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One Year Later: "Pay to Play" Developments

An important issue for investment advisers in 2011 was implementing compliance with Securities and Exchange Commission (Commission) Rule 206(4)-5 (the Rule) under the Investment Advisers Act of 1940, as amended (the Advisers Act), which sought to protect state and local governments and their public pension plans from the consequences of "pay to play" practices, and the related amendments to Rules 206(4)-3 (cash payment for solicitations) and 204-2 (recordkeeping) under the Advisers Act (collectively, Related Amendments).

In order to comply with the Rule, investment advisers developed compliance policies and procedures to regulate, monitor and evaluate employee political contributions to officials of government entities. For the past year, investment advisers have been using these new policies to analyze employee requests for contributions that may relate to the advisers' current and prospective client base to make sure that they do not run afoul of the Rule's harsh remedies for noncompliance.[1] At the same time, pay to play issues generally have gained prominence in the media and the courts as we move forward into the 2012 general election cycle.

In connection with this new regulatory initiative, the Commission staff has issued further guidance to clarify myriad issues that arose when trying to implement the Rule and Related Amendments. In view of these developments, we are providing a brief update of regulatory and judicial developments since the Rule and Related Amendments went into effect on March 14, 2011.

Summary of the Pay to Play Rule

Under the Rule, it is unlawful for an investment adviser to receive compensation for providing advisory services to a government entity within two years after the adviser or any of its covered associates makes a contribution (above certain *de minimis* thresholds) to an official of such government entity.[2] The Rule does not actually ban contributions or limit them; rather, through its two-year time out provision, the Rule prohibits an investment adviser from providing investment advisory services for compensation to a government entity once a contribution is made to an official of that entity. The Rule also contains a two-year look back period, under which the Rule generally will attribute to an investment adviser contributions made by a person prior to becoming a covered person of the investment adviser.

(continued)

The Rule contains a catchall provision that prohibits an investment adviser or its covered associates from doing any indirect act that, if done directly, would result in a violation of the Rule. Along these lines, the Rule prohibits an investment adviser or any of its covered associates from either directly or indirectly paying a third party (such as a solicitor or a placement agent) to solicit a government client on behalf of the investment adviser, unless the third party is a regulated person, which the Rule defines as an investment adviser or a registered broker-dealer subject to similar pay to play restrictions.[3]

Further, the Rule seeks to prevent bundling by prohibiting an investment adviser or any of its covered associates from coordinating with or soliciting any person or PAC to make (i) any contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or (ii) any 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. Additionally, an investment adviser is required to maintain certain records related to the adviser's obligations under the Rule.

Recent Regulatory Developments

Since the Rule became effective in March 2011, there have been a handful of further regulatory developments. In September 2011, the Commission issued a no-action letter to the Investment Company Institute, granting no-action relief to investment advisers of covered investment pools from the requirement to maintain and keep a list of all government entity clients where the identity of such government entities is not transparent because shares are held through omnibus accounts.[4] Additionally, in November 2011, the Commission staff updated its document titled Staff Responses to Questions About the Pay to Play Rule (Pay to Play Q&A).[5] The Pay to Play Q&A covers a number of areas relevant to the Rule, including compliance dates; the definitions of covered associate, government entity and official; and third-party solicitation.

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On June 8, 2012, the SEC extended the date by which advisers must comply with the Rule's ban on third-party solicitation to ensure an orderly transition for advisers and third-party solicitors, as well as to provide additional time for them to adjust compliance policies and procedures after the transition. The SEC extended the compliance date until nine months after the compliance date of the final rule adopted by the SEC by which municipal advisor firms must register.[6]

Pay to Play Developments in Certain Jurisdictions

There have been several developments in the pay to play arena – and in areas closely connected with pay to play – in certain jurisdictions. While most of these developments concern legislation rather than securities regulations, they underscore that pay to play is an important issue that likely will remain a hot topic for the foreseeable future. A summary of some of the more significant developments follows:

- The U.S. Court of Appeals for the Second Circuit earlier this year upheld New York City's campaign finance and lobbying laws that restrict campaign contributions by certain businesses and individuals doing business with the city.[7] The circuit court was not persuaded by the challengers' reliance on the Supreme Court's *Citizens United* decision,[8] distinguishing that case on the basis that it struck down limits on independent expenditures in support of a candidate, not direct political contributions to a candidate (which were limited under the city ordinance). The challengers to the New York City

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law filed a petition for certiorari with the Supreme Court, which was denied in June 2012.

- The Montana Supreme Court upheld a state law in December 2011 banning corporate independent campaign expenditures – despite the U.S. Supreme Court's ruling in *Citizens United*.[9] In June 2012, the U.S. Supreme Court, based on *Citizens United*, reversed the earlier decision and effectively overturned the Montana law.

- The city of Philadelphia's new lobbying ordinance went into effect in January 2012. The ordinance requires those that lobby the city and its agencies to register with the Philadelphia Board of Ethics and thereafter file, at quarterly intervals, detailed reports disclosing their lobbying costs and activities.

- Texas Gov. Rick Perry's recent presidential campaign created pay to play issues that directly related to Rule 206(4)-5. Specifically, in light of Perry's ability to appoint members to several Texas state pension funds and related entities, some commentators noted that contributions to his campaign for president could have been subject to federal pay to play rules, including Rule 206(4)-5.

Pay to Play Going Forward

The emergence of Super PACs[10] and the continuing controversy over the *Citizens United* decision will likely keep pay to play issues in the news. As a result of this publicity, along with the regulatory and judicial developments discussed above, we believe that this issue will remain an important one both for the Commission and other regulators. It is important that investment advisers continue in their efforts to comply with the Commission's Rule and other applicable laws. Such efforts should include periodic review of internal policies regarding political contributions and concomitant recordkeeping requirements, as well as related policies and procedures having a connection to the Rule, such as employment policies and handbooks.

If you would like to discuss any of these issues in more detail, please contact us.

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[1] *Political Contributions by Certain Investment Advisers,* SEC Rel. No. IA-3043 [75 FR 41018] (July 1, 2010) (Adopting Release). The SEC adopted amendments to expand the scope of the Rule to apply to exempt reporting advisers and foreign private advisers. *Rules Implementing Amendments to the Investment Advisers Act of 1940*, SEC Rel. No. IA-3221 [76 FR 42950] (June 22, 2011) (Amendment Release). The Rule appears at 17 C.F.R. § 275.206(4)-5.

[2] The Rule defines the term "government entity" to include 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

Stradley Litigation Team Recovers Abderdeen Losses Caused by $1 Billion Satyam Fraud

A team of Stradley litigators represented Aberdeen Claims Administration Inc. in the successful prosecution and settlement of its claims arising out of an alleged financial fraud at India's Satyam Computer Services Ltd. The Satyam fraud involved an alleged overstatement of the cash assets of a public company by $1.4 billion. A number of class action lawsuits were filed across the United States and ultimately consolidated in the Southern District of New York. Stradley Ronon's client, Aberdeen Claims Administration, was the trustee charged with recovering the market losses sustained by twenty mutual funds and institutional investors who had been major Satyam shareholders. In late July, Aberdeen agreed to a separate settlement whereby the mutual funds and institutional investors will recover a substantial portion of their losses. The Wall Street Journal reported on one component of the settlement last week.

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. The Rule defines the term "official" to mean 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.

[3] The SEC has amended the Rule to add "municipal advisors" to the definition of "regulated person." To qualify as a "municipal advisor," a solicitor must be registered under Section 15B of the Securities Exchange Act of 1934 and be subject to the pay to play rules of the Municipal Securities Rulemaking Board. See Amendment Release. On Jan. 14, 2011, the MSRB proposed new Rule G-42 to establish pay to play rules for municipal advisors. MSRB Notice 2011-04 (Jan. 14, 2011). However, on Sept. 9, 2011, the MSRB withdrew its proposal without explanation. The term "municipal advisor," a new category of person created under the Dodd-Frank Act, is any person that undertakes "a solicitation of a municipal entity." Because the definition of "solicitation of a municipal entity" excludes solicitations by affiliates of an investment adviser, which effectively excludes affiliated broker-dealers from the definition of "regulated municipal advisor," the SEC proposed to permit certain persons who do not necessarily fall within the definition of "municipal advisor" to voluntarily register with the MSRB as a municipal advisor. SEC Rel. No. 34-63576 (Dec. 20, 2010). As of Aug. 10, 2012, the SEC has not adopted this proposal.

[4] *Investment Company Institute*, SEC No-Action Letter (Sept. 12, 2011). Rule 204-2(a)(18)(i)(B) was adopted in conjunction with the Rule in 2010 to require that investment advisers keep records about certain government entities.

[5] *Staff Responses to Questions About the Pay to Play Rule* (updated November 2011) (available at http://www.sec.gov/divisions/investment/pay-to-play-faq.htm).

[6] *Political Contributions by Certain Investment Advisers: Ban on Third-Party Solicitation; Extension of Compliance Date*, SEC Rel. No. IA-3418 (June 8, 2012).

[7] *Ognibene v. Parkes*, 671 F.3d 174 (2d Cir. 2012), cert. denied, ____ S. Ct. ____, 2012 WL 950086 (June 25, 2012).

[8] *Citizens United v. Fed. Election Comm'n*, 130 S. Ct. 876 (2010) (corporations must be allowed to use their general treasury funds to engage in independent advertising advocating either for or against the election of a particular federal candidate).

[9] *W. Tradition P'ship, Inc. v. Attorney Gen.*, 271 P.3d 1 (Mont. 2011), *rev'd sub nom. Am. Tradition P'ship, Inc. v. Bullock*, 132 S. Ct. 2490 (2012).

[10] These entities are political action committees that make only independent expenditures, not contributions to candidates, and therefore are permitted to accept unlimited contributions from individuals, unions and corporations.

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