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17 CFR Part 275
Political Contributions by Certain Investment Advisers; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA–2910; File No. S7–18–09]

RIN 3235–AK39

Political Contributions by Certain Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing for comment a new rule under the Investment Advisers Act of 1940 that would prohibit 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 would also prohibit 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. Additionally, the new rule would prevent 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 proposing rule amendments that would 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 would address ''pay to play'' practices by investment advisers.

DATES: Comments should be received on or before October 6, 2009.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov*. Please include File Number S7–18–09 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–18–09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

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

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed rule 206(4)–5 [17 CFR 275.206(4)–5] and proposed amendments to rules 204–2 [17 CFR 275.204–2] and 206(4)–3 [17 CFR 275.206(4)–3] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (''Advisers Act'' or ''Act'').

I. Background and Introduction

Investment advisers provide a wide variety of advisory services to State and local governments.[1] Advisers manage public monies that fund pension plans and a number of other important public programs, including transportation, children's programs, arts programs, environmental reclamation, and financial aid for education. In addition, advisers provide risk management,[2] asset allocation,[3] financial planning [4] and cash management services; [5] assist in investing proceeds from bond

[1] *See* Sofia Anastopoulos, An Introduction to Investment Advisers for State and Local Governments (2d ed. 2007); Werner Paul Zorn, *Public Employee Retirement Systems and Benefits, in* Local Government Finance, Concepts and Practices 376 (John E. Peterson and Dennis R. Strachota, eds., 1st ed. 1991) (discussing the services investment advisers provide for public funds).

[2] *See* Robert A. Fippinger, The Securities Law of Public Finance 669 (2d ed. 2004).

[3] *See, e.g.,* John H. Ilkiw, *Investment Policies, Processes and Problems in U.S. Public Sector Pension Plans: Some Observations and Solutions from a Practitioner, in* Public Pension Fund Management: Governance, Accountability and Investment Policies (Alberto R. Musalem and Robert J. Palacios, eds. 2004). *See also* Barry B. Burr, *The New $100 Billion Club,* Pens. & Inv. (May 4, 1998), at 1.

[4] *See* Cal. Ed. Code § 22303.5 (2008) (requiring teachers' retirement system to offer retirement planning services to beneficiaries); CalSTRS Counseling and Workshops, *available at http://www.calstrs.com/Counseling%20and%20Workshops/index.aspx.* Other funds also offer financial planning services to their beneficiaries. *See, e.g.,* CalPERS Launches Online Education Classes, U.S. States News (Mar. 3, 2008).

[5] *See* Government Finance Officers Association, An Introduction to External Money Management for Public Cash Managers 5 (1991).

offerings;[6] help State and local governments find and evaluate other advisers that manage public funds (''pension consultants'');[7] and provide other types of services.[8]

Most of the public funds managed by investment advisers fund State and municipal pension plans.[9] These pension plans have over $2.2 trillion of assets and represent one-third of all U.S. pension assets.[10] They are among the largest and most active institutional investors in the United States.[11] The management of these funds significantly affects publicly held companies[12] and the securities markets.[13] But most significantly, their management affects taxpayers and the beneficiaries of these funds, including the millions of present and future State and municipal retirees[14] who rely on the funds for their pensions and other benefits.[15]

Public pension plan assets are held, administered and managed by elected officials who often are responsible for selecting investment advisers to manage the funds they oversee. Pay to play practices undermine the fairness of the selection process when advisers seeking to do business with the governments of States and municipalities make political contributions to elected officials or candidates, hoping to influence the selection process. In other cases, political contributions may be solicited from advisers, or it is simply understood that only contributors will be considered for selection. Contributions, in this circumstance, may not always guarantee an award of business to the contributor, but the failure to contribute will guarantee that another is selected. Hence the term ''pay to play.''

Elected officials who allow political contributions to play a role in the management of these assets violate the public trust by rewarding those who make political contributions. Similarly, investment advisers that seek to influence the award of advisory contracts by public entities, by making or soliciting political contributions to those officials who are in a position to influence the awards, compromise their fiduciary obligations. Pay to play practices can distort the process by which investment advisers are selected and can harm advisers' public pension plan clients, and the pension plan beneficiaries, which may receive inferior advisory services and pay higher fees because, for instance, advisers must recoup contributions, or because contract negotiations are not handled on an arm's-length basis. Pay to play practices also may manipulate the market for advisory services by creating an uneven playing field among investment advisers. These practices also may hurt smaller advisers that cannot afford the required contributions. We believe that advisers' participation in pay to play practices is inconsistent with the high standards of ethical conduct required of them under the Advisers Act.

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, in its decision upholding one of the rules on which the proposed rule is modeled, ''[w]hile the risk of corruption is obvious and substantial, actors in this field are presumably shrewd enough to structure their relations rather indirectly.''[16] Pay to play practices may take a variety of forms, including an adviser's direct contributions to government officials, an adviser's solicitation of third parties to make contributions or payments to government officials or political parties in the State or locality where the adviser seeks to provide services, or an adviser's payments to third parties to solicit (or as a condition of obtaining) government business. As a result, the full extent of pay to play practice remains hidden and is often hard to prove.

The rule we are proposing today is modeled on rules G–37 and G–38 of the Municipal Securities Rulemaking Board (''MSRB''),[17] which address pay to play practices in the municipal securities markets.[18] The Commission approved rule G–37 in 1994, after concluding that pay to play practices harm municipal securities markets.[19] MSRB rule G–37

[6] *See In the Matter of O'Brien Partners, Inc.,* Investment Advisers Act Release No. 1772 (Oct. 27, 1998) (settled enforcement action in which financial advisor was deemed subject to the Advisers Act for rendering advice to municipal securities issuers ''concerning their investment of bond proceeds in securities, including [non-government securities], and was compensated for that advice'').

[7] In addition to assisting public funds in selecting investment advisers, pension consultants may also provide advice to State and local governments on such things as designing investment objectives, or recommending specific securities or investments for the fund. Pension consultants may be investment advisers subject to the Advisers Act. *See Applicability of the Investment Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services,* Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)] (''Release 1092'').

[8] For example, public funds may retain advisers to perform custodial services. *See, e.g., Public Employee Retirement Systems, supra* note 1, at 376–77.

[9] For this reason, in this Release, we use the term ''public pension plan'' interchangeably with ''government client'' and ''government entity''; however, our proposed rule would apply broadly to investment advisory activities for government clients, such as those mentioned here in this Background and Introduction, 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 infra* section II.A.3(e) of this Release.

[10] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States, Flows and Outstandings, First Quarter 2009* (June 11, 2009) (at table L.119). Since 2002, total financial assets of public pension funds have grown by 13% *Id.*

[11] 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.*

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

[13] Federal Reserve reports indicate that, of the $2.2 trillion in non-Federal government plans, $1.1 trillion are invested in corporate equities. Flow of Funds Accounts of the United States, *supra* note 10 (at table L.119).

[14] *See* Paul Zorn, 1997 Survey of State and Local Government Employee Retirement Systems 61 (1997) (''[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'').

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

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

[17] In 1999 the Commission proposed a similar rule, which also would have been codified as rule 206(4)–5 under the Advisers Act, had it been adopted. *See Political Contributions by Certain Investment Advisers,* Investment Advisers Act Release No. 1812 (Aug. 4, 1999) [64 FR 43556 (Aug. 10, 1999)] (''1999 Proposing Release''). The Commission also proposed amendments in 1999 to rule 204–2 [17 CFR 275.204–2] under the Advisers Act, which would have required advisers with government clients to keep certain records relating to the 1999 proposed rule. *See id.,* at section II.B. We are not re-proposing that rule or those rule amendments today; we are withdrawing our 1999 proposal and proposing a new rule 206(4)-5 as well as new amendments to rule 204–2.

[18] MSRB rule G–37 and G–38 are available on the MSRB's Web site at *http://www.msrb.org/msrb1/rules/ruleg37.htm* and *http://www.msrb.org/msrb1/rules/ruleg38.htm,* respectively.

[19] *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking*

Continued

prohibits a broker-dealer from engaging in municipal securities business with a municipal issuer for two years after making a political contribution to an elected official of the issuer who can influence the selection of the broker-dealer.[20] The rule also prohibits a broker-dealer from providing or seeking to provide underwriting services to a government if the firm or any of its ''municipal finance professionals'' solicit contributions for a candidate or an elected official of that government, or if they solicit payments to political parties where the firm is providing or seeking to provide services to a government client.[21] MSRB rule G–38 prohibits municipal securities dealers from making payments to consultants for soliciting municipal securities business.[22] We believe that MSRB rules G–37 and G–38 have been successful in addressing pay to play practices in the municipal securities market.[23]

Following the adoption of MSRB rule G–37, we were increasingly concerned that the very success of the rule may have caused pay to play practices to migrate to an area not covered by the MSRB rules—the management of public pension plans.[24] Public pension plans are particularly vulnerable to pay to play practices. Management decisions over these investment pools, some of which are quite large, are typically made by one or more trustees who are (or are appointed by) elected officials. And the elected officials 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,[25] may be members of a governing board that selects advisers,[26] or may appoint some or all of the board members who make the selection.[27]

In response to these concerns, in 1999 we proposed a rule under the Advisers Act, modeled substantially on MSRB rule G–37, that was designed to prevent advisers from participating in pay to play practices affecting the management of public pension plans.[28] In particular, the 1999 rule proposal would have prohibited an adviser from receiving compensation for the provision of advisory services for two years after the advisory firm or any of its partners, executive officers or solicitors, directly or indirectly, made a contribution to an elected official who (or a candidate for an elected office that) has the ability to influence the selection of the adviser.[29] Comments on the proposal were mixed, and some commenters that objected asserted that pay to play was not a problem in the management of public funds.[30]

Since then, it has become increasingly clear that pay to play is a significant problem in the management of public funds by investment advisers. In recent years, we and criminal authorities have brought a number of actions charging investment advisers with participating in pay to play schemes. We recently brought a civil action in Federal court charging former New York State officials, as well as a ''placement agent,'' with engaging in a fraudulent scheme to extract kickbacks from investment advisers seeking to manage assets of the New York State Common Retirement Fund.[31] Investment advisers allegedly paid sham ''placement agent'' fees, portions of which were funneled to public officials, as a means of obtaining public pension fund investments in the

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)] (''MSRB Rule G–37 Approval Order''), at sections V.A.1 and 2. In approving MSRB rule G–37, we concluded that pay to play practices may harm the municipal markets by fostering a selection process that excludes those firms that do not make contributions, causes less qualified underwriters to be retained, and undermines equitable practices in the municipal securities industry. *Id.* at section V.

[20] MSRB rule G–37(b). Shortly after MSRB rule G–37 became effective, a municipal securities dealer challenged it as an infringement on the constitutional rights of municipal securities professionals. A Federal appeals court upheld the constitutionality of MSRB rule G–37, finding that the rule is narrowly tailored to serve a compelling government interest. *See Blount, supra* note 16.

[21] MSRB rule G–37(c). A ''municipal finance professional'' is an associated person of a broker-dealer who is ''primarily engaged'' in municipal securities activities, who solicits municipal securities business on behalf of a broker-dealer, who supervises associated persons primarily engaged in municipal securities activities ''up through and including'' the chief executive officer of the firm (or person performing similar functions), or who is a member of the firm's executive or management committee (or person performing similar functions). MSRB rule G–37(g)(iv).

[22] MSRB rule G–38(a).

[23] Others, including the MSRB, agree. *See, e.g.,* MSRB Notice 2009–35, *Request for Comment: Rule G–37 on Political Contributions and Prohibitions on Municipal Securities Business—Bond Ballot Campaign Committee Contributions* (June 22, 2009) (''The MSRB believes the rule has provided substantial benefits to the industry and the investing public by greatly reducing the direct connection between political contributions given to issuer officials and the awarding of municipal securities business to dealers, thereby effectively eliminating pay-to-play practices in the new issue municipal securities market.'' [footnote omitted]); MSRB Notice 2003–32, *Notice Concerning Indirect Rule Violations: Rules G–37 and G–38* (Aug. 6, 2003) (''The impact of Rules G–37 and G–38 has been very positive. The rules have altered the political contribution practices of municipal securities dealers and opened discussion about the political contribution practices of the entire municipal industry.''); Letter from Darrick L. Hills and Linda L. Rittenhouse of the CFA Institute to Jill C. Finder, Asst. Gen. Counsel of the MSRB, dated Oct. 19, 2001, *available at http://www.cfainstitute.org/centre/topics/comment/2001/01msrb_ruleg37.html* (stating, ''We generally believe that the existing [MSRB] pay-to-play prohibitions have been effective in stemming practices that compromise the integrity of the [municipal securities] market by using political contributions to curry favor with politicians in positions of influence.''); Cmte. on Cap. Mkts. Reg., *Interim Report of the Cmte. on Cap. Mkts. Reg.* (Nov. 30, 2006), *available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf* (stating, upon describing MSRB Rule G–37 and the 2005 amendments to MSRB Rule G–38, ''Taken together, the MSRB's rules have largely put an end to the old ''pay to play'' practices in municipal underwriting.'').

[24] 1999 Proposing Release, *supra* note 17, at section I (''We have become particularly concerned about the possibility that the adoption of rule G–37 has resulted in a shift of pay to play practices to [the management of public pension funds] as political contributions by broker-dealers are curtailed.''). *See also* Bill Krueger, *Money Managers Giving to Boyles,* News & Observer (May 2, 1996), at A1 (noting that rule G–37 ''dried up'' a contribution source for a State treasurer, ''so now he is getting campaign contributions from a group [investment advisers] that is not subject to [rule G–37]''); Gerri Willis, *Filling Carl's War Chest: Comptroller Getting Thousands From State's Money Managers,* Crain's N.Y. Bus. (Sept. 16, 1996), at 1 (noting the observation of a securities executive that ''[b]ecause of the SEC's crackdown on the pay to play nature of the muni bond business, the game has shifted to asset management and brokerage'').

[25] *See, e.g.,* 2 NYCRR § 320.2 (placement of State and local government retirement systems assets (valued at $109 billion as of Mar. 2009) is under the sole custodianship of the New York State Comptroller).

[26] *See, e.g.,* S.C. Code Ann. §§ 9–1–20, 1–11–10 (2008) (board consists of all elected officials); Cal. Gov't Code § 20090 (Deering 2008) (board consists of some elected officials, some appointed members, and some representatives of interest groups chosen by the members of those groups); Md. Code Ann., State Pers. & Pens. § 21–104 (2008) (pension board consists of some elected officials, some appointed members, and some representatives of interest groups chosen by the members of those groups).

[27] *See, e.g.,* Ariz. Rev. Stat. Ann. § 38–713 (2008) (governor appoints all nine members); Hawaii Rev. Stat. § 88–24 (2008) (governor appoints three of eight members); Idaho Code § 59–1304 (2008) (governor appoints all five members).

[28] *See* 1999 Proposing Release, *supra* note 17.

[29] *See id.,* at section II.A.1.

[30] We received 59 comment letters on our 1999 proposal. Commenters representing beneficiaries and public pension plans expressed concern about pay to play practices and generally favored our proposed rule. State government officials and investment advisers generally opposed the rule. State government officials generally argued that there was no demonstrated need for the proposed rule and that State laws are adequate to address any concerns. Most advisers submitting comments opposed the rule's breadth and complained that the consequences of violating the rule were too harsh; some denied the existence of the problem we sought to address. Comment letters on our 1999 proposal and a summary of comments prepared by our staff are available in our Public Reference Room in File No. S7–19–99. Comment letters we received electronically are also available at *http://www.sec.gov/rules/proposed/s71999.shtml.*

[31] *See SEC* v. *Henry Morris, et al.,* Litigation Release No. 21036 (May 12, 2009).

funds those advisers managed.[32] Another settled administrative action involved an investment adviser who allegedly paid kickbacks in return for investment advisory business awarded by the New Mexico State treasurer's office.[33] In addition, we brought two separate cases against the former treasurer of the State of Connecticut and various other parties in which we alleged that the former treasurer awarded State pension fund investments to private equity fund managers in exchange for fees paid to the former treasurer's friends and political associates.[34] Criminal authorities have in recent years also brought cases in New York,[35] New Mexico,[36] Illinois,[37] Ohio,[38] Connecticut,[39] and Florida,[40] charging defendants with the same or similar conduct. In addition, there are a growing number of reports about pay to play activities involving investment advisers in other jurisdictions.[41] These cases involving investment advisers, as well as others involving broker-dealers, may reflect more widespread involvement by securities professionals in pay to play activities.[42]

Recognizing the harm pay to play practices cause in the management of public funds, several States, counties, localities, and even individual public pension funds, have undertaken to prohibit or regulate these practices in recent years.[43] And, most recently, in response to pay to play scandals that have emerged in their jurisdictions, public officials with oversight of public pension funds have written to us expressing support for a Commission rule to prohibit investment advisers from participating in pay to play practices, including prohibiting the use by advisers of placement agents (or other types of consultants) to help secure government business.[44]

These developments indicate that investment advisers may be playing an increasing role in pay to play activities. We therefore believe it is time for us to act with respect to investment advisers who may engage in such activities.[45]

[32] *See id.*

[33] *See In the Matter of Kent D. Nelson,* Investment Advisers Act Release No. 2765 (Aug. 1, 2008); Initial Decision Release No. 371 (Feb. 24, 2009); Investment Advisers Act Release No. 2868 (Apr. 17, 2009) (in which investment adviser was barred from association with any broker, dealer or investment adviser).

[34] *See SEC* v. *Paul J. Silvester et al.,* Litigation Release No. 16759 (Oct. 10, 2000); Litigation Release No. 20027 (Mar. 2, 2007); Litigation Release No. 19583 (Mar. 1, 2006); Litigation Release No. 18461 (Nov. 17, 2003); Litigation Release No. 16834 (Dec. 19, 2000); *SEC* v. *William A. DiBella et al.,* Litigation Release No. 20498 (Mar. 14, 2008). *See also U.S.* v. *Ben F. Andrews,* Litigation Release No. 19566 (Feb. 15, 2006); *In the Matter of Thayer Capital Partners, TC Equity Partners IV, L.L.C., TC Management Partners IV, L.L.C., and Frederick V. Malek,* Investment Advisers Act Release No. 2276 (Aug. 12, 2004); *In the Matter of Frederick W. McCarthy,* Investment Advisers Act Release No. 2218 (Mar. 5, 2004); *In the Matter of Lisa A. Thiesfield,* Investment Advisers Act Release No. 2186 (Oct. 29, 2003).

[35] *See New York* v. *Henry ''Hank'' Morris and David Loglisci,* Indictment No. 25/2009 (NY Mar. 19, 2009) (alleging that the deputy comptroller and a ''placement agent'' engaged in enterprise corruption and State securities fraud for selling access to management of public funds in return for kickbacks and other payments for personal and political gain).

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

[37] *See* Jeff Coen *et al., State's Ultimate Insider Indicted,* Chicago Tribune (Oct. 31, 2008) (describing the thirteenth indictment in an Illinois pay to play probe).

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

[39] *See U.S.* v. *Joseph P. Ganim,* 2007 U.S. App. LEXIS 29367 (2d Cir. 2007) (affirming the district court's decision to uphold an indictment of the former mayor of Bridgeport, Connecticut, in connection with his conviction for, among other things, requiring payment from an investment adviser in return for city business); *U.S.* v. *Triumph Capital Group, et al,* No. 300CR217 JBA (D. Conn. filed Oct. 10, 2000) (the former treasurer, along with certain others, pleaded guilty—while others were ultimately convicted).

[40] *See United States* v. *Poirier,* 321 F.3d 1024 (11th Cir.), *cert. denied sub nom., deVegter* v. *United States,* 540 U.S. 874 (2003) (partner at Lazard Freres & Co., a municipal services firm, was found liable for conspiracy and wire fraud for fraudulently paying $40,000 through an intermediary to Fulton County's independent financial adviser to secure an assurance that Lazard would be selected for the Fulton County underwriting contract).

[41] *See, e.g.,* David Zahniser, *California; Private Finances, Public Role Intersect; Former Pension Board Member Had Consulted for a Firm that Sought Work with the Panel on Which He Served,* Los Angeles Times (May 9, 2009) (discussing alleged pay to play activities relating to a former member of the Los Angeles Fire and Police Pensions Board); Rick Rothacker & David Ingram, *Moore Defends Pension System,* Charlotte Observer (Feb. 25, 2007) (discussing alleged pay to play activities involving North Carolina's State treasurer); Len Boselovic, *Pensions, Politics and Consultants Make for Unsavory Bedfellows,* Pittsburgh Post-Gazzette (Aug. 13, 2006) and Jeffrey Cohan, *Fund Managers 'Pay to Play': Six Firms Managing County's Pension Investments Gave to Board Members' Campaigns,* Pittsburgh Post-Gazzette (Feb. 22, 2001) (discussing alleged pay to play activities relating to the Allegheny County Retirement Board); Mary Williams Walsh, *Political Money Said to Sway Pension Investments,* N.Y. Times (Feb. 10, 2004) (regarding a 2002 audit by then-new controller of Luzerne County, Pennsylvania alleging pay to play activities among various parties involved with county pension funds).

[42] For example, we recently brought a case against the mayor of Birmingham, Alabama, and other defendants, alleging that while the mayor served as president of the County Commission of Jefferson County, Alabama, he accepted undisclosed cash and benefits through a lobbyist as a conduit from the chairman of a Montgomery, Alabama-based broker-dealer, in return for awarding municipal bond business and swap transactions to the broker-dealer. *See SEC* v. *Larry P. Langford et al.,* Litigation Release No. 20545 (Apr. 30, 2008). Several years earlier, we brought an enforcement action against the former treasurer of the City of Chicago, to whom two registered representatives were alleged to have made secret cash payments to obtain a share of the city's lucrative securities investments. *See SEC* v. *Miriam Santos et al.,* Litigation Release No. 17839 (Nov. 14, 2002); Litigation Release No. 19269 (June 14, 2005). We also brought enforcement actions against the registered representatives allegedly involved in the scheme. *See SEC* v. *Miriam Santos, Peter J. Burns, and Michael F. Hollendoner,* Litigation Release Nos. 19270 and 19271 (June 14, 2005). In addition, we brought a case against a broker-dealer, two of its officers and a city official for participating in a scheme to defraud the City of Atlanta in connection with the purchase and sale of certain securities while providing substantial, undisclosed monetary benefits to the city's investment officer who was authorized to select a broker-dealer for the transactions. *See In the Matter of Pryor, McClendon, Counts & Co., Inc. et al.,* Securities Act Release No. 7673 (Apr. 29, 1999); Securities Act Release No. 8062 (Feb. 6, 2002); Exchange Act Release No. 48095 (June 26, 2003); Securities Act Release No. 8245 (June 26, 2003); Securities Act Release No. 8246 (June 26, 2003).

[43] For an example of a State statutory restriction on pay to play activities, *see* Ill. Pub. Act 095–0971 (2008). For an example of a restriction pursuant to a State constitutional amendment, *see* Colo. Const. amend. LIV (2008). For an example of a county restriction, *see* Resolution No. 08–397 (May 8, 2008) Special Pay to Play Restrictions for Professional Service Contracts and Extraordinary Unspecifiable Service Contracts, Monmouth County, NJ. For an example of a city restriction, *see* Ordinance 3663 (July 2, 2007), Prohibition of Redevelopment with Certain Contributors, Township of Franklin, NJ. For an example of a particular local government agency restriction, *see* Cal. Pub. Util. Code § 130051.20 (2008), Contributions to Authority Members, Los Angeles County Metropolitan Transportation Authority. For an example of a particular public pension fund restriction, *see* Prohibitions on Campaign Contributions, California State Teachers' Retirement System, 5 CCR § 24010 (2009).

[44] *See, e.g.,* Letter from New York City Comptroller William C. Thompson, Jr., to Securities and Exchange Commission Chairman Mary L. Schapiro, dated May 12, 2009, *available at http://www.comptroller.nyc.gov/press/pdfs/05-13-09_SEC-letter.pdf,* at 2; Letter from New York State Comptroller Thomas P. DiNapoli to Securities and Exchange Commission Chairman Mary L. Schapiro, dated May 7, 2009, *available at http://www.osc.state.ny.us/press/releases/may09/sec050709.pdf,* at 1–2.

[45] Another reason we believe it is important for us to act is because pay to play practices are characterized by what the *Blount* court called a ''collective action problem [that tends] to make the misallocation of resources persist.'' *Blount, supra* note 16 at 945–46. Elected officials that accept contributions from State contractors may believe

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Section 206(1) of the Advisers Act prohibits an investment adviser from ''employ[ing] any device, scheme, or artifice to defraud any client or prospective client.'' [46] Section 206(2) prohibits advisers from engaging in ''any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client.'' [47] The Supreme Court has construed section 206 as establishing a Federal fiduciary standard governing the conduct of advisers.[48]

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.[49] In making such contributions, the adviser hopes to benefit from officials that ''award the contracts on the basis of benefit to their campaign chests rather than to the governmental entity.'' [50] If pay to play is a factor in the selection process, the public pension plan can be harmed in several ways. The most qualified adviser may not be selected, potentially leading to inferior management, diminished returns or greater losses. 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 may be directed for the benefit of the adviser, potentially at the expense of the pension plan, thereby using a pension plan asset for the adviser's own purposes.[51]

We believe that play to play is inconsistent with the high standards of ethical conduct required of fiduciaries under the Advisers Act. We have authority under section 206(4) of the Act to adopt rules ''reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.'' [52] Congress gave us this authority to prohibit ''specific evils'' that the broad anti-fraud provisions may be incapable of covering.[53] The provision thus permits the Commission to adopt prophylactic rules that may prohibit acts that are not themselves fraudulent.[54] As noted above, pay to play practices are rarely explicit and often hard to prove, which makes a prophylactic rule particularly appropriate.[55] We are today proposing new rule 206(4)–5 under the Advisers Act designed to eliminate adviser participation in pay to play practices.

II. Discussion

A. Rule 206(4)–5: ''Pay To Play'' Restrictions

The rule we are proposing today is designed to protect public pension plans from the consequences of pay to play practices by preventing advisers' participation in such practices. As a result, advisers and government officials may attempt to structure their transactions in a manner intended to hide the true purpose of a contribution or a payment. For that reason, our proposed pay to play restrictions would capture not only direct political contributions by advisers, but also other ways that advisers may engage in pay to play arrangements. Rule 206(4)–5 would accomplish this through three measures. First, the rule would make 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 that is in a position to influence the award of advisory business.[56]

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they have an advantage over their opponents that forswear the contributions, and firms that do not ''pay'' may fear they will lose government business to those that do. *See id. See generally* Mancur Olson, The Logic of Collective Action; Public Goods and the Theory of Groups 44 (17th ed. 1998) (group members that seek to maximize their individual personal welfare will not act to advance common objectives absent coercion or other incentive**).** *See also* Paul Jacobs, *Donations to Pension Officials Scrutinized; Politics: Connell, Fong Say They Are not Influenced by Contributions from Firms Doing Business with State Systems,* L.A. Times, Aug. 21, 1997, at A41 (fund contractor quoted as saying, ''[i]f you don't contribute, you're subject to the concern that others might make contributions'').

[46] 15 U.S.C. 80b–6(1).

[47] 15 U.S.C. 80b–6(2).

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

[49] *See* 1999 Proposing Release, *supra* note 17, at 3. As a fiduciary, an adviser has a duty to deal fairly with clients and prospective clients, and must make full disclosure of any material conflict or potential conflict. *See, e.g., Capital Gains Research Bureau,* 375 U.S. at 189, 191–192; Release 1092, *supra* note 7. Most public pension plans establish procedures for hiring investment advisers, the purpose of which is to obtain the best possible management services. When an adviser makes political contributions for the purpose of influencing the selection of the adviser to advise a public pension plan, the adviser seeks to interfere with the merit-based selection process established by its prospective clients—the public pension plan. The contribution creates a conflict of interest between the adviser (whose interest is in being selected) and its prospective client (whose interest is in obtaining the best possible management services). Even if the conflict was acknowledged and disclosed by the adviser, disclosure may not be effective in protecting the plan from harm. Disclosure to the trustee or board of trustees may be futile in protecting the plan since the trustees may be similarly conflicted, having accepted the contribution. Disclosure to beneficiaries may also be inadequate as they may be unable to act on the disclosure—beneficiaries generally cannot fire the adviser or find another pension plan.

[50] *See Blount, supra* note 16, at 944–45.

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

[52] 15 U.S.C. 80b–6(4).

[53] S. Rep. No. 1760, 86th Cong., 2d Sess. 4, 8 (1960). The Commission has used this authority to adopt seven rules addressing abusive advertising practices, custodial arrangements, the use of solicitors, required disclosures regarding the adviser's financial condition and disciplinary history, proxy voting, compliance procedures and practices, and deterring fraud with respect to pooled investment vehicles. 17 CFR 275.206(4)–1; 275.206(4)–2; 275.206(4)–3; 275.206(4)–4; 275.206(4)–6; 275.206(4)–7; and 275.206(4)–8.

[54] Section 206(4) was added to the Advisers Act in *Public Law* 86–750, 74 Stat. 885 (1960) at sec. 9. *See* H.R. Rep. No. 2197, 86th Cong., 2d Sess. (1960) at 7–8 (''Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud and deceit * * * [Section 206(4)] would empower the Commission, by rules and regulations to define, and prescribe means reasonably designed to prevent, acts, practices, and courses of business which are fraudulent, deceptive, or manipulative. This is comparable to Section 15(c)(2) of the Securities Exchange Act [15 U.S.C. 78o(c)(2)] which applies to brokers and dealers.''). *See also* S. Rep. No. 1760, 86th Cong., 2d Sess. (1960) at 8 (''This [section 206(4) language] is almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers.''). The Supreme Court, in *United States* v. *O'Hagan,* interpreted nearly identical language in section 14(e) of the Securities Exchange Act [15 U.S.C. 78n(e)] as providing the Commission with authority to adopt rules that are ''definitional and prophylactic'' and that may prohibit acts that are ''not themselves fraudulent * * * if the prohibition is 'reasonably designed to prevent * * * acts and practices [that] are fraudulent.''' *United States* v. *O'Hagan,* 521 U.S. 642, at 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Securities Exchange Act. *See also Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles,* Investment Advisers Act Release No. 2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] (stating, in connection with the suggestion by commenters that section 206(4) provides us authority only to adopt prophylactic rules that explicitly identify conduct that would be fraudulent under a particular rule, ''We believe our authority is broader. We do not believe that the commenters' suggested approach would be consistent with the purposes of the Advisers Act or the protection of investors.'').

[55] *Cf. Blount, supra* note 16 at 945 (''no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic'').

[56] Proposed rule 206(4)–5(a)(1) states: ''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 Act [15 U.S.C. 80b–6(4)], it shall be unlawful:

Proposed rule 206(4)–5 would not, therefore, 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 aspect of the proposed rule is modeled on MSRB rule G–37 and is consistent with our 1999 proposal.

Second, the rule would prohibit advisers from paying third parties to solicit government entities for advisory business.[57] That is, an adviser would be prohibited from providing or agreeing to provide, directly or indirectly, payment to any person who is not a related person of the adviser for solicitation of government advisory business on behalf of such adviser. This aspect of our proposed rule is modeled on MSRB rule G–38.[58] Third, the rule would also make it unlawful for an adviser itself or through any of its covered associates to solicit or to coordinate contributions for an official of a government entity to which the investment adviser is seeking to provide investment advisory services, or 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. MSRB rule G–37 contains a similar prohibition, as did our 1999 proposal.[59]

We recognize that we cannot anticipate all of the ways advisers and government officials may structure pay to play arrangements to attempt to evade the prohibitions of our proposed rule. For that reason, we are also proposing to include a provision that would make 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 proposed rule. Finally, for purposes of the proposed rule, an investment adviser to certain pooled investment vehicles in which a government entity invests or is solicited to invest would be treated as though the adviser were providing or seeking to provide investment advisory services directly to the government entity.

Although today's proposal is similar to the one we made in 1999, we are proposing a few critical changes in response to intervening developments that we highlight in the discussion below. We have made these changes to conform our proposal to measures undertaken in recent years to curtail pay to play activities by the MSRB and various State and local authorities and to deter circumvention of the restrictions through the use of third-party placement agents or through an adviser obtaining government clients indirectly by soliciting investment in funds it manages.

1. Advisers Subject to the Rule

Proposed rule 206(4)–5 would apply 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)].[60] 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.[61] The rule would not apply, however, to most small advisers that are registered with the State securities authorities,[62] and certain other advisers that are exempt from registration with us.[63] We believe that the rule would apply to most advisers to public pension plans.[64] We request comment on the scope of the proposed rule. Should we apply the rule to State-registered advisers? Should we limit the rule only to advisers registered (or required to be registered) with us? Should we apply the rule to advisers that are exempt from registration in reliance on Advisers Act section 203(b)(3)? We request comment on whether we should extend the scope of the rule to apply to advisers exempt from registering with us pursuant to any or all of the other categories under Advisers Act section 203(b). For example, should we include advisers exempt from registration pursuant to any or all of Advisers Act sections 203(b)(1) (intrastate advisers), 203(b)(2) (advisers with only insurance company clients), 203(b)(4) (investments advisers that are charitable organizations), 203(b)(5) (advisers that are plans described in section 414(e) of the Internal Revenue Code of 1986 or certain persons associated with such plans), or 203(b)(6) (certain commodity trading advisors)?[65] To the extent that they are able to have government clients at all, are any of these advisers likely to engage in pay to play?

We note that proposed rule 206(4)–5 would regulate the activities of investment advisers—business organizations over which we have clear regulatory authority under the Advisers Act. The rule would have no effect on State laws, codes of ethics or other rules governing the activities of State and municipal officials or employees of

(1) For 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)], to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made).''

[57] Proposed rule 206(4)–5(a)(2)(i).

[58] MSRB rule G–38 was amended in 2005 to prohibit municipal securities dealers from paying third-party solicitors to solicit municipal securities business. *In the Matter of Self-Regulatory Organizations; Municipal Securities Rulemaking Board; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change Relating to Solicitation of Municipal Securities Business under MSRB Rule G–38,* Exchange Act Release No. 52278 (Aug. 17, 2005) [70 FR 49342 (Aug. 23, 2005)]. Our 1999 proposal did not include an analogous prohibition.

[59] *See* MSRB rule G–37(c); 1999 Proposing Release, *supra* note 17, at section II.A.2.

[60] Proposed 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.

[61] *See* discussion *infra* section II.A.3(e).

[62] Section 203A of the Advisers Act [15 U.S.C. 80b–3A] prohibits investment advisers with less than $25 million in assets under management from registering with the Commission; although we do not propose to include them within the coverage of this rule, they remain subject to the Act's general anti-fraud authority. *See, e.g., Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 1633, n.154 and accompanying text (May 15, 1997) [62 FR 28112 (May 22, 1997)] (''Both the Commission and the States will be able to continue bringing antifraud actions against investment advisers regardless of whether the investment adviser is registered with the State or the SEC.''). *See also* S. Rep. No. 293, 104th Cong., 2d Sess. 3–4 (1996) (''1996 Senate Report'') at 4.

[63] *See, e.g,* exemption for intrastate investment advisers under section 203(b)(1) [15 U.S.C. 80b–3(b)(1)].

[64] With the exception of the exemption from registration provided for by section 203(b)(3) [15 U.S.C. 80b–3(b)(3)], advisers that are exempt from SEC registration are unlikely to have State or municipal government clients as providing advisory services to them would result in the adviser no longer being eligible for the exemption, *e.g.,* section 203(b)(2) [15 U.S.C. 80b–3(b)(2)] and section 203(b)(4) [15 U.S.C. 80b–3(b)(4)]. Moreover, based on a review of a sampling of requests for proposals from State and municipal governments for investment advisory services, a common requirement is that the adviser be registered with the SEC or a State. *See, e.g., Request for Information Vermont Pension Investment Committee—Vermont Manager Program RFI* (Feb. 27, 2009) (stating that eligible investment advisers must be SEC-registered with at least $100 million in assets under management), *available at: http://www.vermonttreasurer.gov/documents/rfp/20090316_VPICVermontManagerProgram.pdf.* It also is our understanding from discussions with representatives of the State securities regulators that a very small percentage of State-registered advisers have State or municipal government clients.

[65] Our 1999 proposed rule would have applied to all investment advisers not prohibited from registering with the Commission. *See* 1999 Proposing Release, *supra* note 17.

public pension plans over whom we have no regulatory jurisdiction.[66]

2. Relationship With MSRB Rules; Alternative Approaches

As discussed above, we modeled proposed rule 206(4)–5 on MSRB rules G–37 and G–38, which we believe have successfully addressed pay to play in the municipal bond market. This approach should minimize the compliance burdens on firms that would be subject to both rule regimes because firms that are already subject to MSRB rules would already have developed policies and systems for compliance that could be adapted to meet investment adviser requirements. Certain provisions of our proposed rule, however, are somewhat different in ways that reflect the different statutory framework under which the rule would be adopted and the differences between municipal underwriting and asset management. Comment is requested on whether we should use rules G–37 and G–38 as the models for proposed rule 206(4)–5.[67] If not, are there alternative models that would be more appropriate? Are there significant differences in governments' selection process for municipal underwriters and investment advisers that we have not addressed but that should be reflected in the rule? Would our approach adequately protect public pension plans, their sponsors and participants against the adverse effects of pay to play practices?

We understand many advisers have established restrictions on pay to play practices in their codes of ethics and compliance policies. Instead of, or in addition to, adopting a new rule to address pay to play practices, should we amend our code of ethics rule[68] or our compliance rule[69] to require all registered advisers to adopt policies and procedures designed to prevent them from engaging in pay to play practices?[70] Should we instead, or also, require an executive officer of each adviser to certify annually that the adviser or its covered associates did not participate in pay to play? Should some other employee of the adviser, such as the chief compliance officer, make the certification?

In 1999, we considered proposing a different approach to address pay to play, which would have required an adviser to disclose information about its political contributions to officials of government entities to which it provided or was seeking to provide investment advisory services. We decided not to propose such an approach at that time because we thought that disclosure would not be effective to protect public pension plan clients.[71] Disclosure to a pension plan's trustees might be insufficient because, in some cases, the trustees would have received the contributions. Disclosure to plan beneficiaries also would likely be insufficient because they are generally unable to act on the information by moving their pension assets to a different plan or reversing adviser hiring decisions. Moreover, disclosure requirements may not stop pay to play practices and can be circumvented.[72] Accordingly, we do not believe that relying on disclosure is sufficient to address these problematic practices.[73] We request comment on whether we should, nonetheless, consider this approach, as well as potential alternative approaches that may be more effective or less costly.

3. Pay To Play Restrictions

(a) Two-Year ''Time Out'' for Contributors

Proposed rule 206(4)–5(a)(1) would prohibit investment advisers from providing advice for compensation to a ''government entity''[74] 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.''[75] We are proposing that the time out be two years long because the duration needs to be sufficiently long to have a deterrent effect. We recognize, however, that a longer ban could be overly harsh.[76] We note that MSRB rule G–37 contains a two-year time out, which appears, based on the success of the MSRB rules, to have operated as an effective deterrent

[66] A number of commenters in 1999, including those representing State and local officials, argued that the rule would be an intrusion on State sovereignty. We disagree. We have a responsibility to regulate the activities of investment advisers. Our objectives in the proposed rule do not relate to campaign finance, but rather to prohibiting fraudulent activity by investment advisers. We believe our proposed rule is appropriately tailored to those ends.

[67] For instance, in 1999, we requested comment on our use of MSRB rule G–37 as a model, and several commenters responded that, because of distinctions between the investment adviser profession and the municipal securities industry, we should not follow the approach of MSRB rule G–37. Some commenters asserted that, unlike municipal underwriters, advisers' business relationships with State and municipal clients are ongoing and long-term and thus the two-year ban is much more harsh a consequence. While municipal underwritings themselves tend to be episodic, underwriting relationships are often longstanding. As a result, the rules' time outs may have similar effects.

[68] Rule 204A–1 under the Advisers Act [17 CFR 275.204A–1].

[69] Rule 206(4)–7 under the Advisers Act [17 CFR 275.206(4)–7].

[70] Some commenters in 1999 suggested that the better approach would be to require advisers to adopt codes of ethics designed to prevent pay to play practices. The Investment Counsel Association of America (subsequently renamed the Investment Advisers Association) submitted to the comment file relating to our 1999 proposal ''*Best Practice Pay-to-Play Guidelines for Adviser Codes of Ethics,*'' advocating such an approach as an alternative to our 1999 proposal. *See http://www.sec.gov/rules/proposed/s71999/tittswo2.htm.* The ICAA offered the following three alternative policies on political contributions, and suggested that advisers should tailor these policies to fit their respective circumstances: (1) A contribution ban above a certain *de minimis* amount (either with respect to all political contributions or ones that fall within certain specified parameters); (2) a pre-clearance process for contributions; or (3) a disclosure policy with respect to contributions. At that time, codes of ethics were voluntary. However, in 2004, the Commission adopted a requirement that advisers adopt and implement codes of ethics that include a standard of conduct that reflects the adviser's fiduciary obligations, although the code of ethics rule does not directly address pay to play practices. *See* Advisers Act rule 204A–1 [17 CFR 275.204A–1]; *Investment Adviser Codes of Ethics,* Investment Advisers Act Release No. 2256 (July 2, 2004) [69 FR 41696 (July 9, 2004)]. *See also* Investment Counsel Association of America, Report on Pay-to-Play and the Investment Advisory Profession (May 15, 2000), *available at http://www.investmentadviser.org/eweb/docs/Publications_News/PublicDocs_UsefulWebsites/PubDoc/report* (condemning practices by which investment professionals try to gain access to business through political contributions, and urging its members to adopt codes of ethics designed to prevent pay to play).

[71] In response to our 1999 Proposal, some commenters suggested requiring advisers to disclose publicly their contributions to State and local officials. Statutes requiring disclosure of political contributions are designed to inform voters about a candidate's financial supporters; an informed electorate can then use the information to vote for or against a candidate. But, as several other commenters correctly pointed out, our goal is not campaign finance reform, and how voters might react to such disclosure is not, for us, the relevant concern. Our primary concern is the protection of advisory clients and investors who are affected by pay to play practices whom we have the responsibility to protect under the Advisers Act.

[72] *See infra* note 158 and accompanying text regarding swap arrangements that may be used to circumvent public disclosure.

[73] MSRB rule G–37, however, does establish a reporting and disclosure system for broker-dealers subject to that rule. MSRB rule G–37(e)(ii).

[74] ''Government entity'' is defined by the proposed rule as ''any State or political subdivision of a State, including any agency, authority, or instrumentality of the State or political subdivision, a plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof; and officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.'' Proposed rule 206(4)–5(f)(5).

[75] Proposed rule 206(4)–5(a)(1).

[76] We note that, notwithstanding the proposed duration of the rule's ''time out''—two years—the reach of the time out is relatively narrow in the sense that it only prohibits advisers from receiving compensation for providing advice from the particular government entities to whose officials triggering contributions have been made. It does not limit the adviser from receiving compensation from other government entities as to which triggering contributions have not been made.

in the municipal securities context.[77] We request comment on whether two years is an appropriate length of time.[78]

(1) Prohibition on Compensation

Investment advisers making contributions covered by the proposed rule would not be prohibited from providing advisory services to a government client, even after triggering the two-year time out. Instead, an adviser would be prohibited from *receiving compensation* for providing advisory services to the government client during the time out. This approach is intended to avoid requiring an adviser to abandon a government client after the adviser or any of its covered associates makes a political contribution covered by the rule. An adviser subject to the prohibition would likely, at a minimum, be obligated to provide (uncompensated) advisory services for a reasonable period of time[79] 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.[80] We request comment on our proposed approach. Is there another approach that would cause less disruption to the government client?

(2) Officials of a Government Entity

The prohibitions in the rule would be triggered by a contribution to an ''official'' of a ''government entity.'' Government entities under the proposed rule include all State and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds.[81] An official would include 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 selection of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for or can influence the outcome of the selection of an investment adviser.[82] Generally, executive or legislative officers who hold a position with influence over the hiring of an investment adviser are government officials under the proposed rule.[83] These definitions are substantively the same as those in MSRB rule G–37.[84]

We request comment on our proposed definition of ''official.'' For instance, a candidate for Federal office may be an ''official'' under the rule, just as such a person may be under MSRB rule G–37, not because of the office he or she is running for, but as a result of an office he or she currently holds.[85] As a preliminary matter, we do not believe that an incumbent State or local official should be excluded from the definition solely because he or she is running for Federal office, but we request comment on this aspect of the proposed rule. Should such a candidate for Federal office be excluded?[86] Are there other persons to whom an adviser or its covered associates might make a contribution to influence the selection of that adviser? For example, should we expand the rule's prohibitions to apply expressly in cases where an adviser or a covered associate gives a contribution to others closely associated with the official—such as an official's political action committee (''PAC''), his or her inauguration or transition committee,[87] a local or State political party that provides assistance to such official,[88] or

[77] *See supra* note 24. Several commenters in 1999 suggested that, because advisers' business relationships with State and municipal clients are ongoing and long-term, as compared to the relationships between municipal underwriters and their clients, the two-year ban is much more harsh a consequence. As we note above, while municipal underwritings themselves tend to be episodic, underwriting relationships are often longstanding, which may result in the rules' time outs having similar effects. *See supra* note 67.

[78] Some commenters in 1999 objected to two years as being too long a period of time (arguing, for example, that because changing investment advisers can be so disruptive to a pension fund that such a fund would be extremely unlikely to return to an adviser after a ''time out,'' thereby rendering the two-year ban tantamount to a permanent one), whereas others suggested that the period be longer or that it track the remainder of the term of the government official to whom the contribution was made.

[79] Some commenters in 1999 indicated concern that government entities that retain advisers who trigger the two-year time out—and would therefore be unable to receive compensation for two years—might try to delay an adviser's ability to withdraw in order to enjoy the benefits of investment advice for free. We believe that while an adviser's fiduciary obligations require it to act in the best interests of its clients, they do not require it to provide uncompensated advice indefinitely because it is prohibited from receiving compensation under the rule—rather, the adviser may need to continue to provide advice for only a reasonable period of time.

[80] An investment adviser that violates the rule may be required, under its fiduciary duties, to continue providing advisory services to the public pension plan, for a reasonable period of time, until the plan obtains a new adviser. *See Temporary Exemption for Certain Investment Advisers,* Investment Advisers Act Release No. 1846 (Nov. 29, 1999) [64 FR 68019, 68024 (Dec. 6, 1999)] (describing an investment adviser's fiduciary duties to an investment company in the case of an assignment of the advisory contract).

We note that the two-year time out in MSRB rule G–37 operates to prohibit a broker, dealer or municipal securities dealer from engaging in *all* municipal securities business; it does not distinguish between providing compensated and uncompensated services. MSRB Rule G–37(b)(i). *See also* MSRB Rule G–37 Interpretive Notices, Interpretation of Prohibition on Municipal Securities Business Pursuant to Rule G–37 (Feb. 21, 1997) (determining that once a dealer enters into contract and a subsequent contribution results in a prohibition, the dealer ''should not be allowed to continue with the municipal securities business, subject to an orderly transition to another entity to perform such business''). *But see infra* note 189 (discussing MSRB's approach to transitions in the context of pre-existing engagements relating to municipal fund securities, such as interests in Section 529 plans).

[81] *See supra* note 74.

[82] Proposed rule 206(4)–5(f)(6). The two-year time out would be triggered by contributions, not only to elected officials who have legal authority to hire or select the adviser, but to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser. A person who serves at the will of an elected official is likely to be subject to that official's influences and recommendations. We note that MSRB rule G–37 also applies to elected officials empowered to appoint persons with the authority to select which broker-dealers will receive government business.

[83] 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.

[84] *See* MSRB rule G–37(g)(ii) and (g)(vi).

[85] Proposed rule 206(4)–5(f)(6), in relevant part, defines ''official'' as *any person* * * * who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity * * *, '' and a ''government entity,'' in relevant part, as ''any State or political subdivision of a State'' (emphasis added). Accordingly, any person, including a person running for Federal office, who meets the definition of ''official'' would be covered under the rule. *See also* MSRB rule G–37(g)(ii) and (g)(vi) (defining ''issuer'' and ''official of an issuer'', respectively); MSRB Qs & As, Question IV.2 and IV.3, *available at http://www.msrb.org/msrb1/rules/QAG-372003.htm* (explaining how G–37 applies to candidates for Federal office).

[86] Some 1999 commenters urged that contributions to candidates for Federal office be excluded from the rule, while others agreed these contributions should be covered. In particular, certain commenters asserted that this aspect of the proposed rule would have a disparate effect on candidates for Federal office because State and local politicians would experience limitations on their ability to receive Federal campaign contributions while their opponents would be subject to no such limitations. These commenters also claimed the rule would have little effect because if the candidate for Federal office was successful, he or she would quickly lose his or her ability to influence the selection of an investment adviser at the State or local level. Other commenters thought it appropriate that the rule apply to candidates for Federal office. As noted above, our emphasis in the proposed rule remains on the *current* office of an elected official and his or her ability to affect the selection of an investment adviser, regardless of what outside positions that official may seek.

[87] A contribution to an official, as opposed to a committee, for inauguration or transition expenses would be a contribution under the proposed rule. *See infra* note 93 and accompanying text. This approach is consistent with the approach in MSRB rule G–37. We are proposing a similar approach for reasons of regulatory consistency; nonetheless, we have included this request for comment on whether we should include contributions to such committees.

[88] Under the proposed rule, such contributions or payments by an adviser (or its covered associates) would only trigger the rule's provisions to the extent that an adviser was trying to do indirectly

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a foundation or other charitable institution associated with such official? [89]

(3) Contributions

The proposed rule covers ''contributions'' made by an investment adviser and its covered associates. The proposed rule uses the same definition of contribution as MSRB rule G–37.[90] A contribution would generally be any gift, subscription, loan, advance, deposit of money, or anything of value [91] 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.[92] It would also include transition or inaugural expenses incurred by a successful candidate for State or local office.[93] We request comment on our proposed definition of ''contribution.'' [94] Are there additional items of value that, as with transitional or inaugural expenses, should be specified in and covered by the definition? For instance, should we include the expenses an investment adviser would incur in organizing or sponsoring a conference at which a government official is invited to attend or is a speaker? [95] If so, how should our rule distinguish legitimate conferences or meetings from those that are more akin to fundraising events? [96] Are there items that should be excluded from the definition?

(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. For this reason, MSRB rule G–37 limits its prohibitions to contributions made by ''municipal finance professionals'' employed by a broker-dealer. No group analogous to municipal finance professionals, however, exists within the typical investment advisory firm. In many of the pay to play enforcement actions we have brought involving investment advisers, we have alleged that political contributions or other payments were made to influence the selection of the advisory firm by executives of the adviser or persons who solicit government clients on behalf of the adviser.[97] We therefore are proposing to limit application of the rule's ''time out'' provision to contributions made by the adviser and its ''covered associates,'' which would include the adviser's general partners, managing members, executive officers, or other individual with a similar status or function.[98] Any employee of the

what it is prohibited from doing directly. *See infra* section II.A.3(d) of this Release. In contrast, the prohibition on advisers soliciting contributions or payments from others in proposed rule 206(4)–5(a)(2)(ii) would expressly include 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. *See infra* section II.A.3(c) of this Release. Further, our proposed amendments to rule 204–2 (in particular, rule 204–2(a)(18)(i)(D)) would expressly include a requirement that an adviser subject to the rule make and keep records of, among other things, all direct or indirect contributions or payments made by the investment adviser or any of its covered associates to a political party of a State or political subdivision thereof. Our proposed approach to these provisions generally tracks the MSRB approach.

[89] For a discussion of associated recordkeeping requirements, *see infra* note 206 and accompanying text.

[90] MSRB rule G–37(g)(i).

[91] Commenters to our 1999 proposal raised concerns that volunteer campaign work by advisory employees could trigger the proposed rule's time out provision. We would not consider volunteer campaign work 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, are not used. *Cf.* MSRB Qs & As, Question II.12, *available at http://www.msrb.org/msrb1/rules/QAG-372003.htm.*

[92] Proposed rule 206(4)–5(f)(1). Commenters in 1999 expressed concern that the scope of our proposed rule was too broad. These commenters, many of whom represented investment advisers, raised concerns that the rule as proposed could unnecessarily restrict their employees from making *any* political contributions. Some commenters questioned the constitutionality of our proposal, arguing that the proposed rule would violate First Amendment protections for free speech. In *Blount, supra* note 16, a Federal appeals court upheld a First Amendment challenge to MSRB rule G–37. The Court left open the question of the appropriate level of scrutiny to be applied, but concluded that the rule satisfied even a strict scrutiny test. We believe that the rule we are proposing today similarly is consistent with the First Amendment. Absent provisions to limit the application of the rule's prohibitions, it could result in frequent inadvertent violations that would carry harsh consequences for advisers. Accordingly, we refined the categories of persons whose personal political contributions would be covered under the rule and provided for a self-executing exception that should prevent many inadvertent violations. We believe these changes will address many of the commenters' concerns about the rule we proposed in 1999.

[93] Proposed rule 206(4)–5(f)(1)(iii). Transition or inaugural expenses of a successful candidate for *Federal* office are *not* included. Contributions to political parties are not specifically covered by the definition and thus would not trigger the proposed rule's two-year timeout unless they are a means to do indirectly what the proposed rule would prohibit if done directly (for example, the contributions are earmarked or known to be provided for the benefit of a particular political official). *See* proposed rule 206(4)–5(d). Contributions to State and local political parties are, however, subject to the proposed rule's recordkeeping requirements. *See infra* section II.B and proposed rule 204–2(a)(18)(i)(D).

[94] Commenters in 1999 urged us to adopt a rule prohibiting only political contributions *intended* to influence, or made *for the purpose* of influencing, adviser selection. This approach, they argued, would eliminate the risk that innocent campaign contributions would trigger application of the ''two-year time out.'' Political contributions are made ostensibly to support a candidate, however, and the burden of proving a different intent is very difficult absent unusual evidence. As one court noted, ''actors in this field are presumably shrewd enough to structure their relations rather indirectly.'' *Blount, supra* note 16. As a result, requiring proof of such an intent would greatly diminish, if not eliminate, the prophylactic value of the proposed rule.

[95] Under the proposed rule, an adviser would be prohibited from soliciting contributions for the official. Proposed rule 206(4)–5(a)(2)(ii).

[96] *Cf. Supervision When Sponsoring Meetings and Conferences Involving Issuer Officials,* MSRB Rule G–37 Interpretive Notice (Mar. 26, 2007), *available at http://www.msrb.org/msrb1/rules/notg37.htm* (rather than addressing meetings and conferences of this nature in its rules directly, the MSRB applies a facts-and-circumstances test on a case-by-case basis).

[97] *See, e.g., In the Matter of Barrett N. Wissman,* Investment Advisers Act Release No. 2879 (May 22, 2009) (in a settled action, the Commission alleged that managing director of registered investment adviser engaged in a fraudulent scheme involving undisclosed kickback payments made by investment management firms and others in connection with the sale of securities to the New York Common Retirement Fund and the investment of the fund's assets in the purchase and sale of securities); *In the Matter of Thayer Capital Partners, TC Equity Partners IV, L.L.C., TC Management Partners IV, L.L.C., and Frederick V. Malek,* Investment Advisers Act Release No. 2276 (Aug. 12, 2004) (in a settled action, the Commission alleged that unregistered adviser, through its chairman, agreed to hire an inexperienced associate of the Connecticut Treasurer as a consultant as a condition to securing a State pension fund investment); *In the Matter of Frederick W. McCarthy,* Investment Advisers Act Release No. 2218 (Mar. 5, 2004) (in a settled action, the Commission alleged that principal and chairman of investment management firm provided $2 million in consulting contracts to associates of the Connecticut Treasurer in order to secure the Treasurer's decision to invest). We have also observed this pattern of contributions in pay to play arrangements in other contexts, including those involving union pension funds. *See, e.g., In the Matter of William M. Stephens,* Investment Advisers Act Release No. 2076 (Nov. 4, 2002) (in a settled action, the Commission alleged that executive vice president and chief investment strategist of registered investment adviser met with people who offered to introduce him to the trustees of union pension funds, and he agreed that after he and his firm became the funds' adviser, he would arrange to divert a portion of the funds into investments controlled by the people who made the introductions, who would, in turn, pay kickbacks to the pension fund trustees who hired him and his firm); *In the Matter of Chris Woessner,* Investment Advisers Act Release No. 2164 (Aug. 26, 2003) (Commission alleged that former vice president of sales at registered investment adviser who was in charge of marketing to pension plans caused his firm to direct client commissions for the benefit of a broker-dealer and pension consultant in exchange for the referral of a union pension fund client to the firm).

[98] Proposed rule 206(4)–5(f)(2)(i). Under our 1999 proposal, the rule would have applied more broadly to ''partners'' (not just a general partner or equivalent) and ''executive officers'' (which we proposed to define as ''the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the investment adviser''). *See* 1999 Proposing Release, *supra* note 17, at section II.A.1. Commenters in 1999 suggested that, instead of applying the rule to *all* partners, we

adviser who solicits [99] government entity clients for the investment adviser would also be a covered associate,[100] as would any PAC controlled by the investment adviser or any of the adviser's covered associates.[101]

Under the proposed rule, the term ''executive officer'' includes the adviser's president and any vice president in charge of a principal business unit, division or function (such as sales, administration or finance) or any other executive officer who, in each case, in connection with his or her regular duties: (i) Performs investment advisory services (or supervises someone who performs them) for an adviser; (ii) solicits (or supervises someone who solicits) for an adviser, including with respect to investors for a covered investment pool; [102] or (iii) supervises, directly or indirectly, executive officers described in (i) or (ii).[103] Accordingly, for instance, the proposed rule would cover contributions by a portfolio manager who is an executive officer, as well as contributions by anyone in the portfolio manager's chain of supervision up to and including the president of the adviser. The rule would also cover contributions by an executive officer who supervises personnel who solicit advisory clients and contributions by anyone in that executive's chain of supervision. The rule would not, however, cover contributions by the adviser's other executives, such as its comptroller, its head of human resources, or its director of information services, unless the contribution is an indirect contribution for the adviser, because the compensation of these individuals is likely to be tied less directly to obtaining or retaining clients.

Contributions by non-executive employees (other than those who solicit government entity clients) would not trigger the rule's prohibitions, unless the adviser or any of its covered associates used the person to indirectly make a contribution.[104] This could occur, for example, if a firm paid a non-executive employee a bonus with the understanding that the bonus would be used by the employee to make a political contribution that, if made by the firm, would trigger the rule's prohibition.[105]

As noted above, the Commission has drafted the proposed rule so that its prohibitions are triggered by political contributions by persons who, in the context of an advisory firm, are likely to have an economic incentive to make contributions to influence the advisory firm's selection and the categories of executives and employees of an adviser that we have seen, most typically, to make political contributions and payments in pay to play situations. We are mindful of the burdens the proposed rule would place on advisory firms and on the ability of persons associated with an adviser to participate in civic affairs. We thus have narrowly tailored the rule to achieve our goal of preventing adviser participation in pay to play practices.

We request comment on the scope of the proposed rule and, in particular, those persons associated with the advisers whose political contributions would trigger the application of the two-year ''time out'' and would be prohibited from soliciting political contributions from others. Have we included persons most likely to have an economic incentive to make political contributions for the purpose of influencing the selection of the adviser?

Have we covered too many persons? If so, how should we narrow the rule? For example, are there certain executive officers of the adviser we should not include? The proposed rule would cover all executive officers who, as part of their regular duties, perform investment advisory services or supervise someone who performs them. Should we instead limit the scope to a subset of such officers? If so, how should we define that subset? [106] Should we extend the rule to cover all portfolio managers, or just those portfolio managers responsible for managing government client assets? Are there other types of employees whose contributions should trigger the time out?

Have we too narrowly drawn the rule to achieve our goals? Should we, for example, include employees of companies that are related persons of an adviser who solicit government entity clients for the investment adviser? As discussed further below, we propose permitting payments to these persons under the proposed ban on payments to third parties because we recognize that an adviser may rely on them to assist it in seeking government clients.[107] Would that same rationale support including them as ''covered associates'' of the adviser (whose contributions would be subject the proposed rule's two-year time out provision)? Would not including them be likely to encourage circumvention of the rule's requirements? [108] We also request comment on whether we should, for example, include certain family members who, and related businesses that, might give political contributions on the adviser's behalf to try to

narrow the rule to apply only to a firm's general partner (or equivalent) and other owners that have a significant ownership interest in the firm. Commenters also suggested that we either exclude executive officers of divisions unrelated to the firm's solicitation and/or advisory functions or limit the rule's application to only the most senior officers of an adviser, such as persons required to be listed on Schedule A of Form ADV. In light of these comments, we have included in our proposed definition of ''covered associates'' only those persons associated with an investment adviser who we believe are more likely to have an economic incentive to make contributions to influence the advisory firm's selection and who we have found, in our enforcement actions, typically make contributions.

[99] *See* proposed rule 206(4)–5(f)(10) (defining ''solicit'').

[100] Proposed rule 206(4)–5(f)(2)(ii). Several commenters in 1999 argued that we would have included too broad a category of solicitors because our definition of ''solicitor'' would have included any person who solicited *any* client for or referred *any* client to the adviser. The two-year time out would have been triggered, for example, by registered representatives who solicited brokerage business for a firm dually registered as a broker-dealer and as an adviser, even though the registered representatives had no involvement with government clients. *See* 1999 Proposing Release, *supra* note 17, at section II.A.1. We have included a narrower category of solicitors in our current proposed rule; the two-year time out provisions would be triggered by a contribution by a person who solicits government entities for advisory services. Many commenters also urged that the definition of ''solicitor'' exclude third-party solicitors. They asserted that it was unfair to hold advisers responsible for the actions of these solicitors, arguing that the advisers did not control their activities. We have excluded third-party solicitors from this two-year time out provision; instead we are proposing to prohibit advisers from soliciting government business through third parties, as discussed in detail in section II.A.3(b) of this Release.

[101] Proposed rule 206(4)–5(f)(2)(iii). Our 1999 proposal would also have included PACs controlled by the investment adviser and the individuals associated with the investment adviser whose contributions would have triggered the ''time out.'' *See* 1999 Proposing Release, *supra* note 17, at section II.A.1. We have proposed to include PACs because these vehicles, which may be regulated by State and/or Federal election law, are often used by corporations, interest groups, or others to make political contributions. *See, e.g.,* Tennessee Registry of Election Finance, *PACs FAQ, available at http://www.state.tn.us/tref/pacs/pacs_faq.htm;* Federal Election Commission, *Quick Answers to PAC Questions, available at http://www.fec.gov/ans/answers_pac.shtml.*

[102] *See* discussion of covered investment pools, *infra,* section II.A.3(e).

[103] Proposed rule 206(4)–5(f)(4). Our proposed definition of ''executive officer'' in rule 206(4)–5(f)(4) is based on the same considerations as a similar definition in Advisers Act rule 205–3 [17 CFR 275.205–3]. Whether a person is an executive officer depends on his or her function, not title; a chief executive officer whose title does not include ''president'' is clearly an executive officer.

[104] Proposed rule 206(4)–5(d).

[105] *See id. See also* discussion of indirect contributions, *infra* section II.A.3(c).

[106] Many 1999 commenters argued that our proposal included too many persons whose activities are unconnected to managing public pension money, making it too likely that an innocent political contribution would trigger a two-year time out. We considered these comments in narrowing the scope of persons covered by our current proposed rule, as described above.

[107] *See* discussion at section II.A.3(b), *infra* .

[108] *See* proposed rule 206(4)–5(d), however.

influence officials of government entities? [109] Under the proposed rule, political contributions by such persons would only result in a violation under the rule if the adviser or its covered associates were acting through them to do indirectly what they cannot do directly under the rule.[110] MSRB rule G–37 addresses this matter similarly. Should we include beneficial owners of the adviser because they have a direct economic stake in the adviser's business relationship with the government client? If so, should the definition include all owners, or only those with a significant ownership stake in an adviser, such as those who have contributed (or that have the right to receive upon dissolution) ten percent or more of the company's capital?

(5) ''Look Back''

Under the proposed rule, the two-year time out would continue in effect after the covered associate who made the triggering contribution left the advisory firm. Moreover, a contribution made by a covered associate of an adviser would be attributed to any other adviser that employs or engages the person who made the contribution within two years after the date the contribution was made.[111] As a result, an investment adviser would be required to ''look back'' in time to determine whether it would be subject to any business restrictions under the proposed rule when employing or engaging a covered associate. This provision, which tracks MSRB rule G–37,[112] would prevent advisers from circumventing the rule by channeling contributions through departing employees, or by influencing the selection process by hiring persons who have made political contributions. Comment is requested on the proposed look-back requirement. For example, would a shorter period be sufficient to prevent circumvention of the rule? [113] If so, what period would be appropriate? Would our proposed look-back provision inappropriately deter politically active individuals from joining advisory firms that provide investment advice to government entities or are seeking to do so?

(6) Exception for De Minimis Contributions

Proposed rule 206(4)–5 contains a *de minimis* exception that would permit each covered associate who is an individual [114] to make aggregate contributions of $250 or less, per election, to an elected official or candidate without triggering the rule's prohibitions if the person making the contribution is entitled to vote for the official or candidate.[115] We have proposed $250 because we believe that contributions of $250 or less are typically made without the intent or ability to influence the selection process for investment advisers and thus do not involve the conflicts of interest the rule is intended to prevent, as well as for reasons of regulatory consistency. The $250 amount is the same as the *de minimis* amount excepted from MSRB rule G–37.[116] Comment is requested on the scope of the exception.[117] Should the amount be increased or decreased, and if so, on what basis? For instance, the MSRB has not adjusted its *de minimis* amount for inflation since it was established in 1994. We have not adjusted the $250 for inflation because of ease of reference to a round number and because an inflation adjustment would result in an amount not significantly higher. We request comment, however, on whether we should adjust our amount for inflation. Should we provide a *de minimis* exception for contributions to officials for whom an individual is not entitled to vote, and if so, what would be an appropriate *de minimis* amount? [118]

(7) Exception for Certain Returned Contributions

We are proposing a second exception from the two-year compensation ban intended to address situations in which the adviser triggers the ban inadvertently.[119] We have attempted to limit the scope of this exception to the types of contributions that we believe are unlikely to raise pay to play concerns. This exception would be available only with respect to contributions made by a covered associate of the investment adviser to officials *other* than those for whom the covered associate was entitled to vote at the time of the contributions and which, in the aggregate, do not exceed $250 to any one official, per election.[120] Further, the adviser must have discovered the

[109] *See, e.g.,* Martin Z. Braun *et al., A Political Family Affair?,* The Bond Buyer (Oct. 21, 2002) (noting that spouses of municipal finance professionals in dealer firms are making campaign contributions to issuer officials who can influence the award of bond business).

[110] Paragraph (d) of proposed rule 206(4)–5. *See* section II.A.3(d) of this Release.

[111] Proposed rule 206(4)–5(a)(1). In no case would the prohibition imposed by the proposed 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 one year and six months after making a contribution, the new employer would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. 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 employed by the adviser. *See infra* section II.B.

[112] MSRB rule G–37(g)(iv). *Cf.* MSRB Qs & As, Question II.12, *available at http://www.msrb.org/msrb1/rules/QAG-372003.htm.*

[113] Commenters in 1999 urged us to reduce the look back period, arguing that politically active individuals might be discouraged from joining advisory firms. However, we are concerned about the prospect of advisers seeking to circumvent the rule by hiring individuals shortly after they have made significant contributions that could influence government officials.

[114] Under the proposed rule, each covered associate, taken separately, would be subject to the $250 *de minimis* exception for elections in which he or she is entitled to vote. In other words, the $250 limit applies per covered associate and is not an aggregate limit for all of an adviser's covered associates.

[115] Proposed rule 206(4)–5(b)(1). Under the proposed rule, primary and general elections would be considered separate elections. Accordingly, a covered person of an investment adviser could, without triggering the prohibitions of the rule, contribute up to $250 in both the primary election campaign and the general election campaign (up to $500) of each official for whom the person making the contribution would be entitled to vote. For purposes of this rule, a person would be ''entitled to vote'' for an official if the person's principal residence is in the locality in which the official seeks election. *See, e.g.,* In the Matter of Pryor, McClendon, Counts & Co., Inc. et al., Exchange Act Release No. 48095 (June 26, 2003) (noting that Rule G–37 allows a person to contribute $250 to a candidate's campaign in the primary and in the general election, for a total of $500 during the election cycle, and clarifying that contributions must be limited to $250 *before* the primary, with an additional $250 allowed *after* the primary for the general election). *See also* MSRB Qs & As, Question II.8, *available at http://www.msrb.org/msrb1/rules/QAG-372003.htm.*

[116] *See* MSRB rule G–37(b)(i).

[117] Some commenters in 1999 suggested that the amount be substantially higher. Some commenters thought we should raise the *de minimis* amount to $1,000 to be consistent with the limits on private contributions for candidates for Federal office. We believe that a higher threshold—such as $1,000—would be significantly more likely to enable a contributor to seek to exert influence over an official with the ability to select an investment adviser, especially in a local election. We also believe a lower amount might be too restrictive—it could preclude individuals from supporting candidates for whom they are able to vote at levels that are less likely to facilitate undue influence.

[118] Our proposed *de minimis* exception only applies to contributions to a candidate for whom the contributor is *entitled to vote.* Whereas the outcome of an election in which a contributor is eligible to vote is likely to have a greater personal impact on the contributor, there is a significantly greater likelihood that a contributor's contribution in an election in which he or she is not entitled to vote could be motivated by other factors, which might include influencing a candidate. In 1999, there was a mixture of support and criticism for limiting the exception to contributions to officials or candidates for whom the contributor is entitled to vote, and one commenter advocated expanding it to a $100 *de minimis* exception for candidates for whom the contributor is *not* entitled to vote.

[119] Proposed rule 206(4)–5(b)(2).

[120] Proposed rule 206(4)–5(b)(2)(i). To the extent that the contribution by a covered associate of the adviser was less than $250 and was for an official for whom the covered associate was entitled to vote at the time of the contributions, the contribution would not have triggered the two-year ban on account of the exception contained in paragraph (b)(1) of the proposed rule.

contribution which resulted in the prohibition within four months of the date of such contribution [121] and, within 60 days after learning of the triggering contribution, must cause the contribution to be returned to the contributor.[122] We believe this exception should only be available when the adviser discovered the triggering contribution, and caused it to be returned, promptly. Our proposal generally tracks MSRB rule G–37's ''automatic exemption'' provision.[123]

To ensure that the exception for certain returned contributions does not encourage an investment adviser to relax its efforts to promote compliance with the rule's prohibitions, no adviser would be entitled to rely on the exception more than twice per 12-month period.[124] And an investment adviser would not be permitted to rely on the exception more than once with respect to contributions by the same covered associate of the investment adviser,[125] regardless of the time period.

We request comment on the proposed criteria for, and limitations on, the exception for certain returned contributions. Are the various time periods we proposed (discovery of contribution within four months of it being made, return of contribution within 60 days of discovery, and limitation of reliance on the exception twice per adviser per 12-month period) reasonable? Would they be effective? Are there other circumstances under which an adviser should be able to avail itself of an exception? Alternatively, should we require that an adviser institute special supervisory procedures (after it relies on the exception for certain returned contributions) for the covered associate making the contribution, including requiring pre-clearance of all contributions, for a specified period of time?

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

After the adoption of rule G–37 in 1994, the MSRB observed that municipal securities dealers sought to circumvent rule G–37 by hiring third-party consultants to solicit government clients on their behalf.[126] These third-party consultants would make political contributions or otherwise seek to exert influence designed to secure municipal business for the municipal securities firm.[127] Two years later, in 1996, the Commission approved, and the MSRB adopted, rule G–38, which required municipal dealers to disclose publicly the terms of their agreements with consultants.[128] In 2005, after concluding that the required disclosure was neither adequate to prevent circumvention of rule G–37, nor consistently being made,[129] the MSRB (with the

[121] *Id.* We believe that requiring that the adviser must have discovered the contribution within four months provides an appropriate time limit for the exception. On one hand, 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. On the other hand, we believe it makes sense to give advisers sufficient time to discover contributions made by covered associates if, for example, their covered associates disclose their contributions to the adviser on a quarterly basis. Also, this provision is consistent with the approach taken in MSRB rule G–37(j)(i).

[122] Proposed rule 206(4)–5(b)(2)(i). The prompt return of the contribution would provide some indication that the contribution would not affect an official of a government entity's decision-making process with regard to choosing an adviser. We have proposed that the contribution must be returned within 60 days to give contributors sufficient time to seek its return, but still require that they do so in a timely manner. Also, this provision is consistent with MSRB rule G–37(j)(i). If the recipient will not return the contribution, the adviser would still have available the opportunity to apply for an exemption under paragraph (e) of the proposed 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.''

[123] MSRB rule G–37(j). We did not include an equivalent provision in our 1999 proposal, and MSRB rule G–37 contained no such provision at that time. However, the MSRB added an ''automatic exemption'' provision in 2003. Exchange Act Release No. 47814 (May 8, 2003) [68 FR 25917 (May 14, 2003)]. Several of the comments we received on our 1999 proposal, while supporting the exemptive provision we proposed at that time, expressed concern that the scope and breadth of the rule would expose advisers to the risk of inadvertent violations, which would necessitate frequent exemptive applications. *See, e.g.,* Comment Letter of the Securities Industry Association (Oct. 29, 1999) (''SIA Comment Letter''); Comment Letter of Morgan Stanley Dean Witter Investment Management Inc. (Nov. 1, 1999) (''MSDW Comment Letter''); Comment Letter of Fidelity Investments (Nov. 1, 1999); Investment Counsel Association of America Comment Letter (Nov. 1, 1999) (''Nov. ICAA Comment Letter''); Comment Letter of Scudder Kemper Investments (Nov. 8, 1999) (''Scudder Kemper Comment Letter''); Comment Letter of Nicholas-Applegate Capital Management (Oct. 26, 1999) (''Nicholas-Applegate Comment Letter''); Comment Letter of Smith Barney Asset Management and Salomon Brothers Asset Management Inc. (Nov. 1, 1999) (''Smith Barney Comment Letter'') (suggesting, alternatively, that the time out period be 30 days for inadvertent violations); Comment Letter of Davis Polk & Wardwell (Nov. 1, 1999) (''Davis Polk Comment Letter''); and Comment Letter of American Bar Association, Subcommittees on Investment Companies and Investment Advisers and on Private Investment Entities of the Committee on Federal Regulation of Securities, Section of Business Law (Jan. 5, 2000) (''ABA Comment Letter''). The exception we have proposed would help address these concerns.

[124] Proposed rule 206(4)–5(b)(2)(ii). We wanted to give each adviser more than one opportunity to refine its compliance procedures to avoid further violations of the proposed rule but, as noted, did not want to allow an adviser to relax its standards by making multiple exceptions available. This will generally create some flexibility to accommodate a covered associate's inadvertent violation.

[125] Proposed rule 206(4)–5(b)(2)(iii). Once a covered associate has been made aware of an ''inadvertent'' violation, a justification for a second violation is more questionable.

[126] *See In the Matter of Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Consultants,* Exchange Act Release No. 36522 (Nov. 28, 1995) [60 FR 62275 (Dec. 5, 1995)] (''The Board believes that rules G–37 and G–20 [regarding gifts and gratuities] * * * along with [the rule on fair dealing] set appropriate standards for dealer conduct in the municipal securities industry. However, the Board is concerned about dealers' increasing use of consultants to obtain or retain municipal securities business. While the Board believes that in many instances the use of consultants is appropriate, it also believes that, in a number of instances, the use of consultants may be in response to limitations placed on dealer activities by rule G–37 and rule G–20. While both of these rules prohibit dealers from doing indirectly what they are precluded from doing directly, indirect activities often are difficult to prove.'' (footnotes omitted)).

[127] *See id.*

[128] *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Consultants,* Exchange Act Release No. 36727 (Jan. 17, 1996) [61 FR 1955 (Jan. 24, 1996)] (''The rule approved today is intended to provide additional information to issuers and to the public to assist in determining the extent to which payments to consultants influence the issuer's selection process in connection with municipal securities business. * * *'') (''MSRB Rule G–38 Adoption Order''). *See also* Municipal Securities Rulemaking Board, *Request for Comments on Revised Draft Amendments to Rule G–38 Relating to Solicitation of Municipal Securities Business (as modified on Oct. 12, 2004)* (Sept. 29, 2004), *available at http://www.msrb.org/msrb1/archive/2004/RevRuleG-38Solicitation.htm#revised1* (noting, with regard to MSRB rule G–38, ''As initially adopted, the rule required * * * that the dealer disclose information about its consulting arrangements to any issuer from which a consultant would solicit municipal securities business on its behalf [and that the dealer disclose] to the MSRB * * * the terms of the consulting agreements and the business obtained by the consultants * * * [with] such disclosures made available to the public through the MSRB Web site * * *'' (footnotes omitted)).

[129] *See* Municipal Securities Rulemaking Board, *Amendments Relating to Solicitation of Municipal Securities Business Under Rule G–38,* SR–MSRB–2005–04 (Mar. 17, 2005), *available at http://www.msrb.org/msrb1/rulesandforms/sec/SR-MSRB-2005-04.pdf* (''The MSRB began its current rulemaking initiative on the solicitation on behalf of brokers, dealers and municipal securities dealers (''dealers'') of municipal securities business by consultants early last year because of certain practices that could present challenges to maintaining the integrity of the municipal securities market. These practices include, among other things, significant increases in recent years in the number of consultants being used, the amount these consultants are being paid and the level of reported political giving by consultants. The MSRB has been concerned that increases in levels of compensation paid to consultants for successfully obtaining municipal securities business may be motivating consultants, who currently are not subject to the basic standards of fair practice and professionalism embodied in MSRB rules, to use more aggressive or questionable tactics in their contacts with issuers.'').

Commission's approval) amended rule G–38 to impose a complete ban on the use of third-party consultants to solicit government clients.[130]

We are concerned that our adoption of a rule addressing pay to play practices by advisers would lead to a similar use of consultants or solicitors by investment advisers to circumvent the rule. Indeed, we have alleged that third-party solicitors have played a central role in each of the enforcement actions against investment advisers that we have brought in the past several years involving pay to play schemes.[131] Government authorities in New York and other jurisdictions have prohibited, or are considering prohibiting, the use of consultants, solicitors, or placement agents by investment advisers to solicit government investment business.[132]

In our 1999 proposal, contributions to a government official by an adviser's third-party solicitor, engaged by the adviser to obtain clients, would have triggered a two-year ''time out'' for the adviser.[133] Several commenters opposed inclusion of contributions by third-party solicitors as a trigger for the ''time out.'' Most argued that this aspect of the rule was unfair and created significant compliance challenges because these solicitors were not, according to the commenters, controlled by advisers.[134]

In light of these considerations, including the apparent difficulties for advisers to monitor the activities of their third-party solicitors, we are proposing to prohibit investment advisers from using third-party solicitors to obtain government clients.[135] Proposed rule 206(4)–5 would make it unlawful for 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)], or any of its covered associates, to provide or agree to provide, directly or indirectly, ''payment'' to any person to solicit a government entity for investment advisory services unless such person is: (i) A ''related person'' of the investment adviser or, if the related person is a company, an employee of that related person; or (ii) any of the adviser's employees, general partners, LLC managing members, executive officers (or other person with a similar status or function, as applicable).[136] The rule's prohibition on an adviser's payments to third-party solicitors may apply to persons commonly called ''finders,'' ''solicitors,'' ''placement agents,'' or ''pension consultants.'' [137]

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[130] *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change Relating to Solicitation of Municipal Securities Business under MSRB Rule G–38,* Exchange Act Release No. 52278 (Aug. 17, 2005) [70 FR 49342 (Aug. 23, 2005)]. As amended, MSRB rule G–38(a) states, ''Subject to section (c) of this rule [regarding transitional payments], no broker, dealer or municipal securities dealer may provide or agree to provide, directly or indirectly, payment to any person who is not an affiliated person of the broker, dealer or municipal securities dealer for a solicitation of municipal securities business on behalf of such broker, dealer or municipal securities dealer.''

[131] *See, e.g., SEC* v. *Henry Morris, et al.,* Litigation Release No. 20963 (Mar. 19, 2009) (the Commission's complaint alleges that investment advisers and a placement agent, among others, engaged in a fraudulent scheme to extract kickbacks from investment management firms seeking to manage assets of the New York State Common Retirement Fund); *In the Matter of Kent D. Nelson,* Investment Advisers Act Release No. 2765 (Aug. 1, 2008); Initial Decision Release No. 371 (Feb. 24, 2009); Investment Advisers Act Release No. 2868 (Apr. 17, 2009) (an administrative law judge found that an investment adviser funneled payments through a third party to the New Mexico State treasurer in exchange for being retained as an adviser by the State treasurer's office); *SEC* v. *Paul J. Silvester et al.,* Litigation Release No. 16759 (Oct. 10, 2000); Litigation Release No. 16834 (Dec. 19, 2000); Litigation Release No. 18461 (Nov. 17, 2003); Litigation Release No. 19583 (Mar. 1, 2006); Litigation Release No. 20027 (Mar. 2, 2007) (alleging that, in order to obtain investment contracts, investment adviser firms made payments to associates of the Connecticut State treasurer, a portion of which were kicked back to the treasurer). *See also supra* notes 31–40 (discussing other cases related to these enforcement actions).

[132] *See, e.g.,* Aaron Elstein, *NY Pension Fund Bans Controversial Middlemen,* Crain's New York Business (Apr. 22, 2009) (describing the New York State Comptroller's ban on placement agents); Press Release, Office of the New York City Comptroller, *Thompson Moves to Ban Placement Agents, Asks State AG to Investigate Quadrangle Transaction,* PR–09–04–095 (Apr. 22, 2009), *available at http://www.comptroller.nyc.gov/press/2009_releases/pr09-04-095.shtm* (describing the New York City Comptroller's calls on the New York City Pension Funds to ban placement agents); Henry Goldman, *New York City Police Pension Bans Placement Agent Use,* Bloomberg (May 5, 2009) (describing the New York City Police Pension Fund's suspension on the use of placement agents); Martin Z. Braun, *New York City's Fire Pension Bans Middlemen, Joining Two Others,* Bloomberg (May 16, 2009) (describing the New York City Fire Pension Fund's suspension on the use of placement agents); Barry Massey, *NM Agency Bans Placement Agents on Investments,* Businessweek (May 26, 2009) (describing the New Mexico State Investment Council's ban on placement agents). *See also In the Matter of the Carlyle Group,* AGNY Investigation No. 2009–071, Assurance of Discontinuance Pursuant to Executive Law § 63(15) (May 14, 2009), *available at http://www.oag.state.ny.us/media_center/2009/may/pdfs/Carlyle%20AOD.pdf; In the Matter of Riverstone Holdings, LLC,* AGNY Investigation No. 2009–091, Assurance of Discontinuance Pursuant to Executive Law § 63(15) (June 11, 2009), *available at http://www.oag.state.ny.us/media_center/2009/june/pdfs/Riverstone%20AOD%20FINAL%20EXECUTED.pdf;* and *In the Matter of PCG Corporate Partners Advisors II, LLC,* AGNY Investigation No. 2009–101, Assurance of Discontinuance Pursuant to Executive Law § 63(15) (July 1, 2009), *available at http://www.oag.state.ny.us/media_center/2009/july/pdfs/PCG%20AOD%20FINAL%20EXECUTED.pdf* (in each case, banning the use of third-party placement agents pursuant to a ''Public Pension Fund Reform Code of Conduct'' in connection with the New York Attorney General's findings that ''private equity firms and hedge funds frequently use placement agents, finders, lobbyists, and other intermediaries * * * to obtain investments from public pension funds * * *, that these placement agents are frequently politically-connected individuals selling access to public money, * * * and that the use of placement agents to obtain public pension fund investments is a practice fraught with peril and prone to manipulation and abuse.'').

[133] *See* 1999 Proposing Release, *supra* note 17, at section II.A.1.

[134] *See, e.g.,* SIA Comment Letter; T. Rowe Comment Letter; MSDW Comment Letter; Comment Letter of Legg Mason, Inc. (Nov. 1, 1999); American Bankers Association Comment Letter (Nov. 1, 1999); Nov. ICAA Comment Letter; Scudder Kemper Comment Letter; Nicholas-Applegate Comment Letter; Smith Barney Comment Letter; Davis Polk Comment Letter; and ABA Comment Letter. We note that rule 206(4)-3 (the ''cash solicitation rule'') under the Advisers Act, among other things, requires an adviser that engages a third-party solicitor for clients: (i) to make a bona fide effort to ascertain whether the solicitor has complied with the adviser's agreement with the solicitor; and (ii) to have a reasonable basis for believing that the solicitor has so complied. Advisers Act rule 206(4)-3(a)(2)(iii)(C) [17 CFR 275.206(4)–3(a)(2)(iii)(C)].

[135] Although rule 206(4)–3 under the Advisers Act (the ''Cash Solicitation Rule'') contemplates that certain client solicitation activities of third parties can be undertaken where certain conditions are met and the adviser both ''makes a bona fide effort to ascertain whether'' and ''has a reasonable basis for believing that'' the solicitor has complied with certain aspects of the rule (Advisers Act rule 206(4)–3(a)(2)(iii)(C) [17 CFR 275.206(4)–3(a)(2)(iii)(C)]), commenters' concerns about the inability of advisers to control the political contribution activity of their solicitors (which is not restricted under the Cash Solicitation Rule) persuade us that a different approach is appropriate for solicitation of government clients.

[136] Proposed rule 206(4)–5(a)(2)(i). Advisers making payments to solicitors must comply with the cash solicitation rule under the Advisers Act. If this component of proposed rule 206(4)–5 is adopted as proposed, investment advisers registered or required to be registered with us would no longer be able to rely on the cash solicitation rule to pay third-party solicitors to obtain government clients. For a discussion of proposed amendments to the cash solicitation rule, *see infra* section II.C.

[137] Pension consultants provide advice to pension plans (public or private) and their trustees with respect to their investments, selection of money managers and other service providers, and other investment-related matters. Many pension plans rely heavily on the expertise and guidance of their pension consultant in helping them to manage pension plan assets. Pension consultants may act as third-party solicitors. Others may act as investment advisers subject to our rule. In 2005, our Office of Compliance Inspections and Examinations published a report highlighting concerns relating to the Advisers Act stemming from examinations of 24 pension consultant firms, including conflicts of interest that arise with respect to pension consultants that provide products and services to both pension plan advisory clients and money managers and mutual funds on an ongoing basis. Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *Staff Report Concerning Examinations of Select Pension Consultants* (May 16, 2005), *available at http://www.sec.gov/news/studies/pensionexamstudy.pdf.* Commission staff also published on the Commission's Web site, in cooperation with the U.S. Department of Labor, tips to assist fiduciaries of employee benefit plans in

The proposed rule would only apply to ''third-party'' solicitors who solicit government entities for investment advisory services.[138] The prohibition on payments to third-party solicitors would not cover solicitations on behalf of an investment adviser by a person who is a ''related person'' of the adviser, any of the related person's employees if the related person is a company,[139] or any executive officer or partner of the adviser.[140] A contribution to a government official by certain of these persons would instead trigger the two-year ''time out'' under paragraph (a) of the proposed rule, during which the investment adviser could not provide investment advisory services for compensation to the government entity whose selection of an adviser that official could influence.[141] We have proposed to include related persons and their employees (if the related persons are companies) in order to enable advisers to compensate parent companies and other owners, subsidiaries and sister companies—as well as employees of related companies—for government entity solicitation activities because we recognize that there may be efficiencies in allowing advisers to rely on these particular types of persons to assist them in seeking clients.[142] We request comment on whether we should include employees of an adviser's related persons that are companies within the group of persons not subject to the ban on payments to third parties. Should we include only employees of certain related persons of the adviser? If so, how should we make that determination? We also request comment on whether there are other types of persons associated with an investment adviser who should not be subject to the ban on payments to third parties. We would define ''payment'' as any gift, subscription, loan, advance or deposit of money or anything of value.[143] We are proposing this definition to cover the various means by which an adviser and its covered associates may seek to compensate a third-party solicitor.[144] A ''finder's fee'' paid for a third-party solicitation would be an example of a prohibited payment. It could also include payments made to pension consultants for performing various services, such as attending or sponsoring conferences, if those services are intended to obtain government clients.[145] Are there other types of payments we should explicitly include in the definition? Are there others that we should exclude, and, if so, why?

We would broadly define ''solicit'' to mean: (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. We are proposing this definition to capture the types of communications in which an investment adviser might engage that we believe should trigger application of the rule's prohibitions—communications for the purpose of obtaining or retaining a client or a contribution.[146] Whether a particular communication constitutes a ''solicitation,'' therefore, depends on the specific facts and circumstances relating to the communication. The nature of information conveyed in any communication and the manner in which it is presented would be relevant factors to consider. Does our proposed definition effectively capture the appropriate scope of communications? If not, what types of communications should we exclude, and why?

We request comment on our proposal to prohibit the use of third-party solicitors of government business. Is our proposed prohibition on the use of third-party solicitors an appropriate means to deter pay to play practices? We propose to prohibit only third-party solicitors as likely posing a significant threat to investor protection; certain related-party solicitors would, instead, be subject to the time out limitations of proposed rule 206(4)–5(a)(1). Is this differentiation appropriate? If not, should we instead subject advisers to the two-year time out for contributions made by their third party solicitors although, as noted above, commenters in 1999 indicated that such a requirement may impose significant compliance challenges? [147] If the differentiation is appropriate, should we also have a two-year look back restriction for any contributions made by the third party? Is there a different approach that would be effective at eliminating circumvention of the rule through the use of third parties? For example, should we consider narrowing the prohibition to accommodate government solicitation activities by third parties if such third parties (and

reviewing conflicts of interest of pension consultants. *Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries* (June 1, 2005), *available at http://www.sec.gov/investor/pubs/sponsortips.htm.*

Although the terms are sometimes used interchangeably, ''finders'' typically locate buyers and/or sellers for a security on behalf of a broker-dealer, ''solicitors'' typically locate investment advisory clients on behalf of an investment adviser, and ''placement agents'' typically specialize in finding investors (often institutional investors or high net worth investors) that are willing and able to invest in a private offering of securities on behalf of the issuer of such privately offered securities.

[138] Proposed rule 206(4)–5(a)(2)(i).

[139] We would define ''related person'' as any person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser. Proposed rule 206(4)–5(f)(9). The term ''company'' is defined in the Advisers Act, in relevant part, as ''a corporation, a partnership, an association, a 'joint-stock' company, a trust, or any organized group of persons, whether incorporated or not.'' 15 U.S.C. 80b–2(a)(5).

[140] More specifically, we do not include any of the following within the prohibition on payments for solicitation of government clients: executive officers, general partners, managing members (or, in each case, persons with similar status or function), employees, or ''related persons'' of the investment adviser. Proposed rule 206(4)–5(a)(2)(i). We make this distinction because related person solicitors are subject to an adviser's (or its affiliates') control and thus should not present the compliance challenges that advisers pointed to with respect to third-party solicitors. *See supra* note 134 and accompanying text. MSRB rule G–38's exclusions are based on two similar definitions—of ''affiliated person of the broker, dealer or municipal securities dealer'' and of ''affiliated company of the broker, dealer or municipal securities dealer.'' MSRB rule G–38(b)(i) and (b)(ii).

[141] Pursuant to proposed rule 206(4)–5(a)(1), certain contributions by the investment adviser and its covered associates would trigger the two-year time out. For a discussion of the two year ''time out'' provision of the proposed rule, *see supra* section II.A.3(a). We are not proposing that contributions by ''related persons'' and their employees would trigger the two-year time out, although we request comment on whether to include in the definition of ''covered associate'' an employee of a related person who solicits a government entity for the adviser. *See* discussion at section II.A.3(a)(4), *supra. See also* proposed rule 206(4)–5(d).

[142] For example, if an adviser's sister company has an office in a given location, the adviser might seek the assistance of a sister company's employee at that location to solicit local government business on its behalf rather than relying on its own personnel who might be located a significant distance away.

[143] Proposed rule 206(4)–5(f)(7). MSRB rule G–38 incorporates the definition of ''payment,'' as well as the definitions of ''issuer'' and ''municipal securities business'' from MSRB rule G–37(g).

[144] As well as the various means by which an adviser and its covered associates may seek to solicit other persons or coordinate donations to political parties. *See infra* section II.A.3(d).

[145] The proposed rule's prohibition on making payments to third-party solicitors of government clients would apply expressly only to investment advisers and their covered associates. *But see* proposed rule 206(4)–5(d) (the proposed rule's prohibitions on an adviser and its covered associates doing indirectly what cannot be done directly). For a discussion of this provision, *see infra* section II.A.3.(d) of this Release. The proposed rule would not prohibit government entities from retaining ''pension consultants'' (or other third-parties) and paying them to recommend particular investment advisers for the management of public funds.

[146] *See* proposed rule 206(4)–5(f)(10). MSRB rule G–38 contains a similar definition. *See* MSRB rule G–38(b)(i).

[147] *See supra* note 134.

their related persons) commit not to contribute to (or solicit contributions for) officials of any government entity from which any adviser that hires them is seeking business? To what extent might the proposed ban on using third parties to solicit government business disproportionately impact the ability of certain investment advisers, such as those that are smaller and less established, to compete in the market to provide advisory services to government clients? Conversely, to what extent might the proposed ban benefit smaller or less established advisers who are currently unable or unwilling to engage in pay to play practices to compete for government business?

(c) Restrictions on Soliciting and Coordinating Contributions and Payments

Another way an adviser can attempt to influence the selection process is by coordinating contributions for an elected official or payments to a political party, or by soliciting others to make contributions to an elected official or payments to a political party.[148] Therefore, proposed rule 206(4)–5(a)(2)(ii) would prohibit an adviser and its covered associates from soliciting any person or PAC to make, or from coordinating, any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services, or any payment [149] 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.[150] Our proposed restrictions on soliciting and coordinating contributions and payments generally track MSRB rule G–37.[151] The MSRB amended its rule in 2005, with Commission approval, 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.[152] The MSRB had not previously been able to deter this misconduct, despite issuing informal guidance in both 1996 and in 2003.[153] We are proposing a similar prohibition on soliciting or coordinating payments to political parties in States or localities where the investment adviser is providing or seeking to provide investment advisory services to a government entity because we are concerned that our adoption of a rule that only prohibits advisers from soliciting others to make, or coordinating, contributions to officials would lead to the development of a similar gap in which advisers could circumvent the rule by making payments to political parties to influence an official.[154]

Proposed rule 206(4)–5(a)(2)(ii) would also prohibit advisers from seeking to influence the selection process by, for example, ''bundling'' [155] contributions

[148] For examples of solicitation or coordination of contributions in the municipal securities dealer context, *see In the Matter of Pryor, McClendon, Counts & Co., Inc. et al.*, Exchange Act Release No. 48095 (June 26, 2003) (Commission alleged that a broker-dealer violated rule G–37(c) because its president delivered three $250 money orders (in other people's names) in addition to his own personal check for $250 to the campaign of a New York City mayoral candidate during a period when the firm was engaged in municipal securities business with New York City); *In the Matter of FAIC Securities, Inc.*, Exchange Act Release No. 36937 (Mar. 7, 1996) (Commission alleged that the broker-dealer willfully violated G–37(c) because the firm's municipal finance professionals approved its affiliated companies' political contributions to candidates for office who could influence the awarding of municipal securities business by the State of Florida and by Dade County, Florida, and during the two-year period following those contributions, the firm continued to seek, and was selected, to participate in negotiated underwritings of certain municipal securities by both Dade County and a State agency).

[149] *See supra* note 143 and accompanying text for the definition of ''payment.'' This definition is derived from the definition of ''contribution,'' but does not include the limits on the purposes for which such money is given, as currently set forth in the proposed definition of contribution. We are including ''payments,'' as opposed to ''contributions,'' here to deter an adviser from circumventing the rule's prohibitions by coordinating indirect contributions to government officials through payments to political parties. We noted similar concerns in the context of MSRB Rule G–37 when we approved a recordkeeping provision in rule G–8 to require persons subject to that rule to keep records relating to political party payments. *See SEC Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Rule G–37 on Political Contributions and Prohibitions on Municipal Securities Business, and Rule G–8, on Recordkeeping,* Exchange Act Release No. 35446 (Mar. 6, 1995) (''[S]ome [industry participants] currently are urging dealers to make payments to political parties earmarked for expenses other than political contributions (such as administrative expenses or voter registration drives). Since these payments would not constitute ''contributions'' under the rule, the recordkeeping and reporting provisions would not apply. The MSRB is concerned, based upon this information, that the same pay-to-play pressures that motivated the MSRB to adopt rule G–37 may be emerging in connection with the fundraising practices of certain political parties described above.'').

[150] Proposed rule 206(4)–5(a)(2)(ii). An investment adviser would be seeking to provide advisory services to a government entity when it responds to a request for proposal, communicates with a government entity regarding that entity's formal selection process for investment advisers, or engages in some other solicitation of investment advisory business of the government entity. A violation of paragraph (a)(2)(ii) of the proposed rule would not trigger a two-year ban on the provision of investment advisory services for compensation, but would be a violation of the rule. This provision would prohibit, for example, an adviser's solicitation of a payment to the political party of the State in which the adviser was seeking to provide advisory services to a government entity of the State, but would not preclude that adviser from soliciting a payment to a local political party, unless the adviser was doing so as a means to do indirectly what the adviser could not do directly under the proposed rule (for example, if the adviser was soliciting the payment as a means to funnel payments to an official of the government entity from which the adviser was seeking business). *See* proposed rule 206(4)–5(d).

[151] *See* MSRB rule G–37(c). We note, however, that G–37 did not contain a prohibition on soliciting or coordinating payments to political parties in 1999, and our 1999 proposal did not contain such a provision. 1999 Proposing Release, *supra* note 17.

[152] *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 (Feb. 15, 2005), *available at http://www.msrb.org/msrb1/archive/2005/2005-11.asp* (''G–37(c) Notice'') (''[T]he MSRB is especially troubled by the emergence of recent media and other reports that issuer agents have informed dealers and [municipal finance professionals] that, if they are prohibited from contributing directly to an issuer official's campaign, they should contribute to the affiliated party's ''housekeeping'' account. The MSRB is concerned that dealers or [municipal finance professionals] who make such payments may be doing so in an effort to avoid the political contribution limitations embodied in 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 on Supervisory Procedures 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).

[153] *See* G–37(c) Notice, *supra* note 152. (''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, and PACs give rise to at least the appearance that dealers may be circumventing the intent of Rule G–37.'').

[154] We note that a direct contribution to a political party by an adviser or its covered associates would not trigger the two-year time out provision of the proposed rule (although we request comment on our proposed definition of ''contribution''), unless the contribution was a means for the adviser to do indirectly what the proposed 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 supra* note 93. We are proposing, however, that an adviser be prohibited from soliciting others to make, or coordinating, payments to political parties because, as the MSRB's experience has shown, advisers could otherwise use such means to circumvent the proposed rule's limitations on direct contributions to government officials.

[155] An employee or person acting on an adviser's behalf ''bundles'' contributions or payments by

or payments from its employees or others or by making or coordinating contributions or payments through a third party, such as a ''gatekeeper.'' [156] In a gatekeeper arrangement, political contributions or payments are arranged by an intermediary, typically a pension consultant, which distributes or directs contributions or payments to elected officials or candidates.[157] The gatekeeper ensures that advisers not making a requisite amount of contributions or payments are not included among the final candidates for advisory contracts. In addition, a gatekeeper could arrange ''swaps'' of contributions or payments between elected officials in order to obscure the significance of the contributions or payments from public disclosure or to circumvent plan restrictions on contributions to trustees.[158] Under the proposed rule, the gatekeeper in these arrangements would be coordinating political contributions or payments and, if the gatekeeper is an investment adviser, would itself violate the proposed rule's restrictions on coordinating contributions or payments.[159] The adviser would also violate the proposed rule if it paid the third-party solicitor to coordinate political contributions or payments in order to obtain business.

We request comment on this aspect of the proposed rule, including our proposed definitions. Is it appropriate to differentiate between ''contributions'' to officials and ''payments'' to political parties? Are there alternative approaches that would effectively deter these types of indirect pay to play arrangements? Do commenters believe that our proposed inclusion of payments to State and local political parties closes an important gap in which contributions might be made indirectly to officials for the purposes of influencing their choice of investment advisers? Alternatively, do commenters believe that our proposed inclusion of political parties is unnecessary?

(d) Direct and Indirect Contributions or Solicitations

Rule 206(4)–5(d) would also prohibit acts done indirectly, which, if done directly, would result in a violation of the rule.[160] Thus, an adviser and its covered associates could not circumvent the rule by directing or funding contributions through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the adviser. 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, as a result of the contribution, 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 (described above) thus would be considered made ''indirectly'' for purposes of the proposed rule. We request comment on this aspect of the proposed rule.

(e) Investment Pools

(1) Application of the Rule to Pooled Investment Vehicles

Pay to play activities in the context of investment pools [161] also raise concerns about the potential for fraud.[162] The fraud that may result from pay to play practices can occur in a number of circumstances involving the government official and the pooled investment vehicle. The following are examples of pay to play relationships involving

coordinating small contributions or payments from several employees of the adviser or others to create one large contribution or payment. For an example of this in the context of the municipal securities industry, *see In the Matter of Pryor, McClendon, Counts & Co., Inc. et al.,* Securities Act Release No. 48095 (June 26, 2003) (''Counts[, the president of the broker-dealer firm,] gave his administrative assistant $750 in cash, told her to purchase three separate money orders, and told her to make them payable for $250 each to the candidate's campaign. Counts instructed his assistant to make out one of the money orders as if it were from the assistant herself, and to make out the other two as if they were from the wife of a [firm] employee and a friend of Counts', respectively. Counts then caused those money orders to be delivered to the candidate's campaign together with Counts' own personal check for $250. [When two of the three money orders were subsequently returned,] Counts instructed his assistant to deposit the returned $500 into [the firm]'s bank account, which she did.'').

[156] We are proposing that solicitation of contributions of others for an official of a government entity to which an adviser is providing or seeking to provide investment advisory services by an adviser or its covered associates be subject to a flat prohibition under the rule, rather than trigger a two-year ''time out,'' because we recognize it may be more difficult for an adviser to monitor solicitation activities (as opposed to direct contribution activity). For a discussion of an adviser's obligation to adopt policies and procedures reasonably designed to prevent violations of the Advisers Act pursuant to our ''compliance rule,'' *see infra* note 207 and accompanying text.

[157] *See, e.g., SEC* v. *Morris et al.,* Litigation Release No. 21001 (Apr. 15, 2009) (the Commission's complaint alleges that placement agents acted as gatekeepers by directing investment management firms to funnel kickbacks through various entities); *In the Matter of Kent D. Nelson,* Initial Decision Release No. 371 (Feb. 24, 2009) (an administrative law judge found that an investment adviser funneled payments through a third party to the New Mexico State treasurer, acting as gatekeeper by extracting $4.4 million in finder's fees from broker-dealers and siphoning $2.9 million to the State treasurer's office to influence the office's discretionary commitment of funds, in exchange for being retained as an adviser by the State treasurer's office); (Investment Advisers Act Release No. 2868 (Apr. 17, 2009). Similar types of arrangements exist outside of the context of government investments, such as in the area of union pension funds. *See, e.g., In the Matter of Duff & Phelps Investment Management Co., Inc.,* Investment Advisers Act Release No. 1984 (Sept. 28, 2001) and related case *In re Performance Analytics, et al.,* Investment Advisers Act Release No. 2036 (June 17, 2002) (in a settled action, the Commission alleged that an investment adviser entered into an arrangement with gatekeeper broker-dealer in which the adviser would direct its trades to broker-dealer if the broker-dealer would continue to recommend the adviser to the union pension fund board, and the broker-dealer allegedly funneled payments to certain trustees on the pension fund board to preserve its role as gatekeeper and to preserve the adviser's role as adviser to the fund).

[158] For example, Adviser A advises Plan X, while Adviser B advises Plan Y. The ''gatekeeper'' may direct a political contribution from Adviser A to the elected official, who is a trustee to Plan Y, and from Adviser B to the elected official, who is a trustee to Plan X, agreeing to place both advisers on each plan's approved list. Persons reviewing records of the political contributions would have no way of determining that the contributions were swapped and that they created conflicts of interest on the part of the advisers as well as the elected officials.

[159] Regardless of whether the gatekeeper is an investment adviser, a person participating in such a scheme could, if the rule is adopted, be considered to be aiding and abetting an adviser's violation of the rule. *See* section 209(d) of the Act [15 U.S.C. 80b-9(d)] (authorizing Commission enforcement action for aiding and abetting a violation of the Advisers Act or any Advisers Act rule).

[160] Proposed rule 206(4)–5(d). *See also* section 208(d) of the Advisers Act [15 U.S.C. 80b–8(d)]; MSRB rule G–37(d).

[161] Investment pools may include, but are not limited to: mutual funds, hedge funds, private equity funds, and venture capital funds.

[162] *See, e.g., SEC* v. *Paul J. Silvester et al.,* Litigation Release No. 16759 (Oct. 10, 2000) (action in which investment adviser allegedly paid third party solicitors who kicked back a portion of the money to the former Connecticut State Treasurer in order to obtain public pension fund investments in a hedge fund managed by the adviser); *SEC* v. *William A. DiBella et al.,* Litigation Release No. 20498 (Mar. 14, 2008) (consultant was found to have aided and abetted the former Connecticut State Treasurer in a pay to play scheme involving an investment adviser to a private equity fund who had paid third-party solicitors to obtain public pension fund investments in the fund); *In the Matter of the Carlyle Group,* AGNY Investigation No. 2009–071, Assurance of Discontinuance Pursuant to Executive Law § 63(15) (May 14, 2009), *available at http://www.oag.state.ny.us/media_center/2009/may/pdfs/Carlyle%20AOD.pdf; In the Matter of Riverstone Holdings, LLC,* AGNY Investigation No. 2009–091, Assurance of Discontinuance Pursuant to Executive Law § 63(15) (June 11, 2009), *available at http://www.oag.state.ny.us/media_center/2009/june/pdfs/Riverstone%20AOD%20FINAL%20EXECUTED.pdf;* and *In the Matter of PCG Corporate Partners Advisors II, LLC,* AGNY Investigation No. 2009–101, Assurance of Discontinuance Pursuant to Executive Law § 63(15) (July 1, 2009), *available at http://www.oag.state.ny.us/media_center/2009/july/pdfs/PCG%20AOD%20FINAL%20EXECUTED.pdf* (three settled actions brought by New York Attorney General in which advisers allegedly paid third-party solicitors who kicked back a portion of the money to the former New York Deputy State Treasurer in order to obtain public pension investments in private equity funds managed by the advisers).

investment pools that implicate the concerns underlying this rulemaking:

- When an investment adviser to a pooled investment vehicle makes a contribution to a government official and the government official directs that public monies (*e.g.,* pension plan assets) be invested in that adviser's pooled investment vehicle;
- When an investment adviser to a pooled investment vehicle makes a contribution to a government official and that government official chooses that investment adviser to be an adviser to a government sponsored plan, such as a ''529 plan;'' [163] and
- When an investment adviser to a pooled investment vehicle makes a contribution to a government official and that government official chooses that adviser's pooled investment vehicle as an investment option in a government sponsored plan, such as a ''529 plan,'' [164] regardless of whether the adviser is also chosen to be the adviser to the plan.

Pay to play activities can harm public pension plans and their beneficiaries. Such activities can cause competition in the market for investments to be manipulated, which can distort the process by which investment decisions regarding public investments are made, and can result in public pension plans making inferior investments. In addition, the pension plan may pay higher fees because advisers must recoup the contributions, or because the contract negotiations are not handled on an arm's-length basis.

An adviser's participation in pay to play activities may also defraud other investors in a pooled investment vehicle. For example, in a pay to play kickback scheme, the government investor in the pooled vehicle would receive a kickback payment from the adviser while other investors in the pool may pay higher advisory fees as a result of the adviser trying to recoup the cost of the kickback. As another example, a government investor that has engaged in a pay to play scheme with an investment adviser may leverage the fact of the adviser's payment to obtain additional benefits for itself that may operate as a fraud on other investors in the pooled vehicle.

Therefore, the proposed prophylactic rule seeks to address pay to play practices by advisers managing pooled investment vehicles.[165] The proposed rule would subject an adviser to a covered investment pool to the prohibitions of proposed rule 206(4)–5 [166] so that the government entities, the pooled investment vehicles, and the other investors in that vehicle are also protected against the harms that may result when advisers engage in pay to play practices.

(2) Covered Investment Pools

The proposed rule's prohibitions would be applicable only with respect to an adviser that manages a *covered investment pool.*[167] The proposed rule would generally define ''covered investment pool'' [168] as: (i) Any investment company as defined in section 3(a) of the Investment Company Act of 1940 (''Investment Company Act''); [169] or (ii) any company that would be an investment company under 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.[170]

Our 1999 proposal would have applied the rule only to advisers managing private funds, such as hedge funds and private equity funds,[171] that are typically excepted from the definition of investment company by either section 3(c)(1) or 3(c)(7) of the Investment Company Act.[172] We have expanded upon that proposal to include advisers managing investment companies [173] (which are registered under the Investment Company Act [174]) as well as collective investment trusts (which are excepted from the definition of investment company by section 3(c)(11)).[175] Both of these types of collective investment pools today are used as either funding vehicles for, or investments of, government-sponsored savings and retirement plans. These plans include, for example, college savings plans (such as ''529 plans'' [176]) and retirement plans (such as ''403(b) plans'' [177] and ''457 plans'' [178]). They 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.[179]

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[163] This practice would be covered under (a)(1) of the proposed rule. *See supra* section II.A.3.(a) of this release. For a specific discussion of the application to ''529 plans,'' *see* discussion below at footnotes 176–189 and related text.

[164] *See* Elliot Blair Smith, *Fund Scandal Worries Tuition Plan Investors,* USA Today (Nov. 19, 2003), at B1 (reporting that the former governor of Wisconsin received campaign contributions from the founder of a mutual fund company, and subsequently the then-governor's staff created a panel of four State employees that selected the founder's firm to manage the State's 529 plan and provide the plan's investment options).

[165] *See* proposed rule 206(4)–5(c).

[166] *Id.*

[167] *See* proposed rule 206(4)–5(c). As described below, proposed rule 206(4)–5 narrows this definition to exclude certain investment companies for the purposes of paragraph (a)(1) of the proposed rule.

[168] Proposed rule 206(4)–5(f)(3).

[169] 15 U.S.C. 80a–3(a).

[170] 15 U.S.C. 80a–3(c)(1), (7) or (11).

[171] *See* 1999 Proposing Release, *supra* note 17, at section II.A.4.

[172] 15 U.S.C. 80a–3(c)(1) and (7).

[173] 15 U.S.C. 80a–3(a).

[174] 15 U.S.C. 80a–8.

[175] 15 U.S.C. 80a–3(c)(11). We note that a bank maintaining a collective investment trust would not be subject to the proposed rule if the bank falls within the exclusion from the definition of ''investment adviser'' in Section 202(a)(11)(A) of the Advisers Act [15 U.S.C. 80b–2(a)(11)(A)]. A person who falls within the definition of an investment 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.

[176] 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 law 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. *See* Section 2(b) of the Investment Company Act [15 U.S.C. 80a–2(b) and Section 202(b) of the Advisers Act [15 U.S.C. 80b–2(b) (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 Securities Exchange Act of 1934 [15 U.S.C. 78a–15(a)(1) and 15B] (''Exchange Act''). 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, unless they qualify for a specific exemption from registration under the Advisers Act, are generally required to be registered with the Commission and would therefore be subject to our proposed rule.

[177] 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)].

[178] 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].

[179] For example, many 529 plans allow plan participants to select among various underlying investment options to direct the investment of their contributions. The participants' contributions are then invested in options of the 529 plan and the plan, in turn, invests its assets in the investment companies or other investments on which the plan options are based. The Internal Revenue Code requires that in order to set up a 529 plan investor contributions must be held in a qualified trust. *See* 26 U.S.C. 529(b). Often, the adviser to the 529 plan also advises the registered investment companies that serve as the underlying investment options for the plan. Sometimes, however, registered investment companies advised by investment advisers that do not provide advisory services directly to the government entity may serve as the underlying investment options for the plan.

Government-sponsored savings plans have grown enormously in recent years.[180] Competition for an adviser's fund to be selected as an investment option in government-sponsored savings plans is keen,[181] and we are concerned that advisers to pooled investment vehicles are making political contributions to influence the decision by government entities of the funds to be included as options in such plans. Of course, as discussed above,[182] proving such a direct *quid pro quo* or intent to influence in a specific case often will not be possible. As previously stated, it is precisely because of that difficulty that a prophylactic rule is needed.[183] We are concerned about the harmful effects pay to play activities may have in this context on these government-sponsored plans and their beneficiaries. Plans and their beneficiaries may be harmed, for example, if because of an adviser's political contributions, a government official causes a government-sponsored plan to invest in a fund managed by that adviser that charges higher fees or is less well managed than a fund that may have been chosen on the basis of pure merit. In addition, pay to play practices could be particularly damaging in the 529 context if a State offers only one, or very few, investment options to its participants.[184] Accordingly, we are proposing to include these other pooled investment vehicles often managed by investment advisers.

Under the rule, each of the pay to play prohibitions (with one exception discussed below) would be equally applicable to an investment adviser that manages assets of a government entity through the entity's investment in a covered investment pool managed by that adviser. For example, if an investment adviser subject to our rule makes a campaign contribution to an official of a government entity in a position to influence the decision to invest government assets in a private equity fund managed by that adviser, the investment adviser would be prohibited from receiving compensation with respect to the government entity's investment in the private equity fund.

In the case of an adviser to a publicly-offered registered investment company, however, we propose to apply the two-year ''time out'' provision only when the investment company is included in a plan or program of a government entity (*e.g.,* a 529 plan).[185] When a government entity invests in publicly-offered securities of a registered investment company, we are generally less concerned that the investment company's adviser would be motivated by pay to play considerations if, for example, the adviser has not bid for, or solicited, the government entity's business. Moreover, in many circumstances in which a government entity determines to make an investment in an investment company for cash management or other purposes, the adviser may not even be aware that a government entity has made an investment.[186] We are mindful that subjecting advisers and their covered associates to the two-year ''time out'' in these situations could create substantial compliance challenges because the adviser would have to monitor investments by these government entities in its investment companies to ensure that a contribution by the adviser or its covered associates did not trigger a time out. In contrast, we have included an exception that would subject to the two-year time out provision an adviser to a publicly offered registered investment company that is included in a plan or program of a government entity because we believe pay to play concerns are more likely to be present in that situation, and advisers will clearly know that the government entity is a client or investor in the adviser's investment company. As noted above, significant competition exists among advisers to have their funds selected as investment options in government-sponsored savings plans, which we believe may contribute to the risk of pay to play.[187]

We believe it is appropriate, however, to apply the other two substantive prohibitions of the proposed rule[188] to advisers to pooled investment vehicles regardless of whether it is included in a plan or program of a government entity. We believe the same concerns regarding pay to play are raised under those prohibitions whether the adviser is managing the government entities' assets directly or through a pooled investment vehicle.

For example, an investment adviser subject to our proposed rule that manages a registered investment company would be prohibited from compensating a third party to solicit an investment by a government entity in the fund or soliciting others to make contributions to officials of a government entity that the adviser seeks to have invest in the fund. For purposes of the two-year time out, however, a mutual fund adviser would *not* need to screen for investments from government entities to determine if a disqualifying campaign contribution has been made if the fund is used for investment of a State government's general assets or for investment by the State's pension fund. If the registered investment company is to be included in that State's 529 plan, however, the investment adviser *would* be subject to the two-year time out on contributions.[189]

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[180] *See* Investment Company Institute, *529 Plan Program Statistics, Dec. 2008* (May 22, 2009), *available at http://www.ici.org/research/stats/529s/529s_12-08* (indicating that 529 plan assets have increased from $8.6 billion in 2000 to $104.9 billion in the fourth quarter of 2008, and that 529 plan participants have increased from 1.3 million in 2000 to 11.2 million in the fourth quarter of 2008); Investment Company Institute, *The U.S. Retirement Market, 2008,* 18 Research Fundamentals, No. 5 (June 2009), *available at http://www.ici.org/pdf/fm-v18n5.pdf* (indicating that 403(b) plan and 457 plan assets have increased from $627 billion in 2000 to $712 billion in the fourth quarter of 2008); SEI, *Collective Investment Trusts: The New Wave in Retirement Investing* (May 2008), *available at https://longjump.com/networking/RepositoryPublicDocDownload?id=80031025axe1395095578&docname=SEI%20CIT%20White%20Paper%205.08.pdf&cid=80031025&encode=application/pdf* (citing Morningstar data indicating that collective investment trust assets nearly tripled from 2004 to 2007 and grew by more than 150 percent between 2005 and 2007 alone).

[181] *See, e.g.,* Charles Paikert, *TIAA–CREF Stages Comeback in College Savings Plans,* Crain's New York Business (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).

[182] *See supra* notes 16 and 55 and accompanying text.

[183] *See, e.g. Blount, supra* note 16, at 945.

[184] *See, e.g., Restrictions Lessen Benefits of State College Savings Plans,* USA Today (Dec. 1, 2003), at A20 (''[M]any States offer only a few investment options * * * [and] limit investors to a single fund company. * * * While plans vary, States typically have negotiated an exclusive deal with one fund company.'').

[185] Proposed rule 206(4)–5(c), (f)(3). Accordingly, the time out provision *would* be applicable, for example, if a particular mutual fund is selected to be an investment option for participants in a 529 plan; the time out provision would *not* be applicable if a State government invested its pension fund assets in that same mutual fund. We define a ''plan or program of a government entity'' in the proposed rule as any investment program or plan sponsored or established by a government entity, including, but not limited to, a ''qualified tuition plan,'' such as a 529 plan, a retirement plan, such as a 403(b) plan or 457 plan, or any similar program or plan. Proposed rule 206(4)–5(f)(8).

[186] In contrast, where securities are privately placed, such as securities of a private fund, the adviser (and through its compliance program, its personnel) should be aware that an investment from a government entity is being solicited and should therefore be in a position to refrain from making contributions that would trigger a ''time out'' with respect to receiving compensation from that government entity.

[187] *See supra* note 180 and accompanying text.

[188] Proposed rule 206(4)–5(a)(2)(i) and (ii).

[189] The proposed rule would prohibit the receipt of compensation from the investment company by

Continued

We request comment on the definition of covered investment pool under the proposed rule. Should we also apply the rule in the context of government investments in structured finance vehicles in which public funds may invest? [190] Should we, alternatively or in addition, limit the applicability of the proposed rule's prohibitions in the context of registered investment companies to circumstances under which the government entity's investment is of a sufficiently large size such that the fund adviser is more likely to have an incentive to attempt to influence the government entity's decision-making process? If so, how should we define that threshold? Should we, for example, base it on the amount of assets in the fund, such as 5 percent of the fund's assets? Should we treat differently under the rule advisers to funds in plans where the adviser is not the sole or primary adviser to the plan or where a different adviser's funds are included as investment options under the plan? For example, are there sub-advisory arrangements in which a sub-adviser would not know or be able to influence whether, or which, government entities are being solicited for a covered investment pool? If so, how should we define those sub-advisers? Should we circumscribe the rule's applicability so it is not triggered in the context of government entity investments in particular types of funds, such as money market funds, where the ability of the adviser to profit might be attenuated because, for example, those particular types of funds tend to generate lower margin or investments tend to be for relatively short terms? Should we provide exceptions to the provision subjecting an adviser to a two-year ''time out'' from receiving compensation in the context of specific types of government entity investments (such as short-term investments for cash management)?

(3) Applying the Compensation Limit to Covered Investment Pools

If a government entity is an investor in a covered investment pool at the time the contribution triggering a two-year ''time out'' is made, the proposed rule would require the adviser to forgo any compensation related to the assets invested or committed by that government entity.[191] We recognize the provisions of the proposed rule that would require the adviser to either waive its fee or terminate the relationship raise different issues for investment pools than for separately managed accounts due to various structural and legal differences.

In the case of a private fund, the adviser typically could waive or rebate the related fees and any performance allocation or carried interest.[192] The adviser may also seek to cause the pooled investment vehicle to redeem the investment of the government entity. For many private funds, such as venture capital and private equity funds, it may not be possible for a government entity to withdraw its capital or cancel its commitment without harm to the other investors. We request comment on ways to prevent advisers to these funds from benefitting from contributions covered by the two-year time out, while protecting other investors in the funds.

The options for restricting compensation involving government investors in registered investment companies are more limited, due to both Investment Company Act provisions and potential tax consequences.[193] One approach that would meet the requirements of the proposed rule would be for the adviser of a registered investment company to waive its advisory fee for the fund as a whole in an amount approximately equal to fees attributable to the government entity.[194] We request comment on other options that may be available, including alternatives that might require us to revise the proposed rule.

An adviser to a covered investment pool that serves as an investment option in a government program such as a 529 plan might seek to eliminate its investment pool as an option in order to comply with or mitigate costs arising from the rule's two-year ''time out.'' As a result, plan investors may be denied an appropriate investment alternative. Would elimination of the option be an inappropriate consequence we should seek to prevent? Have we appropriately applied the rule to curb pay to play activities (that may be effectuated, for example, through revenue sharing arrangements) while still permitting funds to be marketed and distributed to government entities in the ordinary course of business through compensated third parties, such as registered broker-dealers?

(f) Exemptions

We are proposing a provision under which an adviser may apply to us for an order exempting it from the two-year compensation ban.[195] Under the proposed rule, the Commission could

the investment adviser, not the inclusion of the investment company in the 529 plan, and would also prohibit the receipt of any advisory fee to which the adviser is entitled if it is also a direct adviser to the 529 plan.

We note that a firm retained by a government entity to distribute interests in a 529 plan (*i.e.,* municipal fund securities) may be subject to MSRB rules. *See* Municipal Securities Rulemaking Board, *Interpretive Notice: Rule D–12: Interpretation Relating to Sales of Municipal Fund Securities in the Primary Market* (Jan. 18, 2001), *available at http://www.msrb.org/msrb1/rules/NewRuleD-12Interpretation.htm.* Such a distributor may have an affiliated investment adviser that is retained by the government entity to provide investment advice to the 529 plan. Thus, the distributor could be subject to MSRB rules G–37 and G–38, while the affiliated investment adviser could be subject to our proposed rule, if adopted. As we note above, the investment adviser's fiduciary obligations could require it to continue to provide investment advice without compensation after it or a covered associate gives a contribution that triggers our proposed rule's two-year ''time out'' while MSRB rule G–37 typically would ban a firm from continuing to engage in municipal securities business for two years after a triggering contribution is made. *See supra* note 80. However, the MSRB has provided additional flexibility in the context of contracts to distribute securities such as interests in 529 plans. *See* Municipal Securities Rulemaking Board, *Interpretation on the Effect of a Ban on Municipal Securities Business under Rule G–37 Arising During a Pre-Existing Engagement Relating to Municipal Fund Securities* (Apr. 2, 2002), *available at http://www.msrb.org/msrb1/rules/notg37.htm* (allowing a dealer that has become subject to G–37's ban on new municipal securities business to continue receiving compensation throughout the duration of the ban if certain conditions are met). We are not proposing a similar approach under our rule because it would undermine the deterrent effect of having a two-year time out.

[190] These might include, for example, pools exempt from the definition of ''investment company'' under Section 3(c)(5) or (6) of the Investment Company Act [15 U.S.C. 80a–3(c)(5) and (6)] and pools relying on rule 3a–7 under the Investment Company Act. [17 CFR 270.3a–7]. Pursuant to our proposed definition of ''covered investment pool,'' the rule would apply to an investment by a government entity in a structured finance vehicle that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act [15 U.S.C. 80a–3(c)(1) and (7)]. *See* proposed rule 206(4)–5(f)(3).

[191] *See* discussion at Section II.A.3.(a)(1), *supra.* We note that the phrase ''for compensation'' includes both profits and the recouping of costs, so the proposed rule would not permit an adviser to continue to manage assets at cost after a disqualifying contribution is made.

[192] Some commenters on our 1999 Proposal noted that a performance fee waiver raises various calculation issues. An adviser making a disqualifying contribution could comply with the proposed rule 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 earned over the life of the investment.

[193] *See, e.g.,* Rule 18f–3 under the Investment Company Act. Moreover, other regulatory considerations, such as the Employee Retirement Income Security Act of 1974 [29 U.S.C. 18] (''ERISA''), may impact these arrangements with respect to collective investment trusts.

[194] This may also be done at the class level or series level for private funds organized as corporations.

[195] 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 proposed rule.

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 or when imposition of the prohibitions is unnecessary to achieve the rule's intended purpose.[196]

In determining whether to grant an exemption from the two-year compensation ban, we would take into account the varying facts and circumstances that each application presents. Further, we would 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 this section; (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.[197]

These factors are similar to those considered by FINRA and the appropriate bank regulators in determining whether to grant an exemption under MSRB rule G–37(i).[198] As suggested above, when applying the criteria, we expect to take into account, among other things, the varying facts and circumstances presented by each application. The factors are intended to assist us in determining whether granting relief is appropriate. For example, one factor relates to whether the adviser had and implemented reasonably designed policies and procedures. Several other factors relate to the adviser's knowledge of the contribution and its conduct after the contribution was discovered. The remaining factors largely relate to the particular facts surrounding the contribution that may affect whether it is appropriate for us to grant relief in that situation. For example, the same amount of money contributed in a local election may have a much greater impact than in a Federal election. Facts regarding the timing and amount of the contribution, the contributor's employment status at the time of the contribution, as well as the contributor's apparent intent or motive may suggest whether the contribution was made to influence the selection of the adviser. We would apply these exemptive provisions with sufficient flexibility to avoid consequences disproportionate to the situation, while effecting the policies underlying the rule.[199] Should we provide for additional exemptions from the proposed rule? We request comment on the proposed criteria for exemptions by application. Are there additional criteria the Commission should explicitly consider when determining whether to grant an exemption?

B. Recordkeeping

We are also proposing amendments to rule 204–2 [200] to require an investment adviser that is registered or required to be registered with us and (i) has or seeks government clients or (ii) provides investment advisory services to a covered investment pool in which a government entity investor invests or is solicited to invest, to make and keep certain records of contributions made by the adviser and its covered associates. We believe these records would be necessary to allow us to examine for compliance with rule 206(4)–5, if adopted.

The proposed amendments would require 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 for which the investment adviser or any of its covered associates is providing or seeking to provide investment advisory services, or which are investors or are solicited to invest in any covered investment pool to which the investment adviser provides investment advisory services, as applicable; [201] (iii) all government entities to which the investment adviser has provided investment advisory services, along with any related covered investment pool(s) to which the investment adviser has provided investment advisory services and in which the government entity has invested, as applicable, in the past five years, but not prior to the effective date of the proposed rule; [202] and (iv) all direct or indirect contributions or payments made by the investment adviser or any of its covered associates to an official of a government entity, a political party of a State or political subdivision thereof, or a PAC.[203] The adviser's records of contributions and payments would be required to be listed 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 proposed rule 206(4)–5(b)(2).[204] These requirements are generally consistent with the MSRB recordkeeping rule for broker-dealers.[205]

Should we exclude *de minimis* contributions from the recordkeeping requirement? Should we expand our recordkeeping requirements to cover records of contributions or payments not just to government officials and political parties, but also persons associated with officials of government entities, regardless of whether contributions or payments to these individuals trigger the prohibitions

[196] This provision is similar to our 1999 proposal.

[197] Proposed rule 206(4)–5(e). If the proposed rule is adopted, we would grant such exemptions pursuant to our authority under Section 206A of the Advisers Act [15 U.S.C. 80b–6a].

[198] *See* MSRB rule G–37(i).

[199] An adviser applying for an exemption could place advisory fees earned between the date of the contribution triggering the prohibition and the date on which we determine whether to grant an exemption in an escrow account. The escrow account would be payable to the adviser if the Commission grants the exemption. If the Commission does not grant the exemption, the fees contained in the account must be returned to the public fund.

[200] 17 CFR 275.204–2.

[201] We note that an adviser may identify its clients on its books through the use of codes. *See* Advisers Act rule 204–2(d) [17 CFR 275.204–2(d)].

[202] *See id.*

[203] Proposed rule 204–2(a)(18)(i). We note that this provision is intended to include records of direct contributions an adviser or its covered associates makes under proposed rule 206(4)–5(a)(1), as well as records of contributions or payments an adviser or its covered associates coordinates or solicits another person or PAC to make under proposed rule 206(4)–5(a)(2)(ii), which would be considered indirect contributions or payments.

[204] Proposed rule 204–2(a)(18)(ii).

[205] MSRB rule G–8(a)(xvi). Like rule G–37, the proposed rule requires an investment adviser to keep, in addition to records of political contributions, records of any other ''payments'' made to officials, political parties or PACs. *See* proposed amendment to rule 204–2(a)(18)(i)(D). *See also supra* note 149 and accompanying text for an explanation of how the rule distinguishes between contributions and payments. The MSRB also requires certain records to be made and kept in accordance with disclosure requirements that our proposed rule does not contain.

contained in our proposed pay to play rule? [206]

To manage compliance with the proposed rule effectively, we would expect that the adviser would adopt sufficient internal procedures—which would include keeping certain records—to prevent the rule's prohibitions from being triggered.[207] As discussed above, a single contribution could, under the rule, lead to a two-year suspension of compensated advisory activities for a government client. Therefore, we anticipate that many, if not all, of the records that we propose to require registered advisers make and keep under our proposed amendments would be those an adviser undertaking a serious compliance effort would ordinarily make and keep. We request that commenters opposing the new recordkeeping requirements suggest alternative means that would be sufficient to aid examinations for compliance with the proposed rule.

C. Amendment to Cash Solicitation Rule

We are also proposing a technical amendment to rule 206(4)–3 under the Advisers Act, the ''cash solicitation rule.'' That rule makes it 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.[208]

Because paragraph (iii) of rule 206(4)–3 contains provisions regarding more general restrictions on third-party solicitors that would cover solicitation activities directed at any client—whether a government entity client or not—our proposed technical amendment would be designed to note the specialized provisions prohibiting payments by an adviser to third-party solicitors of government clients that are contained in proposed rule 206(4)–5. Specifically, we propose to add a new paragraph (e) to rule 206(4)–3 to alert advisers and others that special prohibitions apply to solicitation activities involving government entity clients under our proposed pay to play rule.[209]

D. Transition Period

The prohibition and recordkeeping requirements under the proposed rule would arise from contributions made on or after the effective date of the rule, if adopted. As a result, firms would need to have developed and adopted appropriate procedures to track contributions and would need to begin monitoring contributions made by their covered associates on that date. The Commission requests comment on whether firms would require additional time to develop procedures to comply with the proposed rule and, if so, how long of a transition period following the rule's adoption would be necessary? For example, if a transition period is necessary, would 90 days be an appropriate amount of time? Would longer be necessary, *e.g.*, six months, and if so, why?

E. General Request for Comment

Any interested persons wishing to submit written comments on the proposed rule and rule amendment that are the subject of this Release, or to suggest additional changes or submit comments on other matters that might have an effect on the proposals described above, are requested to do so. Commenters suggesting alternative approaches are encouraged to submit proposed rule text.

III. Cost/Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules, and understand that there would be compliance costs with proposed rule 206(4)–5 and the proposed amendment to rule 204–2.[210] We are mindful of the burdens the proposed rule would place on advisory firms and limitations it would place on the ability of certain persons associated with an adviser to make contributions to candidates for certain offices and to solicit contributions for certain candidates and payments to political parties. We thus have narrowly tailored the rule to achieve our goal of ending adviser participation in pay to play practices, while seeking to limit these burdens.

The proposed rule and rule amendments would address ''pay to play'' practices by investment advisers that provide, or are seeking to provide, advisory services to government entity clients and to certain covered investment pools in which a government entity invests. The proposed rule would prohibit 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 proposed rule would also prohibit 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, or for a solicitation of a government entity to invest in certain covered investment pools, on behalf of such adviser. Additionally, the proposed rule would prevent an adviser from coordinating or soliciting from others contributions to certain elected officials or candidates or payments to certain political parties. Our proposed amendment to rule 204–2 would require a registered adviser (or adviser required to be registered) to maintain certain records of the political contributions made by the adviser or certain of its executive or employees.

A. Benefits

As discussed extensively throughout this release, we expect that proposed rule 206(4)–5 would yield several important direct and indirect benefits. At its core, the rulemaking addresses practices that undermine the integrity of our markets. Overall, the proposed 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. Accordingly, we believe that the proposed rule will achieve its goals of protecting public pension plans, beneficiaries, and other investors from the resulting harms.

Curtailing 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 leading to inferior management, diminished returns or greater losses. By addressing pay to play practices, we would be leveling 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 their skills and the quality of their advisory services. These benefits could result in substantial savings and better performance for the public pension

[206] *See supra* note 89 and accompanying text.

[207] *See* Advisers Act rule 206(4)–7 [17 CFR 275.206(4)–7] (setting forth guidelines for advisers' compliance policies and procedures).

[208] 17 CFR 275.206(4)–3.

[209] Proposed rule 206(4)–3(e).

[210] We are also proposing to make a conforming technical amendment to rule 206(4)–3 to address potential areas of conflict with proposed rule 206(4)–5. We do not expect that this technical amendment will affect the costs associated with the rulemaking.

plans, their beneficiaries, and participants.[211]

By leveling the playing field among advisers competing for State and local government business, the proposed rule could also eliminate or minimize manipulation of the market for advisory services provided to State and local governments. 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 create increased costs for firms that may feel they have no alternative but to pay to play. Additionally, pay to play practices potentially expose an adviser to other costs, such as liability, defense costs and distraction from its duties. Curtailing pay to play arrangements enables advisory firms, particularly smaller advisory firms, to compete on merit, rather than their ability or willingness to make contributions.

Moreover, the absence of arm's-length negotiations may enable advisers to obtain greater ancillary benefits, such as ''soft dollars,'' from the advisory relationship, which may be directed for the benefit of the adviser, potentially at the expense of the pension plan, thereby using a pension plan asset for the adviser's own purposes.[212] Additionally, taxpayers could benefit because they might otherwise bear the financial burden of bailing out a government pension fund that has ended up with a shortfall due to poor performance or excessive fees that might result from pay to play.

Applying the proposed 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 would extend the same benefits regardless of whether an adviser subject to the proposed 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 will provide 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 proposed amendments to rule 204–2 would benefit the public plans and their beneficiaries and participants in State plans or programs as well as investment advisers that keep the required records. The public pension plans, beneficiaries, and participants would benefit from these amendments because the records required to be kept would provide Commission staff with information to review an adviser's compliance with proposed rule 206(4)–5 and thereby may promote improved compliance. Advisers would benefit from the proposed amendments to the recordkeeping rule as these records would assist the Commission in enforcing the rule against, for example, competitors whose pay to play activities, if not uncovered, could adversely affect the competitive position of a compliant adviser.

B. Costs

The proposed rule and rule amendments would impose costs on advisers that provide advisory services to government clients, though we have tried to minimize the costs associated with an inadvertent violation of proposed rule 206(4)–5 by including an exception for certain returned contributions. The proposed rule would require an adviser with government clients, and an adviser that solicits business from government clients, to incur costs to monitor contributions made by the adviser and its covered associates, and to establish procedures to comply with the proposed rule and rule amendments. The initial and ongoing compliance costs imposed by the proposed rule would vary significantly among firms, depending on a number of factors. These include the number of covered associates of the adviser, the degree to which compliance procedures are automated, the extent to which an adviser has a pre-existing policy under its code of ethics or compliance program,[213] and whether the adviser is affiliated with a broker-dealer firm that is subject to rules G–37 and G–38. A smaller adviser, for example, would likely have a small number of covered associates, and thus expend less resources to comply with the proposed rule and rule amendments than a larger adviser.

A large adviser is likely to spend more resources to comply with the rule than a smaller adviser. However, based on staff observations, a large adviser is more likely to have an affiliated broker-dealer that is required to comply with MSRB rules G–37 and G–38.[214] Such a large adviser could likely use some or all of the compliance procedures established by its broker-dealer affiliate to facilitate its compliance with proposed rule 206(4)–5. As a result, many advisers with broker-dealer affiliates may spend less resources to comply with the proposed rule and rule amendments.[215]

We anticipate that advisory firms subject to proposed rule 206(4)–5 would develop compliance procedures to monitor the political contributions made by the adviser and its covered associates. We estimate that the costs imposed by the proposed rule would be higher initially, as firms establish and implement procedures and systems to comply with the rule and rule amendments. It is anticipated 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 1,764 investment advisers registered with the Commission may be affected by the proposed rule and rule amendments.[216]

[211] According to U.S. census data as of 2007, there are 2,547 State and local government employee retirement systems.

[212] *See supra* note 51.

[213] *See* Investment Counsel Association of America Comment Letter (May 15, 2000) (''May ICAA Comment Letter'') (''According to our members, many investment advisers already have policies and procedures in place to report contributions under State and local law and to avoid pay to play issues.'').

[214] According to registration information available from Investment Adviser Registration Depository (''IARD'') as of July 1, 2009, there are 1,312 SEC-registered investment advisers (or 11.57% of the total 11,340 registered advisers) that indicate in Item 5.D.(9) of Form ADV that they have State or municipal government clients. Of those 1,312 advisers, 108 (or 82.4%) of the largest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer; and 202 of the largest 20% (or 87.1%) have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer. Conversely, only 46 (or 35.1%) of the smallest 10% have one or more affiliated broker-dealers or are, themselves, also registered as a broker-dealer; and only 72 of the smallest 20% (or 31.0%) 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 G–37 and G–38.

[215] *Cf.* Comment Letter of US Bancorp Piper Jaffray (Nov. 15, 1999) (''U.S. Bancorp Letter'') (''[T]he more the Rule mirrors G–37, the more firms can borrow from or build upon compliance procedures already in place. * * * [H]owever, [there are] many differences between the rules that would result in significant new burdens.'').

[216] This number is based on registration information available from IARD as of July 1, 2009. As noted previously, there are 1,312 SEC-registered investment advisers (or 11.57% of the total 11,340

Continued

Of the 1,764 advisers, we estimate that approximately 1,300 advisers have fewer than five covered associates that would be subject to the proposed rule each, a ''smaller firm''; approximately 328 advisers have between five and 15 covered associates each, a ''medium firm''; and approximately 136 advisers have more than 15 covered associates that would be subject to the prohibitions of the proposed rule each, a ''larger firm'' [217].

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)] would be subject to proposed rule 206(4)–5.[218] 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).[219] Applying the same principles we used with respect to registered investment advisers, we estimate that 231 of those advisers manage pooled investment vehicles in which government client assets are invested and would therefore be subject to the proposed rule.[220]

For purposes of this analysis, it is assumed that each exempt advisory firm that would be subject to the proposed rule would likely either be smaller firms or medium firms, in terms of number of covered associates because it is unlikely that an adviser that is limited to fewer than 15 clients would have a large number of advisory personnel that would be covered associates.[221]

Although the time needed to comply with the proposed rule would vary significantly from adviser to adviser, the Commission staff estimates that firms with government clients would spend between 8 hours and 250 hours to establish policies and procedures to comply with the proposed rule. Commission staff further estimates that ongoing compliance with the proposed rule would require between 10 and 1,000 hours, annually. These estimates are derived in part from conversations with industry professionals regarding broker-dealer compliance with rule G–37 and G–38 and representatives of investment advisers that have pay to play policies in place. In addition, advisory firms may incur one-time costs to establish or enhance current systems to assist in their compliance with the proposed 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 automating compliance and reporting 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. As we noted previously, large advisers are more likely to have broker-dealer affiliates that may already have compliance systems in place for MSRB rules G–37 and G–38 that could be used by an adviser.

Initial compliance procedures would likely be designed, and ongoing administration of them performed, by compliance managers and compliance clerks. We estimate that the hourly wage rate for compliance managers is $258, including benefits, and for compliance clerks, $63 per hour, including benefits.[222] To establish and implement adequate compliance procedures, we estimate that the proposed rule would impose initial compliance costs of approximately $2,064 [223] per smaller firm, approximately $26,156 [224] per medium firm, and approximately $52,313 [225] per larger firm.[226] It is estimated that the proposed rule would impose annual, ongoing compliance

registered advisers) that indicate in Item 5.D.(9) of Form ADV that they have State or municipal government clients. Based on this data point and other responses to Item 5.D., we further estimate that 289 (or 11.57%) of the 2,502 registered investment advisers that manage ''other pooled investment vehicles'' (and do not also indicate that they have State or municipal government clients) are advising pooled investment vehicles in which government clients invest, and we estimate that 79 (or 11.57%) of the 679 registered investment advisers that manage registered investment companies (and do not also indicate that they have State or municipal government clients) are advising registered investment companies that are available as an investment option in a government plan or program. The sum of 1,312, 289 and 79 is 1,680. The proposed rule also applies to those advisers that seek to obtain government clients, and we do not know the precise number of such advisers. We believe, however, that the percentage of advisers is likely not great because, according to IARD data, there has not been any appreciable growth or shrinkage over the past five years in the percentage of SEC-registered advisers who have State or municipal government clients; the percentage has been almost unchanged. Accordingly, we estimate that an additional 5% (or 84) of SEC-registered advisers are seeking government clients, for a total of 1,764 (1,680 + 84) registered advisers subject to the proposed rule.

[217] These estimates are based on IARD data, specifically the responses to Item 5.B.(1) of Form ADV, that 967 (or 73.7%) of the 1,312 registered investment advisers that have government clients have fewer than five employees who perform investment advisory functions related to those government clients, 244 (or 18.6%) have five to 15 such employees, and 101 (or 7.7%) have more than 15 such employees. We then applied those percentages to the 1,764 advisers we believe will be subject to the proposed rule for a total of 1,300 smaller, 328 medium and 136 larger firms.

[218] The proposed amendments to rules 204–2 and 206(4)–3 would apply only to advisers that are registered, or required to be registered, with the Commission.

[219] This number is based on our review of registration information on IARD as of July 1, 2009, IARD data from the peak of hedge fund adviser registration in 2005, and a distillation of numerous third-party sources including news organizations and industry trade groups.

[220] 11.57% of 2000 is 231.4. *See supra* note 216.

[221] *See* section 203(b)(3) of the Advisers Act [15 U.S.C. 80b–3(b)(3)].

[222] 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 2008,* modified by Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

[223] The per firm cost estimate is based on our estimate that development of initial compliance procedures for smaller firms would take 8 hours of compliance manager time (at $258 per hour).

[224] With respect to our estimated range of 8–250 hours, we assume a medium-sized firm would take 125 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 medium firms would take 93.75 hours of compliance manager time (at $258 per hour) and 31.25 hours of clerical time (at $63 per hour).

[225] With respect to our estimated range of 8–250 hours, we assume a larger firm would take 250 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 187.50 hours of compliance manager time (at $258 per hour) and 62.5 hours of clerical time (at $63 per hour).

[226] Some commenters in 1999 suggested that our cost estimates, then, were too low. *See* U.S. Bancorp Letter (''[W]e believe the initial compliance cost estimates in the [1999] Release of $285 for a small firm, $13,387.50 for a medium firm and $22,312.50 for a large firm underestimate by orders of magnitude the initial costs of compliance.''); Comment Letter of American Council of Life Insurance (Nov. 1, 1999) (''Many of our member companies have observed that the proposal's compliance cost projections are speculative and unrealistic, especially when applied to large diversified financial institutions like life insurers. * * * Moreover, the cost estimates are greatly understated when the proposed rule is applied to large diversified life insurers offering investment advice as one of several products and services. * * * One of our larger diversified member companies has estimated that it would cost approximately $200,000 per year to administer compliance with the proposed rule for the approximately 200–300 people the rule would encompass. The company developing these estimates based its estimate of hours and labor costs on its actual compliance with Rule G–37.''). We have significantly increased our cost estimates from our 1999 proposal. We also note that the scope of persons covered under the current rule proposal is narrower than the scope of persons proposed to be covered in 1999. *See supra* note 98 and accompanying text.

expenses of approximately $2,580 [227] per smaller firm, $104,625 [228] per medium firm, and $209,250 [229] per larger firm.

We further anticipate that approximately one-third of advisers that we estimate would be subject to the rule may also engage outside legal services to assist in drafting policies and procedures.[230] We estimate 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 large firm, at a rate of $400 per hour. For a smaller firm we estimate a total of $1,200 in outside legal fees for each of the estimated 325 advisers that would seek assistance, for a medium firm we estimate a total of $4,000 for the estimated 164 advisers that would seek assistance, and for each of the 102 larger firms we estimate a total of $12,000.[231] Thus, we estimate that approximately 591 investment advisers will incur these additional costs, for a total cost of $2,270,000 among advisers affected by the proposed rule amendments.

Additionally, we expect that on average approximately five advisers annually will apply to the Commission for an exemption from the proposed rule.[232] We estimate that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, and that counsel will spend 16 hours preparing and submitting an application for review at a rate of $400 per hour. As a result, each application will cost approximately $6,400, and the total estimated cost for five applications annually will be $32,000.

The prohibitions of the proposed rule may also impose other costs on advisers, covered associates, third-party solicitors, and political officials. An adviser that becomes subject to the prohibitions of the proposed rule would no longer be eligible to receive advisory fees from its government client. This could limit the number of advisers able to provide services to potential government entity clients. The adviser, however, 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 provides uncompensated advisory services to a government client would 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 political contributions to political officials, possibly imposing costs on the officials if they are unable to secure alternate funding. Under the proposed rule, covered associates and executives may face new limitations on the amounts and to whom they can contribute. In addition, these same individuals could be prohibited from soliciting others to contribute or from coordinating contributions to government officials or political parties in certain circumstances. These limitations and prohibitions, including if a firm chose to adopt policies or procedures that are more restrictive than the proposed rule, could be perceived by the individuals subject to them as costs imposed on their ability to express their support for certain candidates for elected office and government officials.

Because the proposed rule would prohibit advisers from compensating third parties to solicit government entities for advisory services, advisers that currently rely on third-party solicitors to obtain government clients may have to bear the expense of hiring and training in-house staff in order to continue their solicitation activities. While third-party solicitors are not subject to the proposed rule, the proposed ban on advisers' use of third-party solicitors may have a substantial negative impact on persons who provide third-party solicitation services, and if their businesses consists solely of soliciting government entities on behalf of investment advisers, the proposed rule could result in these persons instead being employed directly by advisers or shifting the focus of their solicitation activities. In addition, small investment advisers and new investment advisers that do not have the capital to hire employees to obtain government clients may find it difficult to enter the market to provide advisory services to government pension plans or to obtain additional government clients.

We also anticipate that the proposed amendment to rule 204–2 would impose additional costs. The proposed amendments to rule 204–2 would require that SEC-registered advisers maintain certain records of campaign contributions by certain advisory personnel.[233] For purposes of the Paperwork Reduction Act, we have estimated that Commission-registered advisers would incur approximately 3,528 additional hours annually to comply with the proposed amendments to rule 204–2.[234] Based on this estimate, we anticipate that advisers would incur an aggregate cost of approximately $222,264 per year for the total hours advisory personnel would spend in complying with the proposed recordkeeping requirements.[235] Unregistered advisers that would be subject to proposed rule 206(4)–5 would not be subject to the proposed amendments to rules 204–2 and 206(4)–3.

C. Request for Comment

The Commission requests 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. We request data to quantify the costs and value of the benefits associated with the

[227] 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 $258 per hour) per year.

[228] The per firm cost estimate is based on our estimate that ongoing compliance procedures for medium firms would take 375 hours of compliance manager time (at $258 per hour) and 125 hours of clerical time (at $63 per hour), per year.

[229] The per firm cost estimate is based on our estimate that ongoing compliance procedures for larger firms would take 750 hours of compliance manager time (at $258 per hour) and 250 hours of clerical time (at $63 per hour), per year.

[230] Based on staff observations, we estimate 75% of larger firms, 50% of medium firms, and 25% of smaller firms would seek to outsource all or a portion of this type of legal work.

[231] As noted above, we estimate 75% of larger firms, 50% of medium firms, and 25% of smaller firms would seek the assistance of outside counsel.

[232] This estimate is based on staff discussions with Financial Industry Regulatory Authority staff responsible for reviewing exemptive applications submitted under MSRB rule G–37.

[233] One commenter in 1999 expressed the view that our proposed amendments to the recordkeeping rule would be burdensome. *See* Nov. ICAA Comment Letter (''The proposed rule, in effect, requires firms to keep an ongoing, continuously updated list of prospective government clients. * * * [I]t is logistically unclear how a firm should compile this list. * * * [T]he burden of continuously compiling this list would be significant.'') We have increased our burden estimate from our 1999 proposal. We note that records are a critical component of proposed rule 206(4)–5. In particular, such records are necessary for examiners to inspect advisers for compliance with the terms of the proposed rule. We also note that it is typical for advisers seeking business from government entities to do so through a request for proposal or similar process, which would typically generate a record.

[234] *See infra* note 242.

[235] We expect that the function of recording and maintaining records of political contributions would be performed by a compliance clerk at a cost of $63 per hour. *See supra* note 222. Therefore the total costs would be $222,264 (3,528 hours × $63 per/hour).

proposed rule. Specifically, comment is requested on the costs of establishing compliance procedures to comply with the proposed rule, both on an initial and ongoing basis. Comment also is requested on the costs of using compliance procedures of an affiliated broker-dealer that the broker-dealer established as a result of rule G–37 and G–38.[236] In addition, we request 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. As discussed below, section 202(c)(1) of the Advisers Act does not apply to proposed new rule 206(4)–5 or the proposed amendments to rule 206(4)–3. Nonetheless, in the context of the objectives of this rulemaking, we are interested in comments that address whether these proposed rules will promote efficiency, competition and capital formation. We solicit comment on the effect the proposed rule would have on the market for investment advisory services and third-party solicitation services. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with this proposal.

IV. Paperwork Reduction Act

A. Rule 204–2

The proposed amendment to rule 204–2 contains a new ''collection of information'' requirement within the meaning of the PRA, and the Commission has submitted the proposed amendment to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is ''Rule 204–2 under the 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 conduct or sponsor, and a person is not required to respond to a collection of information unless it displays a currently valid 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 Commission staff uses this collection of information in its examination and oversight program, and the information generally is kept confidential.[237]

The current approved collection of information for rule 204–2 is based on an average of 181.15 burden hours each year, per Commission-registered adviser, for a total of 1,954,109 burden hours. The current total burden is based on an estimate of 10,787 registered advisers.

The proposed amendments to rule 204–2 would require every investment adviser registered or required to be registered that provides or seeks to provide advisory services to government entities to maintain certain records of contributions made by the adviser or any of its covered associates. The proposed amendments would require 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 for which the investment adviser or any of its covered associates is providing or seeking to provide investment advisory services, or which are investors or are solicited to invest in any covered investment pool to which the investment adviser provides investment advisory services, as applicable; (iii) all government entities to which the investment adviser has provided investment advisory services, along with any related covered investment pool(s) to which the investment adviser has provided investment advisory services and in which the government entity has invested, as applicable, in the past five years, but not prior to the effective date of the proposed rule; and (iv) all direct or indirect contributions or payments made by the investment adviser or any of its covered associates to an official of a government entity, a political party of a State or political subdivision thereof, or a PAC. An adviser to a covered investment pool in which a government entity invests or is solicited to invest would be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government client. The adviser's records of contributions and payments would be required to be listed 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 proposed rule 206(4)–5(b)(2). These records would be 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 would be found at 17 CFR 275.204–2. Advisers that are exempt from Commission registration under section 203(b)(3) of the Advisers Act would not be subject to the recordkeeping requirements.

Commission records indicate that currently there are approximately 11,340 registered investment advisers subject to the collection of information imposed by rule 204–2.[238] 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 100,176 hours (553 additional advisers[239] × 181.15 hours). We estimate 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 proposed rule amendments.[240] Under the proposed amendments, each respondent would be required to retain the records in the same manner and for the same period of time as currently required under rule 204–2. The proposed amendments to rule 204–2 are estimated to increase the burden by approximately two hours per Commission-registered adviser with government clients annually for a total increase of 3,528 hours.[241] The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 204–2 thus would be 2,057,813 hours.[242] The revised weighted average burden per Commission-registered adviser would be 181.46 hours.[243]

Additionally, we expect advisory firms may incur one-time costs to establish or enhance current systems to

[236] *See* ABA Comment Letter (''Any cost-benefit analysis of the Rule logically should begin, by analogy, with an analysis of the costs that have been borne by Municipal Securities Professionals in complying with MSRB Rule G–37, bearing in mind that the proposed Rule contains no reporting requirements.'').

[237] *See* section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

[238] This figure is based on registration information from IARD as of July 1, 2009.

[239] 11,340 − 10,787 = 553.

[240] *See supra* note 216.

[241] This increased burden relates *only* to the recordkeeping requirements we are proposing to amend. *See supra* section III.B. of this release for an explanation of other estimated costs associated with complying with the proposed rule and rule amendments.

[242] 1,954,109 (current approved burden) + 100,176 (burden for additional registrants) + 3,528 (burden for proposed amendments) = 2,057,813 hours.

[243] 2,057,813 (revised annual aggregate burden) divided by 11,340 (total number of registrants) = 181.46.

assist in their compliance with the proposed 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. We believe they 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.

B. Rule 206(4)–3

The proposed amendment to rule 206(4)–3 contains a revised ''collection of information'' requirement within the meaning of the PRA, and the Commission has submitted the proposed amendment to the OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is ''Rule 206(4)–3—Cash Payments for Client Solicitations.'' Rule 206(4)–3 contains a currently approved collection of information number under OMB control number 3235–0242.

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. 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.[244]

The current approved collection of information for rule 206(4)–3 is based on an estimate that 20% 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 ($7.04 \times 2{,}163$).

The proposed amendments to rule 206(4)–3 would 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 proposed rule 206(4)–5. This collection of information would be 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.

Commission records indicate that currently there are approximately 11,340 registered investment advisers,[245] 20% of which (or 2,268) 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 739.2 hours (105 additional advisers[246] $\times$ 7.04 hours). We assume that approximately 20% of the Commission-registered advisers that use rule 206(4)–3 (or 454 advisers) provide, or seek to provide, advisory services to government clients and would thus be affected by the proposed rule amendments.[247] Under the proposed amendments, each respondent would be prohibited from certain solicitation activities with respect to government clients,[248] which would eliminate the need to enter into and retain the written agreement required under rule 206(4)–3 with respect to those clients. Accordingly, the proposed amendments to rule 206(4)–3 are estimated to decrease the burden by 20%, or approximately 1.4 hours, per Commission-registered adviser that uses the rule and has or is seeking government clients annually, for a total decrease of 635.6 hours. The revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 206(4)–3 thus would be 15,331.6 hours.[249] The revised weighted average burden per Commission-registered adviser would be 6.76 hours.[250]

C. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed amendments to the collection of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090 with reference to File No. S7–18–09. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–18–09, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE., Washington, DC 20549–0213. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication. A comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release.

V. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (''IRFA'') regarding proposed 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.[251]

A. Reasons for Proposed Action

Investment advisers that seek to influence the award of advisory contracts by government entities, by making or soliciting political

[244] *See* section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

[245] This figure is based on registration information from IARD as of July 1, 2009.

[246] 2,268 (20% of current registered investment advisers) − 2,163 (20% of registered investment advisers when burden estimate was last approved by OMB) = 105.

[247] In light of the 11.57% of registered investment advisers that indicate they have State or municipal government clients, we conservatively estimate that 20% of the advisers who rely on rule 206(4)–3 are soliciting government entities to be advisory clients or to invest in covered investment pools those advisers manage. *See supra* note 214.

[248] *See* proposed rule 206(4)–3(a).

[249] 15,228 (current approved burden) + 739.2 (burden for additional registrants) − 635.6 (reduction in burden for proposed amendments) = 15,331.6 hours.

[250] 15,331.6 (revised annual aggregate burden) divided by 2,268 (total number of registrants who rely on rule) = 6.76.

[251] 5 U.S.C. 603(a).

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. 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 proposed rule and rule amendments are designed to prevent fraud, deception and manipulation by reducing or eliminating adviser participation in pay to play practices.

B. Objectives and Legal Basis

Proposed rule 206(4)–5, the ''pay to play'' rule, would prohibit an 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, from providing advisory services for compensation to a government client for two years after the adviser, or any of its covered associates, make 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.[252] In addition, we are proposing to prohibit 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,[253] and from providing or agreeing to provide, directly or indirectly, payment to any third party engaged to solicit advisory business from any government entity on behalf of the adviser.[254] Further, the prohibitions in the proposed rule also would apply to advisers to certain investment pools in which a government entity invests.[255] The proposed rule amendment to rule 204–2 is designed to provide Commission staff with records to review compliance with proposed rule 206(4)–5, and the proposed amendment to rule 206(4)–3 would clarify the application of the cash solicitation rule as a result of proposed rule 206(4)–5.

The Commission is proposing new rule 206(4)–5 and proposing to amend rule 206(4)–3 pursuant to the authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b–6(4) and 80b–11(a)]; to amend rule 204–2 pursuant to the authority set forth in sections 204 and 211 of the Advisers Act [15 U.S.C. 80b–4 and 80b–11]. Section 206(4) gives us authority to prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices. Section 211 gives us authority to classify, by rule, persons and matters within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act. Section 204 gives us authority to prescribe, by rule, such records and reports that an adviser must make, keep for prescribed periods, or disseminate, as necessary or appropriate in the public interest or for the protection of investors.

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 it: (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.[256]

The Commission estimates that as of July 2009 there are approximately 706 small SEC-registered investment advisers.[257] Of these 706 advisers, 57 indicate on Form ADV that they have State or local government clients. The proposed rule also would apply to those advisers that are exempt from registration with the Commission in reliance on section 203(b)(3) of the Advisers Act. We estimate that approximately 231 such unregistered advisers may manage pooled investment vehicles in which government client assets are invested and would be subject to the proposed rule.[258] We do not have data and are not aware of any databases that compile information regarding how may advisers that are exempt from registration with the Commission in reliance on section 203(b)(3) of the Advisers Act and that have State or local government clients. It is unclear how many of these advisers that are exempt from registration that would be subject to the rule are small advisers for purposes of this analysis.

D. Reporting, Recordkeeping, and other Compliance Requirements

The proposed rule would impose certain reporting, recordkeeping and compliance requirements on advisers, including small advisers. The proposed rule imposes a new compliance requirement by: (i) Prohibiting an adviser from providing 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 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 proposed rule amendments would 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, 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, would not be subject to the proposed rule and rule amendments.

As noted above, we believe that a limited number of small advisers will have to comply with the proposed rule and rule amendments. Moreover, to the extent small advisers tend to have fewer clients and fewer employees that would be covered associates for purposes of the rule, the proposal should impose lower costs on small advisers as compared to

[252] Proposed rule 206(4)–5(a)(1).

[253] Proposed rule 206(4)–5(a)(2)(ii).

[254] Proposed rule 206(4)–5(a)(2)(i).

[255] Proposed rule 206(4)–5(c).

[256] 17 CFR 275.0–7(a).

[257] This estimate is based on registration information from IARD as of July 1, 2009.

[258] *See supra* notes 217 and 220.

large advisers as variable costs, such as the requirement to make and keep records relating to contributions, should be lower as there should be fewer records to make and keep.[259]

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no other Federal rules that duplicate, overlap, or conflict with the proposed rule amendments. As discussed above, to make clear the relationship between our rules, we propose making a technical amendment to rule 206(4)–3 to specify that solicitation activities involving government entity clients under our proposed rule 206(4)–5 are subject to limitations set forth in that rule.

F. Significant Alternatives

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.[260] In connection with the proposed rule amendments, 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 proposed 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 proposed rule and rule amendments, or any part thereof, for such small entities.

Regarding the first alternative, the Commission is not proposing different compliance or reporting requirements for small advisers as it may be inappropriate 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 proposal would provide to public pension plan clients and their beneficiaries.

Regarding the second alternative, we will continue to consider whether further clarification, consolidation, or simplification of the compliance requirements is feasible or necessary, but we believe that the current proposal is clear. The proposed rule and rule amendments contain an approach to curtailing pay to play practices that is modeled on established MSRB rules that have already been implemented by financial firms of varying sizes. However, we note that we are proposing an amendment to rule 206(4)–3, the cash solicitation rule, to clarify that the requirements of new proposed rule 206(4)–5 apply to solicitation activities involving government clients.

Regarding the third alternative, we consider 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 proposed rule and related rule amendments. Since we intend to extend the benefit of banning pay to play practices to clients of both small and large advisers, it would be inconsistent to specify different requirements for small advisers.

G. Solicitation of Comments

We encourage written comments on matters discussed in this IRFA. In particular, the Commission seeks comment on:

- The number of small entities, particularly small advisers, to which the proposed 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.

Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect.

VI. Effects on Competition, Efficiency and Capital Formation

The Commission is proposing to amend rule 204–2 pursuant to its 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.'' [261] Section 202(c) of the Advisers Act [262] 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.[263]

We are proposing to amend rule 204–2 to require an adviser to make and keep a list of its covered associates, the government entities the adviser provides advisory services to or seeks to provide advisory services to, and the contributions made by the firm and its covered associates, as applicable, to government officials and candidates.[264] The proposed amendment is designed to provide our examiners important information about the adviser and its covered associates' contributions to government officials and the government entities that the adviser provides advisory services to or seeks to provide those services. We believe that the proposed amendment to the Advisers Act recordkeeping rule would not materially increase the compliance burden on advisers under rule 204–2. Similarly, we do not believe that the proposed amendments to the recordkeeping rule would disproportionately affect advisers with government entity clients or potential government clients. The amendments will apply equally to all SEC-registered advisers. All registered advisers are already subject to a variety of recordkeeping requirements in the course of their business and, therefore, the proposed amendments to the recordkeeping rule should not affect

[259] However, as noted above, many larger advisers with broker-dealer affiliates may spend less 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–37 and G–38. *See supra* note 214 and accompanying text.

[260] 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* section II.A.2., as well as notes 133 and 134 and accompanying text.

[261] 15 U.S.C. 80b–4(a).

[262] 15 U.S.C. 80b–2(c).

[263] In contrast, the Commission is proposing new rule 206(4)–5 and amendments to rule 206(4)–3 pursuant to its authority under sections 206(4) and 211, neither of which requires us to consider the factors identified in section 202(c)(1).

[264] Proposed rule 204–2(a)(18)(i).

efficiency. We do not anticipate that the proposed recordkeeping rule amendments would affect capital formation.

The Commission requests comment whether the proposed amendment to rule 204–2, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,'' [265] the Commission must advise OMB whether a proposed regulation constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results in or is likely to result in: (1) An annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposed new rule and proposed rule amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VIII. Statutory Authority

The Commission is proposing new rule 206(4)–5 and amendments to 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(4), 80b–11(a)].

The Commission is proposing amendments to 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 proposed to be 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:

Authority: 15 U.S.C. 80b–2(a)(11)(G), 80b–2(a)(17), 80b–3, 80b–4, 80b–4a, 80b–6(4), 80b–6a, and 80b–11, unless otherwise noted.

* * * * *

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

275.204–2 Books and records to be maintained by investment advisers.

(a) * * *

(18)(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 for which the investment adviser or any of its covered associates is providing or seeking to provide investment advisory services, or which are investors or are solicited to invest in any covered investment pool to which the investment adviser provides investment advisory services, as applicable;

(C) All government entities to which the investment adviser has provided investment advisory services, along with any related covered investment pool(s) to which the investment adviser has provided investment advisory services and in which the government entity has invested, as applicable, in the past five years, but not prior to [effective date of this section]; and

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

(ii) Records relating to the contributions and payments referred to in paragraph (a)(18)(i)(D) 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) For purposes of this section, the terms ''contribution,'' ''covered associate,'' ''covered investment pool,'' ''government entity,'' ''official,'' ''payment,'' and ''solicit'' have the same meanings as set forth in § 275.206(4)–5.

(iv) 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.

* * * * *

(h)(1) Any book or other record made, kept, maintained and preserved in compliance with §§ 240.17a–3 and 240.17a–4 of this chapter under the Securities Exchange Act of 1934, or with rules adopted by the Municipal Securities Rulemaking Board, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this section, shall be deemed to be made, kept, maintained and preserved in compliance with this section.

* * * * *

3. Section 275.206(4)–3 is amended by adding paragraph (e) and removing the authority citation following the section to read as follows:

§ 275.206(4)–3 Cash payments for client solicitations.

* * * * *

(e) *Special rule for solicitation of government entity clients.* Solicitation activities involving a government entity, as defined in § 275.206(4)–5, shall be subject to the additional limitations set forth in that section.

4. Section 275.206(4)–5 is added to read as follows:

§ 275.206(4)–5 Political contributions by certain investment advisers.

(a) *Prohibitions.* 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 Act (15 U.S.C. 80b–6(4)), it shall be unlawful:

(1) For 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)) to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate of the investment adviser (including a person who becomes a covered associate within two years after the contribution is made); and

(2) For 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

[265] *Public Law* 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

Act (15 U.S.C. 80b–3(b)(3)) or any of the investment adviser's covered associates:

(i) To provide or agree to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless:

(A) Such person is a related person of the investment adviser or, if the related person is a company, an employee of that related person; or

(B) Such person is an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the investment adviser; and

(ii) To coordinate, or to solicit any person or 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.

(b) *Exceptions.*

(1) *De minimis* exception. Paragraph (a)(1) of this section does not apply to contributions made by a covered associate, if a natural person, to officials for whom the covered associate was entitled to vote at the time of the contributions and which in the aggregate do not exceed $250 to any one official, per election.

(2) Exception for certain returned contributions.

(i) An investment adviser that is prohibited from providing investment advisory services for compensation pursuant to paragraph (a)(1) of this section as a result of a contribution made by a covered associate of the investment adviser is excepted from such prohibition, subject to paragraphs (b)(2)(ii) and (b)(2)(iii) of this section, upon satisfaction of the following requirements:

(A) The investment adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution;

(B) Such contribution must not have exceeded $250; and

(C) The contributor must obtain a return of the contribution within 60 calendar days of the date of discovery of such contribution by the investment adviser.

(ii) An investment adviser is entitled to no more than two exceptions pursuant to paragraph (b)(2)(i) of this section per 12-month period.

(iii) An investment adviser may not rely on the exception provided in paragraph (b)(2)(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 Advisers Act (15 U.S.C. 80b–6(4)), it shall be unlawful for 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)) or any of the investment adviser's covered associates to do anything indirectly which, if done directly, would result in a violation of this section.

(e) *Exemptions.* The Commission, upon application, may conditionally or unconditionally exempt an investment adviser from the prohibition under paragraph (a)(1) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors:

(1) 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 Advisers Act (15 U.S.C. 80b);

(2) Whether the investment adviser:

(i) Before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures 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 obtain a return of the contribution; and

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

(3) 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;

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

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

(6) 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:

(1) *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.

(2) *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

(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.

(3) *Covered investment pool* means any investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(a)), or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1), section 3(c)(7) or section 3(c)(11) of that Act (15 U.S.C. 80a–3(c)(1), (c)(7) or (c)(11)), *except that* for purposes of paragraph (a)(1) of this section, an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), the shares of which are registered under the Securities Act of 1933 (15 U.S.C. 77a), shall be a covered investment pool only if it is an investment or an investment option of a plan or program of a government entity.

(4) *Executive officer* of an investment adviser means the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), or any other executive officer of the investment adviser who, in each case, in connection with his or her regular duties:

(i) Performs, or supervises any person who performs, investment advisory services for the investment adviser;

(ii) Solicits, or supervises any person who solicits, for the investment adviser, including with respect to investors for a covered investment pool; or

(iii) Supervises, directly or indirectly, any person described in paragraph (f)(4)(i) or (f)(4)(ii) of this section.

(5) *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 plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof; and

(iii) Officers, agents, or employees of 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 investment program or plan sponsored or established by a government entity, 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) *Related person* of an investment adviser means any person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser.

(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.

(g) *Effective date.* The prohibitions on providing investment advisory services and payments to solicit, in each case as described in this section, arise only from contributions and payments, respectively, made on or after [the effective date of this section].

Dated: August 3, 2009.

By the Commission.

Elizabeth M. Murphy,

Secretary.

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