rule 204–2 contains a “collection of information” requirement within the meaning of the PRA. In the Proposing Release, the Commission solicited comment on the proposed amendment to the collection of information requirement.548 The Commission also submitted the proposed amendment’s collection of information requirement to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under control number 3235–0278. The title for the collection of information is “Rule 204–2 under the Investment Advisers Act of 1940.” Rule 204–2 contains a currently approved collection of information number under OMB control number 3235–0278. An agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 204 of the Advisers Act provides that investment advisers registered or required to be registered with the Commission must make and keep certain records for prescribed periods, and make and disseminate certain reports. Rule 204–2 sets forth the requirements for maintaining and preserving specified books and records. This collection of information is mandatory. The collection of information under rule 204–2 is necessary for the Commission staff to use in its examination and oversight program, and the information generally is kept confidential.549 The respondents are investment advisers registered or required to be registered with us.

Today’s amendments to rule 204–2 require every investment adviser registered or required to be registered that provides advisory services to (or pays or agrees to pay regulated persons to solicit) government entities to maintain certain records of contributions made by the adviser or any of its covered associates and regarding regulated persons the adviser pays or agrees to pay for soliciting government entities on its behalf. The amendments require such an adviser to make and keep the following records: (i) The names, titles, and business and residence addresses of all covered associates of the investment adviser; (ii) all government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years, but not prior to the effective date of the rule; (iii) all direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or payments to a political party of a State or political subdivision thereof, or to a political action committee; and (iv) the name and business address of each regulated person to whom the investment adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf, in accordance with rule 206(4)–5(a)(2)(i).

The adviser’s records of contributions and payments are required to be listed

540 See infra note 559 and accompanying text.
541 We expect that the function of recording and maintaining records of political contributions would be performed by a compliance clerk at a cost of $59 per hour. See supra note 487. Therefore, the total costs would be $200,246 (3,394 hours × $59 per/hour).
542 ($10,000 × 788) + ($100,000 × 122) = $7,880,000 + $12,200,000 = $20,080,000.
543 MassMutual Letter (“The requirement to maintain records of each governmental entity being solicited would require a diverse financial services company like MassMutual to undertake significant legacy software system modifications or build an entirely new system to track each instance of a ‘solicitation,’ which could include phone calls, meetings, or responses to governmental requests. This system would then need to aggregate data across multiple business lines, many with existing systems that may not have the ability to share this data in a useful format. All of these are costly and time consuming activities to meet a requirement that appears to add little value to the Commission’s efforts to ensure compliance with the Proposed Rule.”). See also Davis Polk Letter; Dechert Letter; Holl Letter; SIFMA Letter; Skadden Letter.
544 See proposed rule 204–2(a)(18)(i)(B).
545 Rule 204–2(a)(18)(iii). See NASP Letter (“Many advisers do not have governmental clients but will still have to collect the information attestations which would increase compliance costs while providing no public benefit at all.”)
546 See supra note 353 and accompanying text.
547 See, e.g., ICI Letter.
548 See Proposing Release, at section IV.
549 See section 210(b) of the Advisers Act (15 U.S.C. 80b–10(b)).
in chronological order identifying each contributor and recipient, the amounts and dates of each contribution or payment, and whether such contribution or payment was subject to the exception for certain returned contributions pursuant to rule 206(4)–5(b)(2). An investment adviser is only required to make and keep current the records referred to in (i) and (iii) above if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the adviser provides investment advisory services. The records required by amended rule 204–2 are required to be maintained in the same manner, and for the same period of time, as other books and records under rule 204–2(a).

This collection of information will be found at 17 CFR 275.204–2. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act are not subject to the recordkeeping requirements.

The amendments to rule 204–2 that we are adopting today differ from our proposed amendments in several respects. We have tailored certain of the requirements from our proposal. First, we have limited the rule to provide that only records of contributions, not payments, to government officials, including candidates, are required to be kept under the rule. Second, investment advisers to registered investment companies only have to identify—and keep records regarding—government entities that invest in a fund as part of a plan or program of a government entity, including any government entity that selects the fund as an investment option for participants in the plan or program. Third, we are not adopting provisions of the proposed amendments to the recordkeeping rule that would have required advisers to maintain a list of all government entities that they have solicited. In addition, we have revised the rule so that only those advisers that have government entity clients must make and keep certain required records, unlike the proposal, which would have required all registered advisers to maintain records of contributions and covered associates. We are also adopting a requirement that advisers maintain records of regulated persons they pay to solicit government entities on their behalf, to reflect that rule 206(4)-5 permits advisers to compensate these solicitors.

As noted above, we requested comment on the PRA analysis contained in the Proposing Release. Although a few commenters expressed general concerns that the paperwork burdens associated with our proposed amendments to rule 204–2 might be underestimated, commenters representing advisers to registered investment companies suggested that the proposal significantly underestimated the burden attributed to these covered investment pools.551 With respect to registered investment companies, commenters noted that the proposed recordkeeping requirements required advisers to identify government investors in registered investment companies regardless of whether the fund was part of a plan or program of a government entity, and as a result the proposed amendments to the recordkeeping rule would have been difficult to comply with as fund shareholder records do not necessarily identify government investors.

As a result of these comments, we recognize that we may have underestimated the recordkeeping burden for advisers to registered investment companies that would have been subject to proposed rule 206(4)-5. However, we believe that our change to the definition of “covered investment pool” from the proposal to only include those registered investment companies that are an investment option of a plan or program of a government entity addresses those recordkeeping concerns commenters expressed regarding these covered investment pools and lowers recordkeeping burdens by limiting the records relating to registered investment companies that an investment adviser must keep under the rule.552 In addition, the other changes we highlight above—other than the requirement to keep records regarding regulated persons—would lessen the recordkeeping requirements relative to our proposal and thereby diminish the burdens associated with rule 204–2. We anticipate that commenters’ general concerns that we may have underestimated the burdens we presented in our proposal, as well as the burden associated with the additional requirement to maintain a list of regulated persons that solicit on an adviser’s behalf, will be offset by what we believe will be a reduction in burdens as a result of the various modifications from proposed amendments to the recordkeeping rule, as described above. Moreover, notwithstanding the fact that the amendments we are adopting reduce advisers’ recordkeeping obligations relative to our proposal, we are increasing our estimates to address the additional investment advisers who have registered with us since our proposal was issued.

Prior to today’s amendments, the approved collection of information for rule 204–2, set to expire on March 31, 2011, was based on an average of 181.15 burden hours each year, per Commission-registered adviser, for a total of 1,954,109 burden hours. In addition, the currently-approved collection of information for Rule 204–2 includes a non-labor cost estimate of $13,551,390. The total burden is based on an estimate of 10,787 registered advisers.

Commission records indicate that currently there are approximately 11,607 registered investment advisers subject to the collection of information imposed by rule 204–2.553 As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 148,543 hours.554 In addition, the total non-labor cost has increased to $14,581,509 as a result of this increase in the number of registered advisers.555 In our Proposing Release, we estimated that approximately 1,764 Commission-registered advisers provide, or seek to provide, advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.556 One commenter argued that this estimate was too low because it underestimates the number of investment advisers unregistered in reliance on Section 203(b)(3) of the Advisers Act and estimated to be subject to the Proposed Rule.557 Unregistered

555 This figure is based on registration information from IARD as of April 1, 2010. The figures we relied on in our Proposing Release were based on registration information from IARD as of July 1, 2009. See Proposing Release, at section IV.

556 See Proposing Release, at section IV.

557 Davis Polk Letter ("[T]he cost benefit analysis is based solely on an estimated 1,764 registered investment advisers and does not account for the costs and burdens of compliance attributable to investment advisers exempt from registration. The
advisers are not subject to rule 204–2’s recordkeeping requirements. As a result, they are not included in our estimates for purposes of this analysis. We continue to believe our estimates are appropriate, although we have revised this number for purposes of both our cost-benefit analysis above and our PRA analysis to reflect both an increase in the number of registered advisers since the proposal and the modification from our proposal to not require records of unsuccessful solicitations. We now estimate that approximately 1,697 registered advisers provide advisory services to government clients and to certain pooled investment vehicles in which government entities invest, and would thus be affected by the rule amendments.558

Under the amendments, each respondent is required to retain the records in the same manner and for the same period of time as currently required under rule 204–2. The amendments to rule 204–2 are estimated to increase the burden by approximately 2 hours per Commission-registered adviser with government clients annually for a total increase of 3,394 hours.559 The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 204–2 thus would be 2,106,046 hours.560 The revised average burden per Commission-registered adviser would be 181.45 hours.561

Additionally, as we noted in the Proposing Release and reiterate above, we expect advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the amendments to rule 204–2. These costs would vary widely among firms. Small advisers may not incur any system costs if they determine a system is unnecessary due to the limited number of employees they have or the limited number of government entity clients they have. Large firms likely already have devoted significant resources into automating compliance and reporting and the new rule could result in enhancements to these existing systems.

As a result of these one-time costs, we estimate that there will be an increase to the total non-labor cost burden. We estimated above that the non-labor cost burden has increased to $14,581,509 as a result of the increase in the number of registered advisers since the collection was last approved.562 We believe the one-time costs could vary substantially among smaller, medium, and larger firms as smaller and medium firms may be able to use non-specialized software, such as a spreadsheet, or off-the-shelf compliance software to keep track of the information required by the rule while larger firms are more likely to have proprietary systems. Based on IARD data we estimate that there are approximately 1,271 smaller firms, 304 medium firms, and 122 larger firms.563 We estimate that one half of the smaller and medium firms will not incur these one-time start up costs because they will use existing tools for compliance. We expect the other half of smaller and medium firms will incur one-time start up costs on average of $10,000, in the event they have a greater number of employees and government clients, and larger firms, that likely have the most employees and government clients, will incur one-time start up costs on average of $100,000. As a result, the amendments to rule 204–2 are estimated to increase the non-labor cost burden by $20,080,000.564 Due to this increase, we now estimate the revised total non-labor cost burden for rule 204–2 to be $34,661,509.

B. Rule 206(4)–3

The amendment to rule 206(4)–3 contains a revised collection of information requirement within the PRA. As noted in the Proposing Release, the Commission published notice soliciting comment on the collection of information requirement.565 The Commission submitted the revised collection of information requirement to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. Rule 206(4)–3 contains a currently approved collection of information under OMB control number 3235–0242. The title for the collection of information is “Rule 206(4)–3—Cash Payments for Client Solicitations.” As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 206(4) of the Advisers Act provides that it shall be unlawful for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)–3 generally prohibits investment advisers from paying cash fees to solicitors for client referrals unless certain conditions are met.

563 This estimate is based on registration information from IARD as of April 1, 2010. These estimates are based on IARD data, specifically the responses to Item 5.D(9) of Form ADV, that 997 (or 74.9%) of the 1,332 registered investment advisers that have government clients have fewer than five employees who perform investment adviser functions, 239 (or 17.9%) have five to 15 such employees, and 96 (or 7.2%) have more than 15 such employees. We then applied those percentages to the 1,697 advisers we believe will be subject to the proposed rule for a total of 1,271 smaller, 304 medium and 122 larger firms.

564 $10,000 × 1,271 = $12,710,000 + $100,000 × 122 = $12,200,000 = $24,910,000.

565 See Proposing Release, at section IV.
met. The rule requires that an adviser pay all solicitors’ fees pursuant to a written agreement that the adviser is required to retain. This collection of information is mandatory. The Commission staff uses this collection of information in its examination and oversight program, and the information generally is kept confidential.566

The Commission is adopting amendments to rule 206(4)–3 under the Advisers Act. The amendments to rule 206(4)–3, which are identical to our proposed amendments, require every investment adviser that relies on the rule and that provides or seeks to provide advisory services to government entities to also abide by the limitations provided in rule 206(4)–5. This collection of information is found at 17 CFR 275.206(4)–3. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act would not be subject to rule 206(4)–3.

We requested comment on the PRA analysis contained in Proposing Release. We received no comment on this portion of our analysis. In addition, we have not modified our amendments to rule 206(4)–3 relative to our proposal. The current approved collection of information for rule 206(4)–3, set to expire on March 31, 2011, is based on an estimate that 20 percent of the 10,817 Commission-registered advisers (or 2,163 advisers) rely on the rule, at an average of 7.04 burden hours each year, per respondent, for a total of 15,228 burden hours (7.04 × 2,163).

Commission records indicate that currently there are approximately 11,607 registered investment advisers,567 20 percent of which (or 2,321) are likely subject to the collection of information imposed by rule 206(4)–3. As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 1,112.32 hours (158 additional advisers × 7.04 hours). We estimate that approximately 20 percent of the Commission-registered advisers that use rule 206(4)–3 (or 464 advisers)568 provide, or seek to provide, advisory services to government clients.570 Under the amendments, each respondent would be prohibited from certain solicitation activities, subject to the exception for “regulated persons,” with respect to government clients, activities that otherwise would have been covered by rule 206(4)–3.571 Thus, they would not need to enter into and retain the written agreement required under rule 206(4)–3 with respect to those third parties they are prohibited from paying to solicit government entities.

In the Proposing Release, we estimated a decrease to the burden due to the prohibition on paying third party solicitors to be 20% of the annual burden. As a result of the revised ban on using third parties, we now estimate that the amendments to rule 206(4)–3 will only decrease the burden by 15 percent,572 or approximately 1.06 hour.573 per Commission-registered adviser that uses the rule and has or is seeking government clients annually, for a total decrease of 491.84 hours.574 The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 206(4)–3 thus would be 15,848.48 hours.575 The revised average burden per Commission-registered adviser would be 6.83 hours.576

C. Rule 206(4)–7

As a result of the adoption of rule 206(4)–5, rule 206(4)–7 contains a revised collection of information requirement within the meaning of the PRA. In the Proposing Release, the Commission estimated that registered advisers would spend between 8 hours and 250 hours to establish policies and procedures to comply with rule 206(4)–5.577 Rule 206(4)–7 contains a currently approved collection of information under OMB control number 3235–0585. The title for the collection of information is “Investment Advisers Act Rule 206(4)–7, Compliance procedures and practices.” As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Section 206(4) of the Advisers Act provides that it shall be unlawful for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. Rule 206(4)–7, in part, requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Federal securities laws. This collection of information is mandatory. The purpose of the information collection requirement is to ensure that registered advisers maintain comprehensive, written internal compliance programs. It also assists the Commission’s staff in its examination and oversight program.

Information obtained in our examination and oversight program generally is kept confidential.578 As we previously noted, we expect that registered investment advisers subject to rule 206(4)–5 will modify their compliance programs to address new obligations under that rule. The current approved collection of information for rule 206(4)–7, set to expire on March 31, 2011, is based on 10,817 registered advisers that were subject to the rule at an average burden of 80 hours each year per respondent for a total of 865,360 burden hours.

Commission records indicate that currently there are approximately 11,607 registered investment advisers.579 As a result of the increase in the number of advisers registered with the Commission since the current total burden was approved, the total burden has increased by 63,200 hours (790 × 80 hours). In addition, although the time needed to comply with rule 206(4)–5 will vary significantly from adviser to adviser, as discussed in detail below, the Commission staff estimates that firms with government clients will spend between 8 hours and 250 hours to implement policies and procedures to comply with the rule, depending on the

566 Section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

567 This figure is based on registration information from IARD as of April 1, 2010. The figures we relied on in our Proposing Release were based on registration information from IARD as of July 1, 2009.

568 2,321 (20% of current registered investment advisers) – 2,163 (20% of registered investment advisers when burden estimate was last approved by OMB) = 158.

569 2,321 × 20 percent = 464.

570 In light of the 11.48% of registered investment advisers that indicate they have State or municipal government clients, we conservatively estimate that 20% of the 10,817 registered investment advisers (or 2,163 advisers) rely on the rule, at an average of 7.04 burden hours each year, per respondent, for a total of 15,228 burden hours (7.04 × 2,163).

571 Rule 206(4)–3(a).

572 In our proposal, which would have banned the use of third-party solicitors altogether, we estimated a 20 percent decrease in the burden under rule 206(4)–3. But, to account for the regulated persons to whom exception to the third-party solicitor ban in adopted rule 206(4)–5, we have modified our estimate to only a 15 percent decrease. That is because our staff estimates that one quarter (or 5 percent) of the proposal’s estimated burden reduction relating to entering into and retaining the written agreement required under rule 206(4)–3 will be retained as investment adviser to the third parties that are regulated persons to solicit on their behalf.

573 7.04 × 15 percent = 1.06.

574 464 ÷ 1.06 = 491.84.

575 15,228 (current approved burden) + 1,112.32 (burden for additional registrants) – 491.84 (reduction in burden for amendments) = 15,848.48 hours.

576 15,848.48 (revised annual aggregate burden) divided by 2,321 (total number of registrants who rely on rule) = 6.83.

577 See Proposing Release, at section III.B.

578 Section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

579 This figure is based on registration information from IARD as of April 1, 2010.
annual hour burden of one hour for

firm’s number of covered associates.\textsuperscript{580} Of the 1,697 registered advisers that we estimate may be affected by rule 206(4)–5,\textsuperscript{581} we estimate that approximately 1.271 are smaller firms, 304 are medium firms, and 122 are larger firms.\textsuperscript{582} We anticipate that smaller firms will spend 8 hours, medium firms will spend 125 hours, and larger firms will spend 250 hours,\textsuperscript{583} for a total of 78,668 hours.\textsuperscript{584} to implement policies and procedures. Our estimates take into account our staff’s observation that some registered advisers have established policies regarding political contributions, which can be revised to reflect the new requirements. The revised annual aggregate burden for all respondents to comply with rule 206(4)–7 thus would be 1,007,228 hours.\textsuperscript{585}

D. Rule 0–4

Rule 0–4 under the Advisers Act,\textsuperscript{586} entitled “General Requirements of Papers and Applications,” prescribes general instructions for filing an application seeking exemptive relief with the Commission. The requirements of rule 0–4 are designed to provide the Commission with the necessary information to assess whether granting the orders of exemption is necessary and appropriate, in the public interest and consistent with the protection of investors and the intended purposes of the Act. In light of the adoption of rule 206(4)–5, which contains a provision for seeking an exemptive order from the Commission, we are revising the collection of information requirement for rule 0–4. Rule 0–4 contains a currently approved collection of information under OMB control number 3235–0633. As noted above, an agency may not sponsor, or conduct, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The current approved collection of information contains an estimated total annual hour burden of one hour for

administrative purposes because most of the work of preparing an application is performed by outside counsel and, therefore, imposes minimal, if any, hourly burden on respondents. Because we expect that all, or substantially all, of the work of preparing an application for an exemptive order under rule 206(4)–5 will also be performed by outside counsel, we continue to believe that the current estimate of one hour, in the unlikely event the adviser does perform an administrative role, is sufficient. As a result, we are not increasing our estimated hourly burden in connection with the adoption of rule 206(4)–5.

The current approved collection of information also contains an estimated total annual cost burden of $355,000, which is attributed to outside counsel legal fees. In the Proposing Release, we estimated that approximately five advisers annually would apply to the Commission for an exemption from rule 206(4)–5.\textsuperscript{587} We also estimated that an advisory firm that applies for an exemption would hire outside counsel to prepare their exemptive requests, and that counsel would spend 16 hours preparing and submitting an application for review at a rate of $400 per hour, for a per application cost of $6,400 and a total estimated cost for five applications annually of $32,000.

The Commission requested public comment on these estimates in the Proposing Release, and we received comments indicating that our estimate of five exemptive application submissions per year is too low.\textsuperscript{588} We did not receive comments on our cost estimates. Given that the advisory industry is much larger than the municipal securities industry, and in light of the number of comment letters we received that expressed concern about inadvertent violations of the rule that would not qualify for the exception for returned contributions, our staff estimates that approximately seven advisers annually would apply to the Commission for an exemption from the rule. Although we may not initially receive more than seven applications a year for an exemption, over time, we expect the number of applications we receive will significantly decline to an average of approximately seven annually. We continue to believe that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, but based on commenters’ concerns have raised the number of hours counsel will spend preparing and submitting an application from 16 hours to 32 hours, at a rate of $400 per hour.\textsuperscript{589} As a result, each application will cost approximately $12,800, and the total estimated cost for seven applications annually will be $89,600. The total estimated annual cost burden to applicants of filing all applications has therefore increased to $444,600.\textsuperscript{590}

VI. Final Regulatory Flexibility Analysis

The Commission has prepared the following Final Regulatory Flexibility Analysis regarding rule 206(4)–5 and the amendments to rules 204–2 and 206(4)–3 in accordance with section 3(a) of the Regulatory Flexibility Act.\textsuperscript{591} We prepared an Initial Regulatory Flexibility Analysis ("IRFA") in conjunction with the Proposing Release in August 2009.\textsuperscript{592} The Proposing Release included, and solicited comment, on the IRFA.

A. Need for the Rule

Investment advisers that seek to influence the award of advisory contracts by government entities, by making or soliciting political contributions to those officials who are in a position to influence the awards, violate their fiduciary obligations. These practices—known as “pay to play”—distort the process by which investment advisers are selected and, as discussed in greater detail above, can harm advisers' public pension plan clients, and thereby beneficiaries of those plans, which may receive inferior advisory services and pay higher fees.\textsuperscript{593} In addition, the most qualified adviser may not be selected, potentially leading to inferior management, diminished returns, or greater losses for the public pension plan. Pay to play is a significant problem in the management of public funds by investment advisers. Moreover, we believe that advisers’ participation in pay to play is inconsistent with the high standards of ethical conduct required of them under the Advisers Act. The rule and rule amendments we are adopting today are designed to prevent fraud, deception, and manipulation by reducing or eliminating adviser participation in pay to play practices.

Rule 206(4)–5, the “pay to play” rule, prohibits an investment adviser registered (or required to be registered)

\textsuperscript{580} See section IV.B.1. of this Release (describing the cost estimates associated with compliance with rule 206(4)–5).
\textsuperscript{581} See supra note 558. Advisers that are unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act (15 U.S.C. 80b–3(b)(3)) are not subject to rule 206(4)–7 and, therefore, are not reflected in this burden estimate pursuant to the PRA.
\textsuperscript{582} See supra note 475.
\textsuperscript{583} See supra notes 489–491.
\textsuperscript{584} (1,271 \times 8 = 10,168) + (304 \times 125 = 38,000) + (122 \times 250 = 30,500) = 78,668.
\textsuperscript{585} See Proposing Release, at Section III.B.
\textsuperscript{586} See Davis Polk Letter; ICI Letter.
\textsuperscript{587} See Proposing Release, at Section III.B.
\textsuperscript{588} The hourly cost estimate of $400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.
\textsuperscript{589} $355,000 + $89,600 = $444,600.
\textsuperscript{590} 5 U.S.C. 604(b).
\textsuperscript{591} See Proposing Release, at section V.
\textsuperscript{592} See section I of this Release, for more information about the need for the Commission to take action to prevent pay to play practices.
with the Commission, or unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act, from providing advisory services for compensation to a government client for two years after the adviser, or any of its covered associates, makes a contribution to public officials (and candidates) such as State treasurers, comptrollers, or other elected executives or administrators who can influence the selection of the adviser. In addition, the rule we are adopting prohibits an adviser and its covered associates from soliciting contributions for an elected official or candidate or payments to a political party of a State or locality where the adviser is providing or seeking to provide advisory services to a government entity, and from providing or agreeing to provide, directly or indirectly, payment to any third party, other than a “regulated person,” engaged to solicit advisory business from any government entity on behalf of the adviser. Further, the prohibitions in the rule also apply to advisers to certain investment pools in which a government entity invests or that are investment options of a plan or program of a government entity. The amendment we are adopting to rule 204-2 is designed to provide Commission staff with records to review compliance with rule 206(4)-5, and the amendment to rule 206(4)-3 clarifies the application of the cash solicitation rule as a result of the adoption of rule 206(4)-5.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the IRFA, in particular, on the number of small entities, particularly small advisers, to which the rule and rule amendments would apply and the effect on those entities, including whether the effects would be economically significant; and how to quantify the number of small advisers, including those that are unregistered, that would be subject to the proposed rule and rule amendments. We received a number of comments related to the impact of our proposal on small advisers. The commenters argued that the proposed rule, particularly the provision that would have prohibited advisers from directly or indirectly compensating any third party to solicit government business on its behalf, would be disproportionately expensive for, and would impose an undue regulatory burden on, smaller firms.

C. Small Entities Subject to Rule

Under commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if: (i) Has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.

The Commission estimates that as of April 2010 there are approximately 708 small SEC-registered investment advisers. Of these 708 advisers, 61 indicate on Form ADV that they have State or local government clients, and would, therefore, be affected by the rule. The rule also applies to those advisers that are exempt from registration with the Commission in reliance on section 203(b)(3) of the Advisers Act. As noted above, based on our review of registration information on IARD and outside sources and reports, we estimate that there are approximately 2,000 advisers that are unregistered in reliance on section 203(b)(3). Applying the same principles we used with respect to registered investment advisers, we estimate that 230 of those advisers manage pooled investment vehicles in which government client assets are invested and would therefore be subject to the rule. Based on the current number of registered advisers subject to the rule that are small entities, we estimate that approximately 4 percent of unregistered advisers, or, would be subject to the rule are small entities.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The rule imposes certain reporting, recordkeeping and compliance requirements on advisers, including small advisers. The rule imposes a new compliance requirement by: (i) Prohibiting an adviser from providing investment advisory services for compensation to government clients for two years after the adviser or any of its covered associates makes a contribution to certain elected officials or candidates; (ii) prohibiting an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party, other than a “regulated person,” engaged to solicit advisory business from any government entity on behalf of the adviser; and (iii) prohibiting an adviser or any of its covered associates from soliciting contributions for an elected official or candidate or payments to a political party of a State or locality where the adviser is providing or seeking to provide advisory services to a government entity.

The rule amendments impose new recordkeeping requirements by requiring an adviser to maintain certain records about its covered associates, its advisory clients, government entities invested in certain pooled investment vehicles managed by the adviser, its solicitors, and its political contributions, as well as the political contributions of its covered associates. An investment adviser that does not provide or seek to provide advisory services to a government entity, or to a covered investment pool...
in which a government entity invests, is not subject to rule 206(4)–5 and certain recordkeeping requirements under amended rule 204–2. As noted above, we believe that a limited number of small advisers608 will have to comply with rule 206(4)–5 and the amendments to rules 204–2 and 206(4)–3. To the extent small advisers tend to have fewer clients and fewer employees that would be covered associates for purposes of the rule, the rule should impose lower costs on small advisers as compared to large advisers because variable costs, such as the requirement to make and keep records relating to contributions, should be lower due to the likelihood that there would be fewer records to make and keep.609 Moreover, as discussed above, the rule and amendments were modified from what we had proposed in several ways that we expect will substantially minimize compliance burdens on small advisers.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant impact on small entities.610 In considering whether to adopt rule 206(4)–5 and the amendments to rules 204–2 and 206(4)–3, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule and rule amendments for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule and rule amendments, or any part thereof, for such small entities.

Regarding the first alternative, the Commission is not adopting different compliance or reporting requirements for small advisers as it may be inappropriate to do so under the circumstances. The proposal is designed to reduce or eliminate adviser participation in pay to play, a practice that can distort the process by which investment advisers are selected to manage public pension plans that can harm public pension plan clients and cause advisers to violate their fiduciary obligations. To establish different requirements for small advisers could diminish the protections the rule and rule amendments would provide to public pension plan clients and their beneficiaries.

Regarding the second alternative, we considered whether further clarification, consolidation, or simplification of the compliance requirements would be feasible or necessary, and would reduce compliance requirements. As a result, we have simplified the compliance requirements by limiting the recordkeeping obligations to better reflect the activities of an adviser or a covered associate that could result in the adviser being subject to the two-year time out, including not requiring advisers to maintain records of unsuccessful solicitations of government entities and payments (as opposed to contributions) by advisers or covered associates to government officials.611 Moreover, we are amending rule 206(4)–3, the cash solicitation rule, to clarify that the requirements of new rule 206(4)–5 apply to solicitation activities involving government clients.612

Regarding the third alternative, we considered using performance rather than design standards with respect to pay to play practices of investment advisers to be neither consistent with the objectives for this rulemaking nor sufficient to protect investors in accordance with our statutory mandate of investor protection. Design standards, which we have employed, provide a baseline for advisory conduct as it relates to contributions and other pay to play activities, which is consistent with a rule designed to prohibit pay to play. The use of design standards also is important to ensure consistent application of the rule among investment advisers to which the rule and rule amendments will apply.

Regarding the fourth alternative, exempting small entities could compromise the overall effectiveness of the rule and related rule amendments. Banning pay to play practices benefits clients of both small and large advisers, and it would be inconsistent to specify different requirements for small advisers.

As discussed above, several commenters suggested alternative approaches to our rule.613 Such alternatives include, for example: (i) That we require advisers to disclose their contributions to State and local officials; (ii) that we require advisers to include in their codes of ethics a policy that prohibits contributions made for the purpose of influencing the selection of the adviser; (iii) that we require advisers to adopt policies and procedures reasonably designed to prevent and detect contributions designed to influence the selection of an adviser; (iv) that we mandate preclearance of employee contributions; and (v) that we allow an adviser to customize sanctions based on the severity of the violation.614 While it may be true that some of these approaches could diminish the compliance burdens on advisers, including small advisers, as we explain above, we considered these alternative approaches and do not believe they would appropriately address the kind of conduct at which our rule is directed.615

We are sensitive to the burdens our rule amendments will have on small advisers. We believe that the rule we are adopting today contains a number of modifications from what we had proposed that will alleviate many of the commenters’ concerns regarding small advisers. Most notably, as described above, we have created an exception to the third-party solicitor ban for “regulated persons,” which will, for instance, allow advisers to continue to use third-party placement agents to sell interests in covered investment pools they manage instead of incurring additional costs to hire internal marketing staff, a result that could have disproportionally affected small advisers.616 Moreover, as discussed above, we have modified the exceptions to the rule’s two-year time out provisions in certain respects to reduce the likelihood of an inadvertent or minor violation of the rule, including a shortened look back of six months for certain new covered associates whose contributions are less likely to involve pay to play and a new de minimis exception for contributions to officials for whom a covered associate is not entitled to vote.617 We have also limited certain recordkeeping requirements we had proposed in order to achieve our

608 See section VLC of this Release.
609 However, as noted above, many larger advisers with broker-dealer affiliates may spend fewer resources to comply with the proposed rule and rule amendments because they may be able to rely on compliance procedures and systems that the broker-dealer already has in place to comply with MSRB rules G–36 and G–38. See supra section IV.B.
610 As noted above, we considered two alternatives to certain aspects of proposed rule 206(4)–5: A disclosure obligation and a two-year time out for third-party solicitors. We do not believe either alternative would accomplish our stated objective of curtailing pay to play activities and thereby address potential harms from those activities. See Proposing Release, at section II.A.2, including nn.133 and 134 and accompanying text.
611 See supra note 423 and accompanying text.
612 See section II.D. of this Release.
613 See generally section II.B.2(a) of this Release.
614 See id.
615 See id.
616 See section II.B.2(b) of this Release.
617 See sections II.B.2(a)(5) and (6) of this Release.
goals in a way that balances the costs and benefits of the rule, including not requiring records of unsuccessful solicitations or payments (that are not contributions) by advisers or covered associates to government officials.618

VII. Effects on Competition, Efficiency and Capital Formation

We are adopting amendments to rule 204–2 pursuant to our authority under sections 204 and 211. Section 204 requires the Commission, when engaging in rulemaking pursuant to that authority, to consider whether the rule is “necessary or appropriate in the public interest or for the protection of investors.”619 Section 202(c) of the Advisers Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.620

In the Proposing Release, we solicited comment on whether, if adopted, the proposed amendments to rule 204–2 would promote efficiency, competition and capital formation. We further encouraged commenters to provide empirical data to support their views on any burdens on efficiency, competition or capital formation that might result from adoption of the proposed amendments. We did not receive any empirical data in this regard concerning the proposed amendments. We received some general comments, addressed below, asserting that the proposed amendments to require registered advisers to maintain books and records relating to investment advisory services they provide to government entities would have an adverse impact on competition.

We are amending rule 204–2 to require a registered adviser to make and keep a list of its covered associates, the government entities to which the adviser directly or indirectly provides advisory services, the “regulated person” solicitors the adviser retains, and the contributions made by the firm and its covered associates, as applicable, to government officials and candidates.621 The amendments are designed to provide our examiners important information about the adviser and its covered associates’ contributions to government officials, the government entities to which the adviser directly or indirectly provides advisory services, and the solicitors it retains. These amendments may also benefit advisers as records required under the amended rule will assist the Commission in enforcing the rule against, for example, an adviser whose pay to play activities, if not uncovered, could adversely affect the competitive position of a compliant adviser.

Although we believe that the amendments to the Advisers Act recordkeeping rule will require advisers to incur both one-time costs to establish and enhance current systems to assist in their compliance with the amendments and ongoing costs to maintain records, these costs will be borne by all registered advisers that have government entity clients or that pay regulated entities to solicit government clients on their behalf. As the amendments to the recordkeeping rule do not disproportionally affect any particular group of advisers with government entity clients and do not materially increase the compliance burden on advisers under rule 204–2, we do not believe that they will affect competition across registered investment advisers. Some commenters asserted that certain asset managers that provide advice to government entities but are not subject to the Advisers Act recordkeeping rule, such as banks and advisers that are exempt from registration under the Act, may be at a competitive advantage to registered advisers that must incur the costs of keeping records under the rule.622 While we acknowledge these entities could potentially obtain a competitive advantage for this reason, we do not believe the costs attributable to the amendments to rule 204–2 will have a significant impact on registered advisers such that the advantage gained by asset managers not subject to the Advisers Act recordkeeping rule will be substantial.623 Moreover, exempt advisers or persons that do not meet the definition of investment adviser are not subject to rule 204–2.624 Finally, we also note that banks may be subject to laws and rules that do not apply to registered advisers.

We believe that the amendments to rule 204–2 may, to a limited extent, affect efficiency and capital formation with respect to the allocation of public pension plan assets. The amendments to rule 204–2 will allow our staff to examine for compliance with rule 206(4)–5. Authority to examine records may improve registered investment advisers’ compliance with rule 206(4)–5, which may reduce the adverse effects of political contributions on the selection of investment advisers. While the amendments to the rule will not affect the aggregate amount of pension fund assets available for investment, limiting the effects of political contributions on the investment adviser selection process should improve the mechanism by which capital is formed and allocated to investment opportunities.

VIII. Statutory Authority

The Commission is adopting new rule 206(4)–5 and amending rule 206(4)–3 of the Advisers Act pursuant to the authority set forth in sections 206(4) and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b–6(a)].

The Commission is amending rule 204–2 of the Advisers Act pursuant to the authority set forth in sections 204 and 211(a) of the Advisers Act [15 U.S.C. 80b–4 and 80b–11(a)].

List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements; Securities.

For the reasons set out in the preamble, Title 17 Chapter II of the Code of Federal Regulations is amended as follows.

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 continues to read in part as follows:


2. Section 275.204–2 is amended by adding paragraph (a)(18) and by revising paragraph (h)(1) to read as follows:

624 See section 204 of the Advisers Act, 15 U.S.C. 80b–4 (that provides the Commission authority to prescribe recordkeeping for advisers, other than those specifically exempted from registration).
§ 275.204–2 Books and records to be maintained by investment advisers.

(a) * * *

(i) Books and records that pertain to § 275.206(4)–5 containing a list or other record of:

(A) The names, titles and business and residence addresses of all covered associates of the investment adviser;

(B) All government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years, but not prior to September 13, 2010;

(C) All direct or indirect contributions made by the investment adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a political party of a State or political subdivision thereof, or to a political action committee; and

(D) The name and business address of each regulated person to whom the investment advisory services are provided or promised to be provided, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf; in accordance with § 275.206(4)–5(a)(2).

(ii) Records relating to the contributions and payments referred to in paragraph (a)(18)(i)(C) of this section must be listed in chronological order and indicate:

(A) The name and title of each contributor;

(B) The name and title (including any city/county/State or other political subdivision) of each recipient of a contribution or payment;

(C) The amount and date of each contribution or payment; and

(D) Whether any such contribution was the subject of the exception for certain returned contributions pursuant to § 275.206(4)–5(b)(2).

(iii) An investment adviser is only required to make and keep current the records referred to in paragraphs (a)(18)(i)(A) and (C) of this section if it provides investment advisory services to a government entity or a government entity is an investor in any covered investment pool to which the investment adviser provides investment advisory services.

(iv) For purposes of this section, the terms “contribution,” “covered associate,” “covered investment pool,” “government entity,” “official,” “payment,” “regulated person,” and “solicit” have the same meanings as set forth in § 275.206(4)–5.

* * * * *
(ii) In any calendar year, an investment adviser that has reported on its annual updating amendment to Form ADV (17 CFR 279.1) that it has more than 50 employees is entitled to no more than three exceptions pursuant to paragraph (b)(3)(i) of this section, and an investment adviser that has reported on its annual updating amendment to Form ADV that it has 50 or fewer employees is entitled to no more than two exceptions pursuant to paragraph (b)(3)(i) of this section.

(iii) An investment adviser may not rely on the exception provided in paragraph (b)(3)(i) of this section more than once with respect to contributions by the same covered associate of the investment adviser regardless of the time period.

(c) Prohibitions as applied to covered investment pools. For purposes of this section, 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.

(d) Further prohibition. As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Advisers Act (15 U.S.C. 80b–3(b)(3)(i)), or any of the investment adviser provisions of the Advisers Act (15 U.S.C. 80b–3(b)(3)(ii) of this section.

(iii) An investment adviser may not reasonably designed to prevent violations of this section; and

(ii) Prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and

(iii) After learning of the contribution:

(A) Has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to return a share of the contribution; and

(B) Has taken such other remedial or preventive steps as may be appropriate under the circumstances;

(iii) Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment;

(iv) The timing and amount of the contribution which resulted in the prohibition;

(vi) The nature of the election (e.g., Federal, State or local); and

(vii) The contributor’s apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.

(f) Definitions. For purposes of this section:

(i) Contribution means any gift, subscription, loan, advance, or deposit of money or anything of value made for:

(i) The purpose of influencing any election for Federal, State or local office;

(ii) Payment of debt incurred in connection with any such election; or

(iii) Transition or inaugural expenses of the successful candidate for State or local office.

(ii) Covered associate of an investment adviser means:

(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 person described in paragraphs (f)(2)(i) and (f)(2)(ii) of this section.

(iii) Covered investment pool means:

(i) An investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a) that is an investment option of a plan or program of a government entity; or

(ii) Any company that would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(a)), but for the exclusion provided from that definition by either section 5(c)(1) of that Act or section 3(c)(11) of that Act (15 U.S.C. 80a–3(c)(1), (c)(7) or (c)(11)).

(iv) Executive officer of an investment adviser means:

(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 person who performs similar policy-making functions for the investment adviser.

(v) Government entity means any State or political subdivision of a State, including:

(i) Any agency, authority, or instrumentality of the State or political subdivision;

(ii) A pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

(6) Official means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office:

(i) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or

(ii) 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 by a government entity.

(7) Payment means any gift, subscription, loan, advance, or deposit of money or anything of value.

(8) Plan or program of a government entity means any participant-directed investment program or plan sponsored or established by a State or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to, a “qualified tuition plan” authorized by section 529 of the Internal Revenue Code (26 U.S.C. 529), a retirement plan authorized by section 403(b) or 457 of the Internal Revenue Code (26 U.S.C. 403(b) or 457), or any similar program or plan.

(9) Regulated person means:

(i) An investment adviser registered with the Commission that has not, and whose covered associates have not,
within two years of soliciting a government entity:
(A) Made a contribution to an official of that government entity, other than as described in paragraph (b)(1) of this section; and
(B) Coordinated or solicited any person or political action committee to make any contribution or payment described in paragraphs (a)(2)(ii)(A) and (B) of this section; or
(ii) A “broker,” as defined in section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) or a “dealer,” as defined in section 3(a)(5) of that Act (15 U.S.C. 78c(a)(5)), that is registered with the Commission, and is a member of a national securities association registered under section 15A of that Act (15 U.S.C. 78o–3), provided that:
(A) The rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and
(B) The Commission, by order, finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers than this section imposes on investment advisers and that such rules are consistent with the objectives of this section.
(10) Solicit means:
(i) 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; and
(ii) With respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.
By the Commission.
Dated: July 1, 2010.
Elizabeth M. Murphy,
Secretary.
[FR Doc. 2010–16559 Filed 7–13–10; 8:45 am]
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