State Pension Review Board Meeting
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REPORT ON FINAL PAY TO PLAY RULE ADOPTED BY THE SECURITIES AND EXCHANGE COMMISSION

INTRODUCTION

On June 30, 2010 the Securities and Exchange Commission (the "SEC") voted unanimously to adopt Rule 206(4)-5 (the "Pay to Play Rule" or the "Rule") under the Investment Advisers Act of 1940 (the "Act") addressing "pay to play" practices by investment advisers. The SEC generally uses the term "pay to play" to refer to the certain practices employed by investment advisers by making political contributions and other related payments to government officials who may be in a position to influence the selection of such advisers to manage public funds' (such as pension plans) investment accounts. The Pay to Play Rule is primarily intended to prohibit such corrupt practices and imposes significant regulatory requirements on investment advisers.

Elected officials or their associates who are in a position to select investment advisers and ask such advisers to make political contributions, or otherwise foster the perception that only advisers who make contributions will be considered for selection, hence the term "pay to play."

BACKGROUND

The adoption of the Pay to Play Rule follows the SEC's August 3, 2009 proposal and several widely publicized pay to play scandals. The most notable of all the scandals is the improprieties reported involving the New York State Common Retirement Fund (the "Retirement Fund").[1] The SEC action in the case involved a fraudulent scheme to extract kickbacks from investment

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[1] *See SEC v. Henry Morris, et al.*, Litigation Release No. 21036 (May, 12, 2009). In response to the Retirement Fund investigation revealing rampant corruption in public pension fund management, the New York Attorney General issued a Public Pension Fund Reform Code of Conduct. Important provisions under the code are as follows: (a) A ban on placement agents and lobbyists; (b) A ban on campaign contributions to avoid pay to play; (c) Increased transparency through disclosure; (d) A higher standard of conduct in connection with public pension fund business; (e) Strengthen conflicts of interest policies. The Teacher Retirement System of Texas (the "TRS") embraced the pension fund reforms against certain pay to play practices and in response drafted a policy document as an addendum to its Investment Policy Statement in July of 2009. The document covers concepts like political contributions, improper influence, placement agents and finders and applies to all TRS investment transactions in which a placement agent or finder may be involved.

management firms seeking to manage investment assets held by the Retirement Fund in trust for New York state employees, retirees and other beneficiaries. The SEC alleged that it was an undisclosed *quid pro quo* arrangement under which a multi-million dollar kickback scheme was orchestrated to enrich the deputy comptroller and his political associates acting as placement agents (but did not perform *bona fide* services) by the investment management firms seeking to win investment business from the Retirement Fund. The SEC's complaint further alleged that the deputy comptroller and his associates ensured that certain investment managers who paid millions of dollars in the form of sham placement agent fees were rewarded with lucrative investment management contracts, while investment managers who declined to make such payments were denied the Retirement Fund business. The scheme corrupted the integrity of the Retirement Fund's investment processes and resulted in the Retirement Fund's assets being invested with the undisclosed purpose of enriching government officials and their allies.

The SEC investigation into the Retirement Fund case prompted a national effort with multiple states attempting to rein in such corrupt practices in their respective states.[2] In another similar case, the SEC brought enforcement actions against the former treasurer of the State of Connecticut and other parties in which the SEC alleged that the former treasurer awarded state pension fund investments to private equity fund managers in exchange for payments, including political contributions funneled through the former treasurer’s friends and political associates.[3]

DISCUSSION

The Pay to Play Rules are modeled on rules G-37 and G-38 of the Municipal Securities Rulemaking Board (the “MSRB”), which addresses pay to play issues in municipal markets. A similar federal rule was considered by the SEC in 1999, but was not made final. The New York public pension fund scandal revealed the rampant regulatory failure with a wide range of unregistered “placement agents” who charge money managers to market their services to pension funds. Hence, the SEC through this Rule establishes significant regulatory measures to capture any such delinquency.

[2] In recent years, civil and criminal authorities have also brought cases in California, New Mexico, Illinois, Ohio, Connecticut, and Florida charging the same or similar conduct.

[3] *See SEC v. Paul J. Silvester, et al.,* Litigation Release No. 16759 (Oct. 10, 2009).

Distortion of Public Funds Investment Priorities: Pay to play practices distort public funds investment priorities as well as the process by which investment managers are selected. Fairness of the process by which public contracts are awarded, including a performance-based selection process is undermined. This in turn risks the best interest of the public funds, including pension funds and their beneficiaries, like retired teachers, fire fighters and other government employees and simultaneously creates needless expense for the fund. The SEC chairman, Mary L. Shapiro, stated at the open meeting held to approve the Pay to Play Rule that '*there should be no place for such practices in an investment advisory industry subject to high fiduciary standards*.' Investment skills and quality of service should be the tenets for allowing investment advisers of all sizes to compete for governmental contracts, including management of public pension fund investment accounts that hails trillions of dollars in assets under management.

If a government official's selection process is tainted with pay to play excesses, the public funds, especially public pension plans will be harmed in several ways:

a. the most qualified adviser may fail to be selected;
b. inferior management and performance of the fund due to lack of merit-based selection;
c. pension funds may pay higher fees because advisers would want to recover the contributions made by them; and
d. due to lack of fair contract negotiations for the pension fund's asset management, the advisers may receive greater ancillary benefits potentially at the expense of the pension fund;

Violation of Public Trust and Fiduciary Duties: Public pension funds are among the largest institutional investors in the U.S.; hence, their wealthy investment accounts draw expansive interest of investment managers all across the country. The pension fund assets are held and administered by government officials who often are responsible for selecting investment advisers to manage the funds they oversee. Therefore, the SEC believes that elected officials who allow political contributions to play a role in the management of these assets and who use these assets to reward contributors violate the public trust. Moreover, investment advisers that seek to influence government officials for awards of advisory contracts compromise their fiduciary duties to the pension funds they advise and defraud prospective clients.[4]

Implicit Nature of Pay to Play Practices: According to the SEC, pay to play practices are generally implicit in nature and vary in form, including an adviser's direct contributions to government officials, an advisers solicitation of third parties to make contributions or payments to government officials or political parties in the state or region where the adviser seeks to provide services, or an adviser's payments to third parties to solicit government business. Consequently, the SEC through this rule endeavors to identify and prohibit all direct and indirect pay to play practices, irrespective of the form in which it takes place.

SEC RULEMAKING AUTHORITY

As stated earlier, the SEC regulates investment advisers under the Act. Section 206(1) of the Act prohibits an investment adviser from employing any device, scheme, or artifice to defraud any client or prospective client. Section 206(2) prohibits an investment adviser from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Consequently, the Supreme Court has construed section 206 as establishing a federal fiduciary standard governing the conduct of investment advisers.[5] The SEC has 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."

APPLICABILTY AND EFFECTIVE DATE

The Pay to Play Rule applies to the Investment Advisers registered (or required to be registered) with the SEC under the Act as well as "covered associates" of such advisers. The SEC defines a covered associate as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee;

[4] *See* SEC Release No. IA-3043; File No. S7-18-09

[5] *See Transamerica Mortgage Advisors, Inc. v. Lewis,* I444 U.S. 11, 17 (1979)

and (iii) any political action committee controlled by the investment adviser or by any person described in (i) or (ii) above.[6] In other words, the Pay to Play Rule broadly applies to those advisers or individuals working with the investment advisers for obtaining government clients and, therefore, is more likely to engage in pay to play practices. The Rule also applies to any investment adviser unregistered in reliance on the exemption available under section 203(b)(3) of the Act.[7] The rule became effective on September 13, 2010. However, investment advisers subject to the Pay to Play Rule have six months following the effective date to be in compliance with the Rule. The Rule would not apply to most small advisers that are registered with state securities authorities instead of the SEC.[8] Additionally, the SEC Rule does not preempt state and local pay to play laws that may disqualify advisers from providing services to governmental entities.

COMMENTS RECEIVED AND CORRESPONDING CHANGES TO THE FINAL RULE

The SEC first came up with the proposed rule in August of 2009 with a sixty-day comment period for interested parties to submit their views and thoughts on the proposed rulemaking. The SEC received some 250 comment letters in response to the proposed rule, many of which were from advisers, third-party solicitors, placement agents and their representatives, pension plans and their officials, trade associations, law firms, and public interest groups. Although the Final Rules are similar in many respects to the Proposed Rules, the Final Rules contain a significant change in response to the comment letters that the SEC received. The SEC had previously proposed an absolute ban on the use of placement agents by investment advisers seeking business from government clients. Public pension plans and their officials were divided on this proposed provision. While some of them embraced the proposed rule, including one that stated that the rule is an important means to "increase transparency and public confidence in the

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

[7] Section 203(b)(3) [15 U.S.C. 80b-3(b)(3)] exempts from registration any investment adviser that is not holding itself out to the public as an investment adviser and had fewer than 15 clients during the last 12 months. We are including this category of exempt advisers within the scope of the rule in order to make the rule applicable to the many advisers to private investment companies that are not registered under the Advisers Act.

[8] Advisers with less than $25 million of assets under management are prohibited from registering with the SEC by section 203A of the Act.

investment activities of all public pension funds,"[9] others were critical, arguing that the SEC proposal "may result in unintended hardships being placed upon public pension funds."[10] The SEC did not receive any letters from the plan beneficiaries whom they sought to protect with the Proposed Rule. In light of the comments relating to the ban on placement agents, the SEC deleted its previously proposed absolute ban on the use of placement agents and replaced it with a more lenient provision that allows investment advisers to continue to use placement agents as long as they are either a registered broker-dealer or SEC-registered investment adviser subject to pay to play restrictions.

PAY TO PLAY RULE SUMMARY

The new Pay to Play Rule has numerous elements that prohibit principal avenues for pay to play activities:

A. TWO-YEAR "TIME OUT" FOR POLITICAL CONTRIBUTIONS:

   a. <u>Cooling-off Period:</u> Under the Pay to Play Rule[11] an investment adviser is prohibited from receiving *compensation* for providing advice to a "government entity" within two years after the adviser or a covered associate makes a "contribution" to an "official" of that government entity. The Rule does not ban political contributions and does not limit the amount of any political contribution. Instead, the Rule imposes a two-year time out on receiving compensation for conducting advisory business with a government entity. Furthermore, the Rule not only covers the contributions made to elected officials who have legal authority to hire the adviser, but also extends to officials who can influence the hiring of an adviser, such as a person with appointment authority. This rule is largely based on the MSRB rule G-37 under which a broker-dealer is prohibited from engaging in the municipal securities business for two years after making a political contribution. As noted above, the investment advisers subject to the Rule are not

[9] Comment letter of New York City Comptroller William C. Thomson, Jr. (Oct.6, 2009).

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

[11] Rule 206(4)-5(a)(1)

prohibited from providing advisory services to a government client and are instead prohibited from receiving compensation for providing such services during the time out.[12] The SEC has taken this approach to enable an adviser to fulfill his or her fiduciary obligations of not abandoning a government client after making a triggering contribution and continue providing uncompensated advisory services for a reasonable period of time.[13]

b. Definitions:

i. Government entity: A government entity includes all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457, and 529 plans.[14] The two-year time out is thus triggered by contributions, not only to elected officials who have legal authority to hire the adviser, but also to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser.

ii. Officials: An official includes an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.[15]

iii. Contributions: A contribution is defined to include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such an election.[16] It also

[12] Rule 204(4)-5(a)(1).

[13] *See* SEC Proposing Release, at section II.A.3(a)(1).

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

[15] Rule 206(4)-5(f)(6).

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

includes transition or inaugural expenses incurred by a successful candidate for state or local office.

c. Exceptions:

i. *De Minimis* Exceptions: Individuals can make aggregate contributions of up to $350, per election, to an elected official or candidate for whom the individual is entitled to vote, and up to $150, per election, to an elected official or candidate for whom the individual is not entitled to vote. These *de minimis* exceptions are available only for contributions by individual covered associates and not the investment adviser itself.

ii. Returned Contributions: An investment adviser has an exception for inadvertent political contributions made by a covered associate to an official for whom that covered associate is *not* entitled to vote.[17] However, this exception is only available for contributions that, in the aggregate do not exceed $350 to any one official per election,[18] and the adviser discovers any such contributions within four months of the date of the contribution,[19] and the contributor obtains the return of the contribution within sixty days after discovery.[20]

B. BANNING SOLICITATION OF CONTRIBUTIONS

An investment adviser and its covered associates are prohibited from coordinating, or soliciting[21] any person or political action committee (PAC) to make (i) any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services, or (ii) any payment to a political party of the state or locality where the adviser is providing or seeking to provide investment advisory services to a government entity. These restrictions are intended to prevent an adviser from circumventing the rule's prohibition on direct contribution by "bundling" a large

[17] Rule 206(4)-5(b)(3).
[18] Rule 206(4)-5(b)(3)(i).
[19] *Id.*
[20] *Id.*
[21] Rule 206(4)-5(f)(10)(ii).

number of small employee contributions, or making indirect contributions through a state or local political party.

C. BANNING CERTAIN THIRD-PARTY SOLICITORS OR PLACEMENT AGENTS

The Pay to Play Rule also prohibits an investment adviser and its covered associates to provide or agree to provide, directly or indirectly, payment to any person to solicit government clients for investment advisory services on its behalf. The prohibition is limited to placement agents or third-party solicitors. Thus, this prohibition does not apply (i) to any of the adviser's employees, general partners, managing members, or executive officers, or (ii) if the placement agent or third-party solicitor is a regulated person that is, an SEC registered investment adviser or broker-dealer subject to similar prohibitions against engaging in pay to play practices.

D. MISCELLANEOUS PROVISIONS

a. Banning Indirect Contributions and Solicitations: The Pay to Play Rule prohibits acts done indirectly, which, if done directly would violate the Rule. As a result, an investment adviser and its covered associates cannot funnel contributions through third-parties parties, such as consultants, attorneys, family members, friends or companies affiliated with the adviser as a means to circumvent the rule.[22]

b. Covered Investment Pools: Because of the SEC's continual concern that an adviser may indirectly engage in pay to play practices in the management of government entity funds, it made the Pay to Play Rule applicable not only to an investment adviser's separately managed accounts, but also to covered investment pools.[23] Under the Rule, a covered investment pool includes such unregistered pooled investment vehicles as hedge funds, private equity funds, venture capital funds and collective investment trusts.

c. Recordkeeping: In order to impose new recordkeeping requirements, the SEC in conjunction with the Pay to Play Rule, adopted amendments to Rule 204-2 under the Act. The amended recordkeeping requirements apply to investment advisers

[22] Rule 206(4)-5(d).
[23] Rule 206(4)-5(c)

that have government clients or that provide investment advisory services to investment pools in which government entities invest. Advisers and covered associates are generally required to create and maintain certain records, like contributions made by them to government officials and payment to state or local political parties, in order for the SEC to examine for compliance with the new Pay to Play Rule.

CONCLUSION

Pay to play scandals in the states of New York, New Mexico and California brought this issue to the forefront of the public pension fund governance. Such practices distort the process by which investment advisers are selected and can in turn harm the public pension fund clients, and thereby beneficiaries of those funds. Moreover, the investment adviser's participation in pay to play practices is inconsistent with the high standards of ethical conduct required of them under the Act. Therefore, the Rule and amendments adopted by the SEC will prevent fraud, deception and manipulation by checking and reducing investment adviser participation in such practices. The Rule would also indirectly check similar practices employed by government officials who are in a position to influence the selection of an investment adviser for public pension funds.

In light of the public comments, the SEC rescinded from its earlier position of absolutely banning the use of placement agents by investment advisers in seeking business from government entities. Instead, the Commission revised the placement agent provision to allow the use of registered placement agents subject to SEC's pay to play restrictions. However, the SEC chair has indicated that if the SEC determines that the placement agents continue to inappropriately influence the selection of investment advisers for government clients - even under the enhanced rules – the SEC will consider imposing a full ban on the use of third parties.

The Pay to Play Rule aims to ensure that the placement agents, in soliciting pension fund business, conform to the highest fiduciary, ethical and legal standards and will simultaneously strengthen the faith of the pension fund beneficiaries in the integrity of their pension fund management.