JACKO LAW GROUP, PC

Legal Risk Management Tip
March 2014

IMPORTANT REMINDERS ABOUT PAY-TO-PLAY

Even though spring has only just begun, politicians are already starting to gear up for the November elections. Not only will the election for the US Senate be held this year, but also a myriad of state and local elections will take place. With this backdrop, it's the perfect time to revisit the Securities and Exchange Commission's ("SEC's") Rule 206(4)-5 (the "Rule") of the Investment Advisers Act of 1940 (the "Advisers Act"), more commonly referred to as the "pay-to-play" rule. "Pay-to-play" generally refers to various arrangements whereby an investment adviser may seek to influence the award of advisory business by making or soliciting political contributions to government officials who have the ability to award such business. While this rule has been in effect since 2011, this article will serve as a reminder of the key components of the Rule and discuss updates promulgated by the SEC since the Rule's adoption.

At its core, the Rule applies to all advisers that are registered (or required to be registered) with the SEC,[1][2] and prohibits an investment adviser from (i) providing advisory services, for compensation, to a government entity,[3] elected official[4] or candidate client for two years after the adviser, or any covered associate[5] of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made), makes a contribution[6] to such a client, (ii) providing direct or indirect payments to any third party that solicits[7] government entities for advisory business unless this third party is also a regulated

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[1] The Rule also applies to those adviser that are unregistered due to their reliance on the "private adviser exemption" provided by Section 203(b)(3) of the Advisers Act.

[2] Several states have enacted similar regulations to those promulgated by the SEC. All state-registered investment advisers should be aware of those regulations that apply to their particular situation.

[3] *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, including, but not limited to a "defined benefit plan" as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a State general fund; (iii) a plan or program of a government entity; and (iv) officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

[4] *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.

[5] *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.

[6] *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.

[7] *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.

person; and (iii) soliciting from others, or coordinating contributions from others — a practice referred to as "bundling" — for an elected official who is in a position to influence the selection of the adviser.[8]

Key Considerations of the Rule

While not an exhaustive list, the following gives a discussion regarding some of the key points of the rule.

1. Exceptions and Exemptions

The Rule does provide exceptions, in certain circumstances, both allowing for donations to be made to government officials, as well as for advisers to consider providing services to government officials or entities where contributions have been made.

a. Making Donations – The De Minimis Exception

The Rule permits covered persons to make contributions of up to $350 (per election[9]) to an official for whom the covered person is entitled to vote[10] or to an official seeking the U.S. Presidency. The Rule also permits a covered person to make a contribution of up to $150 (per election) to an official for whom the covered person is not entitled to vote.

b. Providing Services

i. No compensation

The Rule expressly states that should an adviser make a contribution to a government official or entity, that adviser is prohibited from providing services to such a government client *for a fee* for a period of two years. As such, even after making contributions to an official in excess of the de minims exception, an adviser would still be allowed to provide services to such a government client; however, no fees could be collected for such services.

ii. Inadvertent Contribution Cure

The Rule contains a limited cure provision for certain “inadvertent” contributions to an official for whom a covered associate is not entitled to vote.[11] This cure may be utilized only if the following conditions are met: (i) the adviser discovers the impermissible contribution within four months of the date of contribution; (ii) the contribution did not exceed $350; and (iii) the

[8] SEC Rule 206(4)-5.
[9] A covered associate can contribute separately up to the full amount in both the primary and general elections.
[10] A covered associate is “entitled to vote” for a person if such covered associate’s primary residence is located in the area in which the official is running.
[11] An adviser may not rely on this exception more than twice in a 12-month period (unless the adviser has more than 50 employees, in which case it may be relied upon three times), or more than once per covered associate regardless of the time period.

contribution was returned within sixty calendar days from the date the adviser discovered the contribution was made.[12]

iii. Discretionary Exemption Process

According to the Rule, an adviser may apply to the Commission for an order exempting it from the two-year compensation ban when the "imposition of the prohibition is unnecessary to achieve the rule's intended purpose."[13] For example, this may occur when a disgruntled employee makes a greater than $350 contribution as he or she exits the firm. When determining whether or not to accept an adviser's application, the SEC will consider such facts and circumstances as whether the investment adviser adopted and implemented policies and procedures reasonably designed to prevent such a violation, the timing and amount of the contribution and the contributor's apparent intent or motive.[14]

2. "Look Back" Provision

The Rule includes a "look back" provision that attaches to an adviser for contributions made by a person *prior* to becoming a covered associate of the adviser. If those contributions were made by a covered associated who solicits clients for the adviser, the look back period is two years prior to the date the individual became a covered associate of the adviser. However, where the contributions are made by a covered associate who does not solicit clients on behalf of the adviser, the look period is only six months.

3. Application to Covered Investment Pools

In general, the restrictions of the Rule apply with equal force when an adviser provides advisory services to a "covered investment pool"[15] in which a government entity invests or is solicited to invest. The rule does not require a government entity's withdrawal of its investment or cancellation of any commitment made, but does require an adviser to immediately forgo any compensation related to the assets invested by that government entity, or to rebate the portion of its fees or any performance allocation or carried interest attributable to assets of the government client.[16]

Furthermore, according to the SEC, sub-advisers to covered investment pools are not treated as separate and distinct from advisers for purposes of the Rule.[17] However, the SEC further stated that the sub-adviser or adviser that did not make the contribution triggering the two year "time out" mandated by the Rule could continue to receive compensation from the government entity, unless the arrangement were a means to do indirectly what the adviser or sub-adviser could not

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[12] SEC Rule 206(4)-5.
[13] http://www.sec.gov/rules/final/2010/ia-3043.pdf.
[14] For a full list of factors considered by the SEC please see http://www.sec.gov/rules/final/2010/ia-3043.pdf.
[15] Per Rule 206(4)-5(f)(3), a "covered investment pool" means any investment company registered under the Investment Company Act of 1940, as amended, that is an investment option of a plan or program of a government entity, or any company that would be an investment company under section 3(a) of the Investment Company Act of 1940 but for the exclusion provided from that definition by either Section 3(c)(1), 3(c)(7) or 3(C)(11) of the Act.
[16] http://www.sec.gov/rules/final/2010/ia-3043.pdf.
[17] Id.

do directly under the Rule.[18] The SEC also stated that 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 what it could not do directly under the rule.[19]

4. Recordkeeping

Those advisers who provide services to government entities are subject to enhanced recordkeeping requirements under Rule 204-2 of the Advisers Act. For instance, such an adviser must make and keep a record of all political contributions made by the firm and its covered associates in the past five years (but not prior to September 13, 2010).[20] Such records of contributions and payments must be listed in chronological order and should include such relevant information as: (i) the names, titles and business and home addresses of all covered associates; (ii) all government entities to which the firm provides or have provided investment advisory services, or which are or was investors in any fund to which the firm provides or has provided investment advisory services, in the past five years (but not prior to September 13, 2010); (iii) all direct or indirect contributions made by the firm 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; and (iv) the name and business address of each regulated person to whom the firm provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services.[21]

5. Staff Responses to Questions about the Pay to Play Rule

In 2012, the staff of the Division of Investment Management released a "Staff Responses to Questions about the Pay to Play Rule" (the "Pay-to-Play Response")[22] addressing some frequently asked questions regarding the Rule. Among other things, the Pay-to-Play Response clarified that (1) an investment adviser's parent company and its employees generally are not deemed to be covered associates; (2) family members of the investment adviser's employees are not deemed to be covered associates; (3) an investment adviser's independent contractors are deemed to be covered associates; and (4) the definition of "government" does not extend to foreign governments.

Practical Tips and Considerations

All investment advisers subject to the Rule should review and, if appropriate, update their policies and procedures manual and code of ethics to ensure they remain compliant. The following provides several recommendations to consider when conducting such reviews. This list is not comprehensive, and facts unique to each particular situation will warrant additional consideration.

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[18] Id.
[19] Id.
[20] http://www.sec.gov/divisions/investment/pay-to-play-faq.htm.
[21] See Rule 204-2(a)(18) of the Advisers Act.
[22] http://www.sec.gov/divisions/investment/pay-to-play-faq.htm.

1. Perform reviews of your policies and procedures at least annually to ensure that your firm has sufficiently addressed these regulations.
2. As the Pay-to-Play Response points out, the Rule does not pre-empt state and local laws regarding campaign contributions and pay-to-play activities. As such, all firms should review applicable state laws to ensure compliance.
3. Adopt screening methods including circulating a questionnaire to all covered associates at least annually to determine what, if any, political contributions have been made. The same questionnaire should be completed by prospective employees that will become covered associates, and existing employees that are expected to become covered associates, to ensure compliance with the look-back provisions of the Rule.
4. Use alternative "non-contribution" activities to support candidates such as hosting "meet and greets" and performing volunteer work. Just be sure to make the purpose of the events clear, refrain from soliciting contributions and do not use any company funds to sponsor such events.
5. Educate employees so that they are aware of the Rule to prevent accidental violations.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

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