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On June 30, 2010, the Securities and Exchange Commission (the SEC) unanimously approved Rule 206(4)-5 under the Investment Advisers Act of 1940 (the Advisers Act). Rule 206(4)-5 addresses so-called "pay to play" practices in the selection of investment advisers to manage the assets of U.S. state and local government entities (*e.g.*, state pension funds, any state or local government-controlled fund, or any investment program or plan sponsored or established by a state or local government, including participant-directed plans such as 529 tuition plans and 403(b) and 457 retirement plans). The rule applies to both registered advisers and unregistered advisers—including private equity, venture capital and hedge fund advisers—that rely on the existing exemption from registration for advisers with fewer than 15 clients as set forth in Advisers Act Section 203(b)(3). The new rule effectively prohibits investment advisers who advise or seek to advise government entities, as well as certain personnel of such advisers, from making, or causing to be made, greater than *de minimis* political contributions to government officials with authority or influence over the hiring of investment advisers. The new rule also requires that any placement agent retained by an investment adviser to solicit a government entity be either a registered broker-dealer that is itself subject to "pay to play" regulations or a registered investment adviser. The SEC also adopted amendments to Advisers Act Rule 204-2 to impose new recordkeeping requirements related to Rule 206(4)-5 on registered investment advisers. These new rules become effective 60 days after publication in the Federal Register (which is expected to occur shortly after the date of this Client Alert), and investment advisers will have between 6 and 12 months after the new rules' effective date to be in compliance with various provisions of the new rules.

Background

In recent years, a number of state and federal law enforcement and regulatory agencies have conducted well-publicized investigations into "pay to play" practices involving public pension funds, some of which have resulted in criminal and civil charges against investment advisers and their firms (most notably the New York Attorney General's investigation involving investments made by the New York State Common Retirement Fund). On June 30, 2010, the SEC issued Rule 206(4)-5, which is meant to address perceived abuses by investment advisers and government officials involving "pay to play."

Scope of Rule

Rule 206(4)-5 applies to all investment advisers that are registered (or required to be registered) with the SEC, and to all investment advisers that are unregistered because of the exemption provided by Advisers Act Section 203(b)(3) (advisers with fewer than 15 clients during the last 12 months).[1]

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which appears likely to be passed by the Senate and signed into law in the near future, would eliminate the Section 203(b)(3) exemption from registration for advisers with fewer than 15 clients and replace it with certain new, more limited exemptions from registration for certain advisers, including an exemption from registration for advisers that only advise private funds and have less than $150 million in assets under management, and an exemption for venture capital fund managers. The SEC will presumably be required to engage in further rulemaking following the adoption of the Dodd-Frank Act if it wishes to maintain the existing scope of Rule 206(4)-5 under the amended Advisers Act.

Additionally, the rule applies equally to investment advisers who advise government entities directly, and investment advisers who advise "covered investment pools" in which a government entity "invests" for purposes of the rule. As a result, this rule will apply not only to registered investment advisers, but to virtually all unregistered advisers to private equity funds, venture capital funds, hedge funds and other private funds. A "covered investment pool" includes (i) any investment company registered under the Investment Company Act of 1940 (the Investment Company Act) (*e.g.,* mutual funds), but only if the registered investment company is an investment option of a participant-directed plan or program of a government entity, and (ii) any company that would be a registered investment company under Section 3(a) of the Investment Company Act, but for an exclusion provided by Sections 3(c)(1), 3(c)(7) or 3(c)(11) (*e.g.,* hedge funds, private equity funds, venture capital funds and collective investment trusts[2]). The rule's restrictions generally apply to any investment adviser described above and any such adviser's "covered associates," including (i) any general partner/managing member, executive officer and person with a similar status or function, (ii) any employee who solicits, or supervises the solicitation of, a government entity, and (iii) any political action committee controlled by the investment adviser or one of its covered associates.

Restricted Activities

The new rule seeks to prevent abusive practices in the solicitation of investment management opportunities by effectively prohibiting an investment adviser and its covered associates from the following activities:

- Making greater than *de minimis* contributions to any person who is an incumbent, candidate or successful candidate for elective office of a governmental entity, if the office has direct or indirect responsibility for, or can influence the outcome of, the hiring of an investment adviser to manage the governmental entities' investments, or has authority to appoint any person who has such responsibility or influence. Covered associates are permitted to make certain de minimis contributions, on a per official per election basis, without violating the rule (up to $350 if the covered associate is entitled to vote for the official and $150 if the covered associate is not entitled to vote for the official).

- Contributions made in violation of this rule will result in a two-year "time out" period following the contribution date, during which the investment adviser will not be permitted to receive compensation for providing advisory services to such government entity. Because the rule prohibits advisers that have violated the contribution rules from receiving compensation during the two-year "time out" period, *not* from providing advisory services to the relevant government entity during such period, in some cases compliance with the rule may require advisers to manage assets without compensation for a period of time. For example, an adviser that has violated the contribution rules may be required to waive fees and carried interest on a portion of the assets in a pooled investment vehicle attributable to the government entity in question, or to manage a separate account without compensation for a period of time sufficient for the government entity to appoint a replacement manager for the account.

- Soliciting any person or political action committee to make contributions, or bundling smaller contributions into one large contribution, to (i) an official of a government entity to which the investment adviser already provides, or is seeking to provide, investment advisory services, or (ii) a political party of the state or locality where the investment adviser provides, or is seeking to provide, investment advisory services.

- Soliciting advisory business from a government entity through a placement agent, unless the placement agent is a registered investment adviser or a registered broker-dealer subject to "pay to play" regulations comparable

[2] The SEC has clarified that Rule 206(4)-5 applies to a non-bank adviser that provides advisory services to a collective investment trust in which a government entity invests, but does not apply to a bank that maintains a collective investment trust if the bank falls within the exclusion from the definition of "investment adviser" in Section 202(a)(11)(A) of the Advisers Act.

to those imposed by Rule 206(4)-5. This aspect of the rule represents a significant change from the SEC's proposed rule on "pay to play" practices released in August 2009, which would have entirely prohibited the use of placement agents by advisers soliciting government entities. FINRA is currently working on a rule applicable to broker-dealers that will prohibit "pay to play" practices in the solicitation and distribution activities of broker-dealers, and it is anticipated that FINRA will adopt such a rule prior to the compliance date of the portions of Rule 206(4)-5 relating to the use of placement agents.

In addition to the above restrictions, the rule prohibits an investment adviser and its covered associates from doing anything indirectly which, if done directly, would violate the rule.

Exemptions

The SEC acknowledged there may be situations in which a triggering contribution is made inadvertently and, thus, application of the two-year "time out" period prohibiting an investment adviser from receiving compensation may be unnecessary, and in some cases, even detrimental to the government entity. As a result, the SEC has provided two types of potential exemptions from the rule. Subject to certain limitations, if a covered associate makes a small, inadvertent contribution that would otherwise trigger a two-year "time out" period, such "time out" period will not apply if the adviser discovers the contribution within four months and the contribution is returned to the covered associate. An adviser may only rely on this exception once per covered associate, and only twice per calendar year across the firm (for advisers with 50 or fewer employees) or three times per calendar year (for advisers with more than 50 employees). Alternatively, in the case of contributions that cannot be cured under the foregoing exemption, an investment adviser can apply for an order for exemptive relief from the SEC.

Investment Companies

Rule 206(4)-5 applies to investment advisers who advise a "covered investment pool" in which a government entity "invests" for purposes of the rule. In addition to unregistered investment companies such as hedge funds, private equity funds and venture capital funds, a "covered investment pool" includes any investment company that is registered under the Investment Company Act that is an investment option of a participant-directed plan or program of a government entity (*e.g.,* 529 college savings plans and 403(b) and 457 retirement plans). Thus, any investment adviser who advises a registered investment company that has been selected by a government official as a pre-established investment choice for government plan participants is subject to this rule. Conversely, Rule 206(4)-5 will not apply to an investment adviser who advises a registered investment company that is not an option of a participant-directed plan of a government entity, even if there are government entities that hold shares in such investment company. In the final rule release, the SEC described two acceptable options for an investment adviser to a registered investment company who becomes subject to the two-year "time out" period: (i) the adviser can waive the advisory fee for the fund as a whole, in an amount approximately equal to the fees attributable to the government entity, or (ii) the government entity can pay its portion of the advisory fee, and the adviser can rebate that amount to the fund as a whole. Because an adviser to a registered investment company may have difficulty determining the identities of any participant-directed government plan investors (especially if shares are held through an intermediary), the SEC has given investment advisers to registered investment companies additional time to comply with the rule. Advisers to registered investment companies with participant-directed plan investors will have one year to comply with Rule 206(4)-5 (instead of six months) and will also have one year to comply with the amended Rule 204-2 recordkeeping requirements.

Recordkeeping

Rule 204-2 of the Advisers Act has been amended to include new recordkeeping requirements related to Rule 206(4)-5. A registered investment adviser who provides advisory services to a government entity or to a "covered investment pool" in which a government entity invests is required to maintain records documenting all contributions made by its covered associates, as well as a list of all of its advisory clients that are government entities (including any government entities that invest in a pooled fund managed by the investment adviser). A registered investment adviser that solicits government entities on behalf of other investment advisers is also subject to this recordkeeping requirement.

Next Steps

Investment advisers are generally required to be in compliance with the rule's restrictions on political contributions as of six months after the rule's effective date (*i.e.,* March 2011). The rule will only apply to political contributions made on or after this date; contributions made prior to this date will not trigger a "time out" from receiving compensation. Investment advisers are required to comply with the rule's restrictions regarding placement agents as of one year after the rule's effective date (*i.e.,* September 2011). As noted above, special compliance dates apply to advisers to registered investment companies subject to the new rules.

Pursuant to Advisers Act Rule 206(4)-7, registered investment advisers are required to put in place written policies and procedures reasonably designed to prevent violation of the rule, and therefore should review their existing policies, and where necessary, create or amend them to be in compliance with the new rule. Policies adopted by registered investment advisers that advise government entities will need to include appropriate restrictions on contributions by advisory personnel and regular reporting of political contributions, and may also include pre-clearance of contributions. In accordance with amended Rule 204-2, registered investment advisers have until March 2011 to establish recordkeeping policies for political contributions (the period is extended for an additional six months until September 2011 for registered investment advisers who advise a registered investment company that is an investment option in a participant-directed plan). Registered investment advisers will also need to implement new policies and procedures regarding the use of placement agents, which go into effect in September 2011. Unregistered investment advisers should also consider adopting written policies and procedures, including appropriate recordkeeping policies, related to the rule.

Investment advisers will need to consider Rule 206(4)-5 in the context of new hires and the appointment of existing personnel to positions that will cause such persons to become covered associates. Political contributions made by a person within two years prior to the date such person becomes a covered associate (or six months, in the case of a covered associate that does not solicit clients) will trigger Rule 206(4)-5's prohibition on compensation payable by government entities to an investment adviser.

Lastly, investment advisers will want to consider Rule 206-4(5) in the context of the acquisition of advisory firms. As a general rule, contributions by covered associates of an acquired firm will be attributed to its acquirer following the acquisition, and vice versa. This could, for example, result in an acquirer being prohibited from receiving compensation from existing clients following the acquisition in the event personnel of the acquired firm made triggering contributions prior to the acquisition date. The SEC indicated in the final release for Rule 206-4(5) that exemptive relief may be appropriate where a merger of advisory firms was not entered into for the purpose of circumventing the rule, but no automatic relief is provided under the rule. Advisory firms involved in acquisitions where either party advises government entities should review contributions by covered associates of each party as a standard part of transaction due diligence, and should consider whether an application for exemptive relief from Rule 206(4)-5 is necessary or advisable in connection with any such transaction.

[3] The exact compliance dates are unknown as of the date of this Client Alert, as the rule has not yet been published in the Federal Register. We anticipate that the rule will be published shortly, which will result in an effective date in September 2010, and six-month and one-year compliance dates in March 2011 and September 2011, respectively.

State and Local Rules

Many state and local government entities have enacted their own "pay to play" rules. Rule 206(4)-5 does not preempt these state and local rules, and these rules often differ from, and in some cases are more restrictive than, the SEC's new rule. Ropes & Gray has significant experience in helping investment advisers navigate the state-specific rules and restrictions relating to government investment management opportunities and in responding to government inquiries regarding alleged "pay to play" practices.

For more information, please contact your usual Ropes & Gray attorney.