KICKING BACK CORRUPTION IN THE PUBLIC FUND ADVISORY SELECTION PROCESS: THE SEC'S PROPOSED RULE TO CURTAIL PAY-TO-PLAY PRACTICES BY INVESTMENT ADVISERS

NICHOLAS READE EVERETT[*]

I. Introduction

Private investment advisers supply services to many public funds which provide financial support for a vast array of programs that serve the citizens of states and municipalities.[1] The largest and most important sector of privately managed public funds is government pension plans.[2] Accordingly, private investment advisers are entrusted with protecting assets that are vital to the operation of states and municipalities and that are relied upon by the beneficiaries of public pension funds.

The authority to select investment advisers is often delegated to public officials who act as trustees of public funds. [3] The advisers who are hired to provide services to public funds typically charge fees that are paid out of fund assets.[4] Unfortunately, the combination of the role of public officials in the selection process and the ability

---

[*] Boston University School of Law (J.D. 2010); Tufts University, Classics & History B.A. (2006). Mr. Everett thanks Professor Cornelius K. Hurley, Rebecca Hicks Gallup, Yomarie Silva Habenicht as well as the rest of the staff of *The Review of Banking and Financial Law* who helped tremendously in preparing this note for publication.

[1] Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 2910, 74 Fed. Reg. 39,840, 39,840-41 (proposed Aug. 7, 2009) [hereinafter SEC Release].

[2] *Id.* at 39,840, 39,841. According to the 2007 Census of Governments, 18.6 million people are beneficiaries of public pension funds. *Id.* at 39,841 n.15. These funds hold over $2.2 trillion of assets and control over 20% of publicly traded U.S. equity. *Id.* at 39,841; Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 316-17 (2008). Public pension funds represent one third of all U.S. pension assets and are active participants in investment markets. Curtis C. Verschoor, *We Need to Stop Pay-to-Play Corruption*, STRATEGIC FIN., Sept. 2009, at 14, 14.

[3] SEC Release, 74 Fed. Reg. at 39,841.

[4] Benjamin R. Silliman, *Proposed Rules for Credit Ratings Disclosures, Pay-to-Play Practices, Municipal Securities Disclosure*, BANK ACCT. & FIN., Feb.-Mar. 2010, at 41.

of investment advisers to profit by providing services has resulted in the manipulation of many public funds through "pay-to-play" schemes. A pay-to-play arrangement is characterized by a tacit agreement "whereby investment advisers who make political contributions and related payments to key officials are then rewarded with, or afforded the opportunity to compete for, contracts to manage public pension plans and other government accounts."[5]

Pay-to-play arrangements present many dangers to the management of public funds. These dangers have become more apparent over the past few years due to the discovery of pay-to-play practices in several states including: New Mexico, Illinois, Ohio, Connecticut and Florida.[6] Following the exposure of a kickback scheme involving New York's largest pension fund in early 2009, the Securities and Exchange Commission (the "SEC") decided to address the concern and issued a proposal to curtail pay-to-play practices in the public fund advisory selection process. The heart of this proposal is Proposed Rule 206(4)-5 (the "Proposed Rule"), which is designed as a prophylactic regulation that seeks to deter pay-to-play arrangements.[7] The Proposed Rule stands in contrast to present laws that allow authorities to pursue only those investment advisers and public officials who have already engaged in pay-to-play practices.[8] In the view of the SEC, a preventive rule is needed to

---

[5] Mary L. Schapiro, Chairman, Sec. Exch. Comm'n, Statement at SEC Open Meeting (July 22, 2009), *available at* http://www.sec.gov/news/speech/2009/spch072209mls.htm.

[6] SEC Release, 74 Fed. Reg. at 39,843.

[7] Statement by Mary L. Schapiro, *supra* note 5.

[8] *See id.*:

> While the SEC can and has brought fraud cases related to kickbacks in adviser pay to play schemes, we are concerned there may be broader efforts and monetary payments being made to influence the selection of advisers to manage government plans. These payments have a distortive influence on the adviser selection process.

The SEC is able to bring actions against alleged participants in pay-to-play schemes based on violations of the Securities Act, the Securities Exchange Act and the Investment Advisers Act. *See*, *e.g.*, Sec. Exch. Comm'n v. Henry Morris, et al., Litigation Release No. 21036, 2009 WL 1309715 (May 12, 2009) (reporting action brought against alleged pay-to-play participants for engaging in fraudulent scheme involving New York state pension fund in violation of Section 10(b) of the Securities Exchange Act, Rule 10b-5, and Sections 206(1) and 206(2) of the Investment Advisers Act) [hereinafter curtail the use of pay-to-play practices because these manipulative arrangements hinder the prudent management of public funds, encourage advisers to act in a manner inconsistent with their duties under the Investment Advisers Act and injure public perceptions of elected officials and government administration.[9]

As currently drafted, the core framework of the Proposed Rule would act as a powerful deterrent against pay-to-play practices in the advisory selection process. The SEC, however, could bolster the effectiveness of the Proposed Rule and limit its impact on industry participants through the adoption of certain amendments. This note focuses on the SEC's proposal. Section II briefly describes pay-to-play arrangements as well as the dangers associated with this practice and highlights the need for the Proposed Rule. Section III summarizes the structure of the Proposed Rule, summarizing what the SEC intends to accomplish with the Proposed Rule. Sections IV through VII explain in detail the core regulations contained in the Proposed Rule and present both the SEC's and the financial industry's view on the need and adequacy of the regulations.

II. Background of Pay-to-Play

A. History of Pay-to-Play

In a typical pay-to-play arrangement, an investment adviser will make a political contribution to an elected official, either directly or through an intermediary, in exchange for an advisory contract with

---

Morris May Litigation Release]; In the Matter of Kent D. Nelson, Initial Decision Release No. 371, 95 SEC Docket 788, at 5 (Feb. 24, 2009) (barring defendant from associating with any broker or investment adviser pursuant to Section 15(b) of the Securities Exchange Act and Section 203(f) of the Investment Advisers Act for committing wire fraud in furtherance of a pay-to-play scheme); Sec. Exch. Comm'n v. Paul J. Silvester et al., Litigation Release No. 16759, 73 SEC Docket 1255 (Oct. 10, 2000) (reporting action brought against alleged participants in a pay-to-play scheme involving Connecticut state pensions funds and alleging violations of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, Rule 10b-5, and Sections 206(1) and 206(2) of the Investment Advisers Act). Moreover, pay-to-play practices may be prosecuted under state and federal criminal laws, including enterprise corruption, extortion, conspiracy and wire fraud. SEC Release, 74 Fed. Reg. at 39,843 n.35, n.36, n.40.

[9] SEC Release, 74 Fed. Reg. at 39,844.

a public fund over which the official has influence.[10] Investment advisers who participate in these schemes are willing to pay kickbacks because of the lucrative management fees that large public funds provide.[11]

Pay-to-play practices are thought to be widespread and are threatening the integrity of the public fund system:

> 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.[12]

Pay-to-play practices involving public pension funds have become more apparent over the past fifteen years.[13] In 1999, the SEC first attempted to promulgate regulations directed at preventing pay-to-play arrangements in the public fund advisory business.[14] The rule proposed by the SEC at that time, however, failed to gain widespread support from the industry, with many commentators arguing that pay-to-play did not pose a danger to public fund management.[15] Consequently, the SEC withdrew its proposal.[16] Nonetheless, pay-to-play practices have persisted. It has become increasingly clear that these manipulative schemes are in fact harmful to the beneficiaries of public pensions.[17] Moreover, a number of recently publicized cases

---

[10] Press Release, Sec. and Exch. Comm'n, SEC Proposes Measures to Curtail "Pay to Play" Practices (July 22, 2009), *available at* http://www.sec.gov/news/press/2009/2009-168.htm. ("The measures are designed to prevent an adviser from making political contributions or hidden payments to influence their selection by government officials.")

[11] *See id.*

[12] SEC Release, 74 Fed. Reg. at 39,841.

[13] *Id.* at 39,842.

[14] Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 1812, 70 SEC Docket 611 (proposed Aug. 4, 1999); Verschoor, *supra* note 2, at 14.

[15] SEC Release, 74 Fed. Reg. at 39,842.

[16] *Id.* at 39,841 n.17.

[17] *See* Letter from Bob Edgar et al., to Elizabeth M. Murphy, Sec'y, SEC 1-3 (Oct. 6, 2009), http://www.sec.gov/ comments/s7-18-09/s71809-241.pdf.

acted as the impetus for the SEC to promulgate the Proposed Rule in order to curtail the manipulation of the public fund advisory selection process.[18]

The most prominent recent example of a pay-to-play scheme involved New York State's largest pension fund, the Common Retirement Fund (the "CRF").[19] In early 2009, New York Attorney General Andrew Cuomo and the SEC brought actions against public officials and investment advisers for participating in a pay-to-play scheme in New York.[20] The New York state Comptroller (the "Comptroller") is the elected official who serves as the CRF's sole trustee and is charged with operating the fund.[21] The Comptroller typically appoints a Chief Investment Officer who is authorized to select investment advisers.[22] In 2004, the Comptroller's top political consultant, Hank Morris, arranged for the appointment of David Loglisci as Deputy Comptroller and Chief Investment Officer of the CRF.[23] Thereafter, Loglisci and Morris placed portions of the CRF under the management of private equity firms and hedge funds in return for "finder's fees" paid to the two men or their intermediaries.[24] Furthermore, advisers paid kickbacks to Morris in order to acquire investments from the CRF.[25]

This scheme illustrated some of the hazards of pay-to-play practices. First, the desire for personal gain, rather than sound financial advice, guided the CRF's investment decisions. The public officials involved in the scandal violated their fiduciary duty as trustees of the CRF by elevating their own interests over the interests

---

[18] SEC Release, 74 Fed. Reg. at 39,842-43 (recounting actions brought by criminal authorities for pay-to-play practices in New York, New Mexico, Illinois, Ohio, Connecticut, and Florida); Steven W. Rabitz & Marissa J. Holob, *The Outplacement of Placement Agents? SEC Proposes New "Pay-to-Play" Rules*, J. INVESTMENT COMPLIANCE.

[19] Sec. Exch. Comm'n v. Henry Morris, et al., Litigation Release No. 20963, 95 SEC Docket 1305 (Mar. 19, 2009) [hereinafter Morris March Litigation Release]. As of March 31, 2006, the CRF was valued at over $140 billion. *Id.* The fund has over 650,000 members. People v. Morris, Indictment No. 25/2009 (N.Y. Mar. 19, 2009) at 2.

[20] People v. Morris, Indictment No. 25/2009 (N.Y. Mar. 19, 2009) at 2-3; Morris May Litigation Release, *supra* note 8.

[21] Morris March Litigation Release, *supra* note 19.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] Morris May Litigation Release, *supra* note 8.

of the fund's beneficiaries.[26] Second, the investment advisers who participated in the scheme violated their duties under the Investment Advisers Act by participating in a manipulative scheme. Additionally, advisers who did not make the kickback payments and pay finder fees were precluded from doing business with the CRF. Finally, the scandal "seriously eroded public and investor confidence in the integrity of the decision-making process surrounding investments by the [CRF]."[27]

Throughout the United States, investment advisers and public officials have repeatedly manipulated the public fund advisory selection process through pay-to-play arrangements. In so doing, they have injured their own integrity and endangered the assets upon which public fund beneficiaries rely.

B. The Hazards of Pay-to-Play

Pay-to-play practices present a wide array of hazards. Most critically, they prevent public funds from receiving optimal advisory services, thereby injuring the beneficiaries of these funds. In addition, investment advisers violate their statutory duties by participating in these manipulative arrangements. Finally, pay-to-play practices corrupt public officials and promote suspicions of poor government decision-making.

Pay-to-play schemes harm public funds because the adviser selection process is based on bribes rather than the actual needs of the fund. The hazards of pay-to-pay arrangements to public fund beneficiaries were well summarized in a comment letter addressed to the SEC regarding the Proposed Rule:

> Permitting advisers to win contracts to manage public money and provide other financial services . . . by making contributions to elected officials results in the allocation of business not to the advisers best suited for the job, but to the advisers

---

[26] New York Attorney General Andrew Cuomo described this pay-to-play scheme as "a web of corrupt acts for both political and personal gain." Joan Gralla, *NY Pension Adviser Charged in Kickback Scheme*, REUTERS, Mar. 20, 2009, http://www.reuters.com/article/idUSLNE52J02820090320.

[27] Letter from Thomas DiNapoli, State Comptroller, to Elizabeth M. Murphy, Sec'y, SEC (Oct. 2, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-134.pdf.

> with the strongest political relationships. These practices adversely affect the economic interests of millions of America's public servants.[28]

A pay-to-play scheme may lead a public official to select an investment adviser that pays kickbacks rather than the most appropriate adviser for the fund.[29] In turn, this misguided selection can give rise to "inferior management, diminished returns or greater losses."[30] Moreover, the absence of an arm's-length relationship between the public official and investment adviser may result in higher fees.[31] Accordingly, "[p]ay to play practices can result in public plans and their beneficiaries receiving sub-par advisory services – at inflated prices."[32]

Pay-to-play practices also threaten the integrity of investment advisers by creating "the potential to compromise an investment adviser's ethical and legal duties under the Investment Adviser's Act of 1940."[33] Under that Act, investment advisers are prohibited from engaging in "any act, practice, or course of business which is fraudulent, deceptive or manipulative."[34] An adviser that participates in a pay-to-play scheme manipulates the advisory selection process by using bribes to influence trustees of public funds. Furthermore, advisers who engage in pay-to-play schemes risk breaching their fiduciary duty to clients by failing to render advice that is disinterested and divided from their personal interests.[35] A contribution by an adviser directed at securing advisory work "creates a conflict of interest between the adviser (whose interest is

---

[28] Letter from Mercer E. Bullard, President and Founder, Fund Democracy, to Elizabeth M. Murphy, Sec'y, SEC 1 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-177.pdf.
[29] SEC Release, *supra* note 1, at 39,844.
[30] *Id.*
[31] *Id.*
[32] Statement by Mary L. Schapiro, *supra* note 5.
[33] Letter from Bob Edgar et al., *supra* note 17, at 1.
[34] Investment Advisers Act § 206, 15 U.S.C. § 80b-6(4) (2006).
[35] Sec. Exch. Comm'n v. Capital Gain Research Bureau, Inc., 375 U.S. 180, 191-192 (1963); Monetta Fin. Servs., Inc. v. Sec. Exch. Comm'n, 390 F.3d 952, 955 (7th Cir. 2004); *see* Investment Adviser Code of Ethics, 17 C.F.R. § 275.204A-1 (2009); Investment Advisers Act Release No. 2256, 83 SEC Docket 828 (July 2, 2004) (describing how each investment adviser must adopt an ethics standard that reflects "the adviser's fiduciary obligations and those of its supervised persons").

in being selected) and its prospective client (whose interest is in obtaining the best possible management services)."[36] Moreover, the covert nature of pay-to-play schemes means that an adviser would not disclose such a conflict of interest to his or her clients. Investment advisers who engage in pay-to-play practices also have an advantage in the marketplace because they have access to funds that are not available to advisers that refuse to participate in these schemes.[37] As one commentator stated, "pay to play is a nuisance for honest professionals trying to market and sell investment services."[38] Additionally, these arrangements allow certain advisers to take business away from more qualified advisers that do not engage in pay-to-play schemes.[39]

Finally, pay-to-play practices pervert public officials and promote perceptions of corrupt government administration. Politicians have an incentive to engage in pay-to-play schemes because these arrangements are intertwined with campaign funding.[40] The current ease at which candidates for public office can fund their campaigns through kickbacks tempts them to engage in this corrupt practice.[41] Accordingly, pay-to-play schemes distort the motivations of public officials and encourage them to act unethically.[42] Similarly,

---

[36] SEC Release, 74 Fed. Reg. at 39,844 n.49.

[37] *Id.* at 39,841 ("Pay to play practices also may manipulate the market for advisory services by creating an uneven playing field among investment advisers.").

[38] Girard Miller, *Will SEC Ban Pension 'Pay to Play'?*, GOVERNING, Aug. 6, 2009, http://www.governing.com/ column/will-sec-ban-pension-pay-play.

[39] *See* SEC Release, 74 Fed. Reg. at 39,860.

[40] Blount v. Sec. Exch. Comm'n, 61 F.3d 938, 945 (D.C. Cir. 1995), cert. denied, 517 U.S. 1119 (1996) ("As beneficiaries of the practice, politicians vying for state or local office may be reluctant to stop it legislatively . . . if they refuse to enter into similar relations, their campaigns will be financially handicapped."); *See* Editorial, *The Price of Pay-to-Play*, N.Y. TIMES, Jan. 14, 2009, at A32 ("Pay-to-play is a staple of bad government. . . . What's needed is some courage in statehouses to fix the shoddy campaign-finance rules and laissez-faire lobbying privileges and impose bans on 'fact-finding' junkets and other 'honest graft' for legislators. Clear rules would remove any doubt, and any temptation.")

[41] *See* Blount, 61 F.3d at 945.

[42] *See* Letter from Michael R. Bloomberg, Mayor of N.Y., to Elizabeth M. Murphy, Sec'y, SEC 1 (Sept. 9, 2009), *available at* http://www.sec.gov/ comments/s7-18-09/s71809-87.pdf ("New York City taxpayers deserve to know that elected officials, who act as fiduciaries of the pension systems,

pay-to-play schemes result in a negative perception of government administration.[43] The discovery of kickback arrangements that are at the heart of pay-to-play schemes produce suspicions that elected officials use their authority to promote their own self interests rather than to benefit the public. "Democracy works 'only if the people have faith in those who govern, and that faith is bound to be shattered when high officials and their appointees engage in activities which arouse suspicions of malfeasance and corruption.'"[44]

Pay-to-play practices pose a danger to the beneficiaries of public funds and threaten the integrity of investment advisers and public officials. Moreover, based on the widespread manipulation of the advisory selection process of public funds, current laws appear inadequate to effectively deter investment advisers from participating in pay-to-play schemes. Accordingly, through the promulgation of the Proposed Rule the SEC has attempted to craft a regulatory framework that would curb the ability of investment advisers to engage in pay-to-play arrangements.

III. An Overview of the Purpose and Structure of the Proposed Rule

The SEC is attempting to curtail pay-to-play practices in the public fund advisory selection process through the introduction of the Proposed Rule. The SEC proposed this regulation pursuant to §206(4) of the Investment Advisers Act, which authorizes the SEC to promulgate rules designed to prevent "acts, practices, and courses of business as are fraudulent, deceptive or manipulative."[45] In accordance with this authorization, the Proposed Rule seeks to hinder investment advisers and their associates from engaging in pay-to-play arrangements. The SEC hopes that the Proposed Rule will put

---

are making decisions based on the best pension investment rather than their own interest in raising funds for political campaigns.").

[43] Letter from Bob Edgar et al., *supra* note 17, at 1-2.

[44] Nixon v. Shrink Mo. Gov't PAC, 528 U.S. 377, 390 (2000) (quoting United States v. Mississippi Valley Generating Co., 364 U.S. 520, 562 (1961)); *See* Fed. Election Comm'n v. Mass. Citizens for Life, Inc., 479 U.S. 238, 257 (1986) ("Direct corporate spending on political activity raises the prospect that resources amassed in the economic marketplace may be used to provide an unfair advantage in the political marketplace.").

[45] 15 U.S.C. § 80b-6(4).

an end to pay-to-play practices "by preventing advisers' participation in such practices."[46]

The regulations contained in the Proposed Rule apply to any investment adviser registered, or required to be registered, with the SEC and any investment adviser unregistered pursuant to §203(b)(3) of the Investment Advisers Act.[47] The Proposed Rule also ensures that advisers cannot circumvent the regulations by using their employees as conduits as the regulations pertain to all "covered associates."[48] Furthermore, the Proposed Rule treats investment advisers that provide services to "covered investment pools"[49] in which a government entity invests or are solicited to invest as if such advisers were providing or soliciting services directly to the government entity.[50]

---

[46] SEC Release, 74 Fed. Reg. at 39,844.

[47] *Id.* at 39,868-69 (containing the text of Proposed Rule 206(4)-5(a), (d)).

[48] *See id.* at 39,844-45. The Proposed Rule 206(4)-5(f)(2) broadly defines covered associates as any "general partner, managing member or executive officer, or other individual with a similar status or function;" any "employee who solicits a government entity for the investment adviser" and any political action committee that is controlled by the investment adviser or its associates. *Id.* at 39,869.

[49] The Proposed Rule defines a covered investment pool as "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)) . . . ." *Id.* at 39,868-69 (stating the text of Proposed Rule 206(4)-5(f)(3)). The SEC's proposal states that investment pools include mutual funds, hedge funds, private equity funds and venture capital funds. *Id.* at 39,855 n.161. However, for the purpose of section 206(4)-5(a)(1) of the Proposed Rule, certain types of investment companies are exempt from this definition: "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." *Id.* at 39,869 (declaring the text of Proposed Rule 206(4)-5(f)(3)). An example of when this exception would apply is when a government entity invests in a mutual fund. *Id.* at 39,857 n.185.

[50] SEC Release, 74 Fed. Reg. at 39, 869 (presenting the text of Proposed Rule 206(4)-5(c))

The Proposed Rule seeks to curtail pay-too-play practices through three core prophylactic mechanisms: (1) sanctioning advisers that make contributions to public officials involved in the advisory selection process; (2) barring advisers from using third party agents to channel payments intended to solicit government business and (3) prohibiting advisers from coordinating political contributions to public officials and political parties of localities where such advisers are seeking public fund advisory contracts.[51] These three core regulations are complemented by a broad prescription against indirect participation in pay-to-play practices, which prohibits any activity that would violate the Proposed Rule if performed directly.[52]

The SEC modeled much of the Proposed Rule after Municipal Securities Rulemaking Board ("MSRB") rules G-37 and G-38.[53] These two rules are designed to prevent pay-to-play practices in the municipal securities market.[54] MSRB rule G-37 ("Rule G-37") creates a two-year ban from the municipal securities market for dealers that have made political contributions to an elected official that has influence over a government securities issuer.[55] MSRB rule G-38 ("Rule G-38") prohibits dealers from using third party solicitors to obtain government issued securities.[56] Rule G-38 works in conjunction with Rule G-37 to prevent dealers from circumventing

---

[51] Silliman, *supra* note 4, at 43-44.

[52] *Id.* This regulation is intended to close a potential loophole in the Proposed Rule. Furthermore, it "signals the SEC's heightened concern about indirect payments and puts advisers on notice that the SEC will not tolerate attempts to 'game' the rule." Morgan Lewis, Investment Management/Private Investment Fund Lawflash, Aug. 7, 2009, at 4, http://www.morganlewis.com/pubs/IM+PIF_PayToPlayPractices_LF_07aug09.pdf.

[53] SEC Release, 74 Fed. Reg. at 39,841.

[54] *Id.* at 39,841-42; *see generally* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. IA-1812, 70 SEC Docket 611 (Aug. 4, 1999). The SEC never implemented this proposed rule into a formal rule. SEC Release, 74 Fed. Reg. at 39,842; Sarah N. Lynch, *SEC Votes to Propose Rules that Will Ban 'Pay to Play,'* WALL ST. J., July 24, 2009, at C5. The Proposed Rule is also modeled after the similar rule that the SEC proposed in 1999. *See* supra note 14 and accompanying text.

[55] Letter from Peter T. Clarke, Chair, Mun. Sec. Rulemaking Bd., to Elizabeth M. Murphy, Sec'y, SEC 2 (Oct. 23, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-247.pdf.

[56] *Id.*

the prohibition of political contributions.[57] These rules are instrumental devices in the MSRB's successful campaign to restrain pay-to-play practices in the municipal securities market in recent years.[58]

Similar to the MSRB rules, the SEC focused its proposal on preventing investment advisers from making political contributions as part of schemes to secure government advisory contracts. The Proposed Rule is intended to forestall advisers from making both direct and indirect contributions as part of a pay-to-play arrangement.[59] If adopted, the Proposed Rule would act as a powerful prophylactic against manipulation of the advisory selection process and greatly hinder advisers from engaging in kickback schemes. Consequently, the availability of pay-to-play as a means for public officials to enrich themselves and fund their campaigns would be greatly diminished. The Proposed Rule would thus protect the beneficiaries of public funds.

IV. The Two-year Compensation Ban

A. An Overview of the Regulation as it is Proposed

The Proposed Rule's first regulation attempts to prevent direct contributions by advisers that are aimed at securing advisory contracts. As a means of deterring these direct pay-to-play arrangements, this regulation would make it unlawful for any investment adviser or covered associate:

---

[57] *Id.*

[58] Letter from Alexander W. Butler, Assoc. Professor of Fin., Rice Univ., et al., to Elizabeth M. Murphy, Sec'y, SEC (Sept. 30, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-121.pdf (explaining how the authors' research has demonstrated that MSRB rules G-37 and G-38 have effectively addressed pay-to-play practices); Letter from Peter T. Clarke, *supra* note 55, at 2 ("The MSRB believes that Rule G-37 and G-38 have been critical tools for effectively maintaining the integrity of the municipal securities market and protecting investors and the public interest."). Interestingly, the SEC views the success of Rule G-37 and Rule G-38 as a possible cause of the growth of pay-to-play practices involving public funds over the past fifteen years. SEC Release, 74 Fed. Reg. at 39,842.

[59] SEC Release, 74 Fed. Reg. at 39,844.

> [T]o 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) . . . .[60]

The Proposed Rule defines a government entity broadly to include any "plan, program, or pool of assets sponsored or established by [a] state or political subdivision."[61] Thus, this regulation would create a two-year "time out" from receiving compensation for advisory services provided to a public fund following a contribution to an official with influence over the public fund's advisory selection process. The implied prohibition of certain contributions and the two-year compensation ban is intended to be a deterrent against manipulative activity without imposing an excessive burden upon investment advisers.[62] Furthermore, it ensures that an investment adviser subject to the ban may continue to provide services to a government entity client to whom the adviser owes fiduciary duties.[63]

In order to protect the ability of advisers' associates to engage in political speech, the Proposed Rule contains a *de minimis* exception for contributions made by covered associates of less than $250 per election in which the covered associate is entitled to vote.[64] The SEC believes that contributions at or below this amount allow covered associates to engage in political speech "without the intent or ability to influence the selection process of investment advisers."[65]

---

[60] *Id.* at 39,868 (emphasis added) (submitting the text of Proposed Rule 206(4)-5(a)(1)).
[61] *Id.* at 39,869 (stating the text for Proposed Rule 206(4)-5(f)(5)(ii)).
[62] *Id.* at 39,848.
[63] Letter from William A. Jacobson, Dir., Cornell Sec. Law Clinic, to Elizabeth M. Murphy, Sec'y, SEC 2 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-180.pdf.
[64] The Proposed Rule states: "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." SEC Release, 74 Fed. Reg. at 39,869.
[65] *Id.* at 39,850.

Similarly, the Proposed Rule contains a limited exception for contributions made without the intent to participate in a pay-to-play scheme that are timely returned to the contributor when the payment is discovered.[66] This "returned contribution" exception applies to contributions made to officials and candidates for whom a covered associate is not entitled to vote in an election.[67] In order for a contribution to qualify for this exception: (1) the investment adviser must discover the contribution within four months, (2) the contribution must not exceed $250 and (3) the contributor must obtain the return of the contribution within 60 days.[68] Furthermore, each adviser cannot rely on the exception more than twice in a twelve-month period.[69] Additionally, for each covered associate, the investment adviser cannot rely on it more than once regardless of the time period.[70] The SEC believes such an exception protects advisers from "inadvertently" triggering the two-year time out without creating an incentive for an investment adviser "to relax its efforts to promote compliance with the rule's prohibitions."[71]

The Proposed Rule also offers investment advisers the ability to petition the SEC for a discretionary exemption from the two-year time out. The success of an application for this exemption depends upon a number of factors, including the effect on public interests, consistency with the purposes of the Investment Advisers Act, the preventative and remedial steps taken by the adviser, the timing of the contribution, the size of the contribution, the nature of the election for which the contribution was made and the contributor's intent and motive.[72] This exemption is intended to protect advisers in situations "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."[73]

---

[66] *Id.* at 39,869 (presenting the text of Proposed Rule 206(4)-5(b)(2)).
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] SEC Release, 74 Fed. Reg. at 39,869.
[71] *Id.* at 39,851.
[72] *Id.* at 39,867-69.
[73] *Id.* at 39,859.

B. The SEC's View

The SEC designed the Proposed Rule to prevent manipulation of the process through which public funds select investment advisers.[74] The compensation ban is intended to prevent advisers from engaging directly in the *quid pro quo* exchanges that characterize pay-to-play arrangements,[75] while nevertheless allowing advisers to make legitimate political contributions to officials who are not in a position to award advisory contracts.[76] Additionally, because this regulation captures direct contributions by advisers, it is seen as a necessary component of the Proposed Rule's comprehensive scheme to curtail pay-to-play practices.[77]

The SEC believes that a two-year ban from receiving compensation from a government entity following a contribution to a public official with influence over the government entity's advisory selection process strikes an appropriate balance between deterrence and fairness.[78] Although the Commission recognizes that the two-year time out would have a substantial impact upon the business of an investment adviser, it believes that such penalty is necessary to deter pay-to-play practices.[79] "We are proposing that the time out be two years long because the duration needs to be sufficiently long to have a deterrent effect."[80] Furthermore, the SEC recognizes the success of Rule G-37, which contains a similar ban, as strong evidence that a two-year prohibition on compensation would serve as an effective deterrent.[81]

The SEC also views the regulation as sufficiently narrow to avoid overly burdening investment advisers.[82] The Proposed Rule is designed to limit the impact of the compensation ban upon advisers because only contributions to certain officials would be sanctioned.[83] In other words,

---

[74] *Id.* at 39,866.
[75] *See* SEC Release, 74 Fed. Reg. at 39,844-45.
[76] *See id.* at 39,844-45, 39,848.
[77] *See id.* at 39,844-45.
[78] *Id.* at 39,847.
[79] *Id.* at 39,846.
[80] SEC Release, 74 Fed. Reg. at 39,846.
[81] *Id.* at 39,846-47.
[82] *Id.* at 39,846 n.76.
[83] *Id.* at 39,845.

> 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.[84]

This limited scope would prevent the prohibition from unnecessarily punishing advisers that make contributions to officials that have no influence over the public fund advisory selection process.[85]

Similarly, the SEC designed the regulation's carve-outs to prevent the application of the compensation ban to contributions which do not implicate pay-to-play concerns. The returned contribution exception and discretionary exemption would protect advisers and ensure that contributions unrelated to the advisory selection process are not sanctioned.[86] Likewise, the *de minimis* exception would allow covered associates to participate in the democratic process.[87]

In the view of the SEC, the compensation ban resulting from contributions to officials who control the advisory selection process provides a strong incentive against engaging in pay-to-play practices while accounting for the rights of investment advisers and their employees.[88] Accordingly, the SEC believes that this regulation is an essential component of its scheme to curtail pay-to-play practices.[89]

C. The Industry's View

In announcing the Proposed Rule, the SEC requested comments from those who would be affected by the prospective regulations.[90] One widely criticized aspect of the compensation

---

[84] *Id.* at 39,846 n.76.
[85] SEC Release, 74 Fed. Reg. at 39,847 n.76.
[86] *Id.* at 39,850, 39,859.
[87] *Id.* at 39,850.
[88] *Id.* at 39,847.
[89] *See id.* at 39,844-45; Statement by Mary L. Schapiro, *supra* note 5.
[90] SEC Release, 74 Fed. Reg. at 39,860.

prohibition is the regulation's similarity to the MSRB's Rule G-37.[91] Commentators argue that major differences in the business practices of the investment advisory industry and the municipal securities market, including how services are provided and the frequency of such services, require differences in pay-to-play deterrence methods used in these two industries.[92] In the municipal securities market, brokers generally contract with government clients on a transactional basis.[93] Thus, the obligations that a broker owes to a client typically expire once the municipal securities underwriting has concluded.[94] Conversely, public funds employ advisers to continuously manage their investment portfolio. Moreover, investment advisers are fiduciaries whereas municipal securities underwriters are not.[95] As a fiduciary, an adviser would have an obligation to continue to provide services to a client for a period of time, even if uncompensated.[96] Commentators contend that these major differences between the municipal securities market and the investment advisory business

---

[91] *E.g.*, Letter from Monique S. Botkin, Senior Counsel, Inv. Adviser Ass'n, to Elizabeth M. Murphy, Sec'y, SEC 20 4-6 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-181.pdf; Letter from Joan Hinchman, Executive Dir., President and CEO, Nat'l Soc'y of Compliance Prof'ls, to Elizabeth M. Murphy, Sec'y, SEC 4 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-138.pdf; Letter from Simpson Thacher & Bartlett, to Elizabeth M. Murphy, Sec'y, SEC 5-6 (Sept. 21, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-98.pdf 5-6.

[92] *E.g.*, Letter from Ki P. Hong, et al., Skadden, Arps, Slate, Meagher & Flom, to Elizabeth M. Murphy, Sec'y, SEC 6-7 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-220.pdf; Letter from Nora M. Jordan, et al., Davis Polk & Wardwell, to Elizabeth M. Murphy, Sec'y, SEC 4 (Oct. 6, 2009), *available at* http://www.sec.gov/ comments/s7-18-09/s71809-213.pdf; Letter from Jane A. Kanter, Dechert LLP, to Elizabeth M. Murphy, Sec'y, SEC 2-3 (Oct. 22, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-246.pdf.

[93] Letter from Jane A. Kanter, *supra* note 92, at 2.

[94] Letter from Ki P. Hong, et al., *supra* note 92, at 2.

[95] Letter from Jane A. Kanter, *supra* note 92, at 2.

[96] *Id.* at 3, 11; Letter from Ki P. Hong, et al., *supra* note 92, at 3 (describing how investment advisers must provide "advice, skill, and professional services" to clients for the duration of a contract and therefore the ban would force investment advisers with government clients to continue to provide services at a loss); *see* Sec. Exch. Comm'n v. Capital Gains Research Bureau, 375 U.S. 180, 189-92 (1963).

render the two-year compensation ban inappropriate for combating pay-to-play practices involving public funds.[97]

Furthermore, many commentators view the two-year compensation ban as incompatible with the nature of the relationship between advisers and public funds. They argue that the Proposed Rule would harm the business interests of advisers.[98] For example, an adviser subject to the ban that needed to continue to provide services to a public fund in order to fulfill its fiduciary duties could neither recover the costs of such services nor profit from the use of resources required to offer them.[99] Moreover, because of the long-term nature of advisory services, public funds infrequently place advisory contracts up for re-bidding.[100] Therefore, if an adviser loses a client because it cannot provide uncompensated services, that adviser may not be able to regain its lost business even after the two-year ban on compensation has expired.[101]

Furthermore, commentators argue the compensation prohibition would adversely affect public fund beneficiaries because officials would be discouraged or prohibited from selecting advisers that manage closed-end funds.[102] Investments in closed-end funds are often conditioned upon a contractual agreement that prohibits early

---

[97] Letter from David Oestreicher, Chief Legal Counsel, T. Rowe Price Assocs. et al., to Elizabeth M. Murphy, Sec'y, SEC 3 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-206.pdf ("The [SEC] should draft its political contribution rule to recognize this fundamental difference and to show the flexibility that recognizes the best interests of the client *and* fundamental fairness to the adviser.").

[98] *E.g.*, Letter from Ki P. Hong, et al., *supra* note 92, at 4; Letter from Nora M. Jordan et al., *supra* note 92, at 4.

[99] Letter from Ki P. Hong et al., *supra* note 92, at 4.

[100] Letter from Nora M. Jordan et al., *supra* note 92, at 4.

[101] Letter from Nora M. Jordan et al., *supra* note 92, at 4; Andrew Ackerman, *SEC Official Questions Alternative to Pay-to-Play Rule*, BOND BUYER, July 30, 2009, at 5 (reporting that the general counsel for the Investment Advisers Association described the compensation ban as a "death penalty").

[102] Letter from Nora M. Jordan, et al., *supra* note 92, at 4. Closed-end funds are characterized by having a fixed number of shares. Thus, at any time there are a limited number of shares available for purchase. Moreover, if demand for such shares is low then they may sell a discounted value. ANTHONY SAUNDERS & MARCIA MILLON CORNETT, FINANCIAL MARKETS AND INSTITUTIONS 501 (4th ed. 2009).

redemption of shares.[103] Moreover, even if it were possible for an adviser to withdraw a government entity client's shares, this action would likely harm any closed-end fund that holds illiquid assets because it would require a fire sale of some of the firm's investments.[104] Early redemption, therefore, could harm the fund and adversely affect its other investors.[105] Thus, an adviser that manages a closed-end fund who is sanctioned with the compensation ban must choose to either provide uncompensated services for two years or face the potential negative consequences related to early redemption of the government entity client's shares.[106] The threat of being subject to this prisoner's dilemma may dissuade advisers from contracting with government entities.[107] Such circumstances, commentators argued, would adversely affect public fund beneficiaries because it would significantly deteriorate investment options available to government entities.[108]

D. Analysis

Pay-to-play schemes are characterized by unethical arrangements that are harmful to the beneficiaries of public funds, inconsistent with the duties of investment advisers and injurious to the democratic process. Therefore, advisers that participate in these arrangements by making direct contributions to officials with influence over the public fund advisory selection process should suffer harsh consequences. Punitive measures are necessary to curtail pay-to-play practices and deter the manipulation of the selection process. The recent events in New York and elsewhere illustrate the need to impose powerful sanctions against advisers who engage in pay-to-play schemes. Although industry participants argue that the regulation would have a detrimental effect on the investment option available to public funds, pay-to-play practices are extremely harmful to public fund beneficiaries. Accordingly, this regulation, which

---

[103] Letter from Ki P. Hong et al., *supra* note 92, at 4.
[104] Letter from Kent R. Richey, Jones Day, to Elizabeth M. Murphy, Sec'y, SEC 3 (Oct. 5, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-156.pdf.
[105] Letter from Ki P. Hong et al., *supra* note 92, at 4-5.
[106] *Id.*
[107] *See* Letter from Nora M. Jordan et al., *supra* note 92, at 4-5.
[108] *See id.* at 5.

would curb the use of these manipulative arrangements, benefits public funds.[109]

Nonetheless, industry participants raise serious concerns about the potential negative impact of the regulation on the business interests of investment advisers. The consequences of participating in a pay-to-play arrangement must strike a balance between "the rights of the advisers" and "the very real detriment to the public which the numerous cases of pay-to-play involving public pension funds and other public entities have caused."[110] In large part the two-year compensation ban and associated restrictions on contributions achieve this balance. The regulation is an effective deterrent yet has a limited impact on the business of investment advisers and their ability to engage in the political process.[111] Although investment advisers and other market participants argue vigorously that the two-year time out would cause "drastic and deleterious"[112] effects upon the industry, the goal of curtailing manipulative activity requires the imposition of a ban on compensation where an advisory contract has been procured through political contributions, kickback payments or other bribes.[113]

The temporal scope of the ban is sufficiently long to "deter investment advisers from engaging in pay-to-play activities."[114] In the context of long-term advisory relationships, a lengthy ban is necessary in order to effectively deter pay-to-play arrangements.[115]

---

[109] *Cf.* Letter from Mercer E. Bullard, *supra* note 28, at 4-5 (rejecting industry contentions that the Proposed Rule's placement agent ban would negatively impact the ability of public funds to fully explore investment options).

[110] Letter from Bob Edgar et al., *supra* note 17, at 3.

[111] *See* Letter from William A. Jacobson, *supra* note 63, at 2.

[112] Letter from Nora M. Jordan et al., *supra* note 92, at 2; *see* Letter from Ki P. Hong et al., *supra* note 92, at 6-7 (describing how the proposed rule would significantly alter contracts between government entities and investment advisers).

[113] *See* Ackerman, *supra* note 101, at 4.

[114] Letter from William A. Jacobson, *supra* note 63, at 2.

[115] Letter from Mercer E. Bullard, *supra* note 28, at 6

> We disagree with the suggestion that the ban should be shorter because an adviser's relationships are likely to be longer term than those of an underwriter. This claim simply highlights the greater potential for abuse in the adviser context, where pay to play practices may have

However, as the SEC observed in its proposing release, "a longer ban could be overly harsh."[116] The fitness of the two-year period for addressing the problem of direct contributions by advisers is best evidenced by Rule G-37's success. This rule has effectively curbed pay-to-play practices in the municipal securities industry without overly burdening market participants.[117] Although the impact of a two-year sanction would likely differ between investment advisers and municipal securities dealers, the difference is not so great to require a fundamentally different approach to pay-to-play prevention.[118]

Moreover, the Proposed Rule accounts for the nature of the advisory business in that it does not create an outright ban from the industry. Instead, investment advisers who make contributions that are restricted under the Proposed Rule are only barred from receiving compensation from the particular government entity at issue and therefore may continue to provide services to other clients. Thus the two-year time-out effectively recognizes that because investment advisers are fiduciaries of their clients, they cannot immediately stop providing services.[119] Under the Proposed Rule, an investment adviser is not precluded from fulfilling his or her fiduciary duties after making a political contribution to an official with influence over the advisory selection process.[120]

The discretionary exemption allows the SEC to grant advisers reprieve from the ban on compensation if the circumstances surrounding a contribution do not warrant a sanction.[121] Thus, the

---

more adverse effects because of the relatively entrenched nature of the advisory relationship.

[116] *See* SEC Release, 74 Fed. Reg. at 39,846.

[117] Letter from Peter T. Clarke, *supra* note 55, at 3; SEC Release, 74 Fed. Reg. at 39,842, 39,846.

[118] *See* Letter from Nora M. Jordan et al., *supra* note 92, at 4.

[119] SEC Release, 74 Fed. Reg. at 39,847 ("An adviser subject to the prohibition would likely, at a minimum, 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 government client might obligate the adviser to continue to perform under the contract at no fee.").

[120] Letter from William A. Jacobson, *supra* note 63, at 2 ("[I]nvestment advisers would not be prohibited from receiving compensation for providing advisory services to the government client during the time out.").

[121] SEC Release, 74 Fed. Reg. at 39,868-69 (providing the text for Proposed Rule 206(4)-5(e)).

Proposed Rule contains a built-in method for determining on a case-by-case basis whether payments are intended to further a pay-to-play scheme. If subject to the regulation's sanction, advisers would only be prevented from collecting fees for a two-year period from a single client.[122] Also, the rule is not burdensome: advisers can avoid making contributions that are prohibited by the regulation. Investment advisory firms can institute compliance procedures to ensure that their employees do not engage in pay-to-play practices.[123] Additionally, the "returned contribution" exception would aid advisers with their compliance programs by providing some leeway when associates make contributions regulated by the Proposed Rule.[124]

Moreover, no other deterrence method can appropriately balance the need to discourage direct pay-to-play practices with the rights of advisers.[125] Likewise, because advisers can continue to provide services during the two-year period, the time out on compensation is "the least disruptive approach concerning the operations of the government client."[126] An alternative to the two-year compensation ban would be a general prohibition on pay-to-play practices in conjunction with rules designed to force investment advisers to establish compliance procedures.[127] However, such an approach would not offer the same level of protection that a two-year compensation ban provides. Without a two-year time out, investment advisers would lack the incentive to avoid pay-to-play practices.[128] Similarly, requiring advisers to disclose political contributions would fail to effectively deter direct pay-to-play arrangements.[129] As the SEC has stated, disclosure to public fund trustees is insufficient because pay-to-play schemes often involve payments to those very same trustees, while disclosure to fund beneficiaries would also be insufficient because of their lack of control over the advisory

[122] *Id.* at 39,846 n.76.
[123] *See* Investment Advisers Act Compliance Procedures and Practices, 17 C.F.R. § 275.206(4)-7 (2009).
[124] SEC Release, 74 Fed. Reg. at 39,850-51.
[125] Letter from William A. Jacobson, *supra* note 63, at 2; Ackerman, *supra* note 101.
[126] Letter from William A. Jacobson, *supra* note 63, at 2; Ackerman, *supra* note 101.
[127] Letter from Nora M. Jordan et al., *supra* note 92, at 5.
[128] *See* Letter from Mercer E. Bullard, *supra* note 28, at 6.
[129] Ackerman, *supra* note 101 ("Merely requiring improved disclosures of such contributions – which is one alternative floated by industry participants – probably would not be sufficient . . . .")

selection process.[130] Finally, applying the compensation ban only to advisers who make contributions as part of an actual pay-to-play arrangement would immensely weaken the effectiveness of the Proposed Rule because of the difficulty in showing intent.[131] The SEC states, "[p]olitical contributions are made ostensibly to support a candidate . . . and the burden of proving a different intent is very difficult absent unusual evidence. . . . [R]equiring proof of such an intent would greatly diminish, if not eliminate, the prophylactic value of the [P]roposed [R]ule."[132] Accordingly, an effective method for deterring pay-to-play practices is the scheme envisioned by the Proposed Rule in which contributions to specific officials would result in a two-year ban on the adviser providing services for compensation.

Nevertheless, the SEC could adopt certain amendments that would ease the regulation's compliance burden. These amendments would protect the business interests of advisers without diminishing the Proposed Rule's deterrent effect. First, the regulation should allow for a transition period to enable advisers to institute compliance procedures.[133] The potentially drastic impact that a compensation ban could have on an investment adviser makes it prudent for the SEC to take this step in order to prevent advisers from inadvertently triggering the regulation's sanction shortly after the final rule becomes effective.[134] Moreover, it will be a time consuming venture for advisers to properly implement compliance procedures.[135] As observed by an association of industry participants:

> [A]dvisers will have to determine which employees are covered associates, evaluate each state and local individual associated with current and potential government entity clients to determine who would be considered an "official", draft policies and procedures to implement requirements of the rule,

---

[130] SEC Release, 74 Fed. Reg. at 39,846.
[131] *Id.* at 39,848 n.94.
[132] *Id.*
[133] Letter from Monique S. Botkin, *supra* note 91, at 20.
[134] *See* Letter from Ki P. Hong et al., *supra* note 92, at 26.
[135] *See id.*; Letter from Orim Graves, Executive Dir., Nat'l Ass'n of Sec. Prof'ls, Inc., to Elizabeth M. Murphy, Sec'y, SEC 11 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-216.pdf.

> train employees on compliance with the rule and its prohibitions, and review relevant contracts.[136]

Accordingly, the SEC should adopt a six-month transition period following the effective date of the final rule.[137] This period would allow advisers to institute effective compliance procedures without excessively delaying the deterrent effects of the regulation.[138]

A second change that would ease the regulation's compliance burden on advisers is a more flexible approach to the returned contribution exception. This exception should be more sensitive to the size of investment advisory firms. Investment advisers are often small firms, but they can also be also businesses with many employees.[139] Thus, an inflexible number should not govern how often an adviser may utilize the returned contribution exception.[140] Rather, the limitation should be based on how many covered associates the firm employs.[141]

E. Constitutional Issues

The Proposed Rule's limitation on contributions also implicates constitutional issues with respect to potential violations of the First Amendment rights of investment advisers and their associates. The SEC believes that the Proposed Rule tailors the types of contributions that would trigger a two-year compensation ban to be consistent with the First Amendment.[142] Nonetheless, some

---

[136] Letter from Monique S. Botkin, *supra* note 91, at 20.
[137] Letter from Nora M. Jordan et al., *supra* note 92, at 17.
[138] *Id.*
[139] Letter from Kenneth S. Cohen, Senior Vice President and Deputy Gen. Counsel, Mass. Mutual Life Ins. Co., to Elizabeth M. Murphy, Sec'y, SEC 1-2 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-222.pdf (describing how MassMutual employs over 6000 employees who would be banned from making political contributions under the proposed rule).
[140] *See id.*
[141] Letter from Ki P. Hong et al., *supra* note 92, at 19 (suggesting that the proposed rule allow two exceptions for the first 100 covered associates and an additional exception for each 100 covered associates after that); *see* Letter from Kenneth S. Cohen, *supra* note 139, at 1-2.
[142] SEC Release, 74 Fed. Reg. at 39,848 n.92 (noting that, without limitations on which contributions would trigger the ban, the regulation

commentators argue that the regulation's restriction on campaign contributions would infringe advisers' freedom of speech; they question whether the regulation as currently drafted could survive a constitutional challenge.[143]

Although campaign contributions are a form of speech, the federal government nevertheless may restrict political contributions in certain circumstances.[144] The Supreme Court has repeatedly held that limits on direct campaign contributions are permissible.[145] In determining whether the Proposed Rule's contribution restrictions are constitutional, a comparison can be drawn with the District of Columbia's Circuit Court of Appeals' treatment of Rule G-37 in *Blount v. Sec. Exch. Comm'n*.[146] This case arose when a member of a state political party challenged the constitutionality of Rule G-37 after its promulgation. The court rejected a First Amendment challenge after finding that the rule was narrowly tailored to the compelling government interests of corruption prevention and protection of investors and underwriters in the municipal securities market.[147] In applying strict scrutiny to the claim that the rule

---

"could result in frequent inadvertent violations that would carry harsh consequences for advisers").

[143] Letter from W. Hardly Callcott to Elizabeth M. Murphy, Sec'y, SEC (Aug. 3, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-2.pdf; Morgan Lewis, *supra* note 52. In announcing the Proposed Rule, the SEC stated that it believed that the Proposed Rule was closely drawn to avoid any First Amendment Problems. SEC Release, 74 Fed. Reg. at 39,848 n.92.

[144] Blount, 61 F.3d at 941.

> The Supreme Court has characterized the campaign contribution as a 'symbolic act' that 'serves as a general expression of support for the candidate and his views' though noting at the same time that the contribution does not indicate the basis for the support and that a limit on contributions does not 'infringe the contributor's freedom to discuss candidates and issues.' (quoting Buckley v. Valeo, 424 U.S. 1, 21 (1976)).

[145] Buckley, 424 U.S. at 20-21 (determining that federal contribution limits do not significantly impair speech); Nixon v. Shrink Mo. Gov't PAC, 528 U.S. 377, 387, 397-98 (2000) (determining that state contribution limits do not significantly impair speech); *but see* Randall v. Sorrell, 548 U.S. 230, 248 (2006) (acknowledging that despite the permissibility of contribution limits, they nevertheless must exceed "some lower limit").

[146] Blount, 61 F.3d 938.

[147] *Id.* at 944.

infringed freedom of speech, the court stated that the regulation "can be expected materially to advance compelling interests," and "is 'closely drawn' and thus 'avoid[s] unnecessary abridgement of First Amendment rights."[148]

The government may impose contribution ceilings in order to prevent corruption or the appearance of corruption.[149] Blount identified this goal of corruption prevention as one of the compelling interests that supported the constitutionality of Rule G-37.[150] The Proposed Rule is also designed to prevent the corruption of public officials that results from pay-to-play arrangements. Pursuant to *Blount*, the goal of curtailing this type of corruption is a compelling interest that supports the legitimacy of the Proposed Rule.

Blount identified two further compelling government interests that justified the promulgation of Rule G-37: "(1) protecting investors in municipal bonds from fraud and (2) protecting underwriters of municipal bonds from unfair, corrupt market practices."[151] Furthermore, the court determined that these interests fell within Congress's authorization of the MSRB to restrain fraudulent and manipulative activity within the municipal securities market.[152] Congress has provided the SEC with a similar mandate to

---

[148] *Id.* at 946-47 (citing Buckley, 424 U.S. at 25).
[149] Buckley, 424 U.S. at 26 ("It is unnecessary to look beyond the Act's primary purpose to limit the actuality and appearance of corruption resulting from large individual financial contributions in order to find a constitutionally sufficient justification for the $1,000 contribution limitation."); Fed. Election Comm'n. v. Nat'l Conservative PAC, 470 U.S. 480, 496-97 (1985) ("preventing corruption or the appearance of corruption are . . . legitimate and compelling government interests . . . for restricting campaign finances.").
[150] Blount, 61 F.3d at 944

> [I]n Buckley and Austin the legislature was interested in clean elections, whereas here the SEC is interested in clean bond markets. Petitioner insists on the importance of this distinction, saying that the latter interest is less compelling than the former. As we see it, however, one of the primary reasons people object to bought elections is that a bought politician tends to make distorted choices, and the public's concern about a particular type of distorted choice (the choice of bond underwriter) does not logically stand on a lower plane than its concern about bought politicians generally.

[151] *Id.*
[152] *Id.*

promulgate rules to prevent deceptive business practices in the investment advisory business.[153] Two purposes of the Proposed Rule are to protect public funds from corruption and ensure that investment advisers are acting consistently "with the high standards of ethical conduct required of fiduciaries under the [Investment] Advisers Act."[154] Based on the public interest at stake when advisers are selected on the basis of pay-to-play practices, a court would likely find that these purposes likewise represent compelling government interests.

Additionally, *Blount* determined that Rule G-37 was closely drawn to further the compelling interests the court identified. The court refused to strike down the rule based on the fact that the rule did not cover all participants in the municipal securities market.[155] It also found that the decision to leave certain entities outside the rule's scope was based upon a judgment that "the risk of corruption in the conduct left unrestrained [was] too remote to warrant restraint."[156] Similar to Rule G-37, the Proposed Rule does not apply to all participants in the public fund advisory selection process since it only restrains investment advisers and their associates. Pursuant to *Blount*, however, the absence of regulations covering the conduct of public officials would not render the Proposed Rule under-inclusive.

Although *Blount* approved Rule G-37, the holding does not guarantee that a court would uphold the Proposed Rule in a constitutional challenge. *Blount*'s holding may be inapplicable to the Proposed Rule because Rule G-37 does not require municipal securities underwriters to provide uncompensated services.[157] The Proposed Rule may force advisers to offer uncompensated services for a period of time in order to comply with their fiduciary duties.[158]

The Supreme Court's subsequent pronouncements in *Randall v. Sorrell*[159] may cast doubt upon the constitutionality of the Proposed Rule. In *Randall*, the Court struck down a state campaign finance law that limited individual contributions to $400 for statewide office elections, $300 for state senate elections, and $200

[153] 15 U.S.C. § 80b-6(4).
[154] SEC Release, 74 Fed. Reg. at 39,844.
[155] Blount, 61 F.3d at 946-47.
[156] *Id.* at 947.
[157] *Id.*
[158] *See* SEC Release, 74 Fed. Reg. 39,847 n.80.
[159] Randall v. Sorrell, 548 U.S. 230 (2006).

for state representative elections.[160] The Court found the restrictions "substantially lower than both the limits we have previously upheld and comparable limits in other States."[161] Although the Court did not identify a specific threshold amount for when limitations on campaign contributions become unconstitutional, it has never approved a contribution ceiling lower than $1000.[162] Thus, in the view of one commentator, the rule's *de minimis* provision that exempts contributions of less than $250 "is far lower than the range of contribution limits the Court suggested might be constitutionally permissible."[163] Therefore, the SEC should amend the Proposed Rule by raising the *de minimis* contribution limit to at least $1000.

The Proposed Rule's prohibition of contributions to certain officials and associated compensation ban would act as a powerful deterrent against pay-to-play arrangements. Although the adoption of certain changes would ease the potential compliance burden and avoid First Amendment infringements, the regulation is well designed for preventing advisers from making direct contributions that are intended to manipulate the advisory selection process.

V. Prohibition on the use of Third Party Agents

A. Overview of the Regulation

The Proposed Rule's second regulation seeks to prevent advisers from channeling bribes to public officials through intermediaries for the purpose of obtaining government advisory business. In order to deter these indirect pay-to-play arrangements, this regulation would make it unlawful for any investment adviser or covered associate:

> [t]o 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:

---

[160] *Id.* at 253.
[161] *Id.*
[162] Letter from W. Hardly Callcott, *supra* note 143 (citing Randall, 548 U.S. at 249-53).
[163] *Id.*

> (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 . . . .[164]

Thus, the Proposed Rule would prohibit advisers from utilizing third party intermediaries in order to solicit government clients.[165] This prohibition would be applicable to all third party solicitors, regardless of how such parties label themselves.[166]

B. The SEC's View

The SEC believes this second prong of the Proposed Rule is necessary because "advisers and government officials may attempt to structure their transactions in a manner intended to hide the true purpose of a contribution or payment."[167] The compensation ban contained in the first prong would have little practical effect if advisers could easily design pay-to-play arrangements to circumvent it.[168] Moreover, the Commission sees a broad prohibition against the use of *all* third party agents as necessary because of the critical role that these actors play in perpetuating pay-to-play schemes and the "apparent difficulties for advisers to monitor the activities of their third-party solicitors . . . ."[169] Likewise, pay-to-play arrangements are by their very nature conducted covertly; it would therefore be difficult to prohibit advisers from using only those intermediaries who have engaged in pay-to-play practices in the past.[170]

---

164 SEC Release, 74 Fed. Reg. 39,868-69.

165 *Id.* at 39,852.

166 *Id.* ("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.'").

167 *Id.* at 39,844.

168 *Id.* at 39, 851 ("We are concerned that our adoption of a rule addressing pay to play practices by advisers would lead to . . . use of consultants or solicitors by investment advisers to circumvent the rule.").

169 SEC Release, 74 Fed. Reg. at 39,852.

170 Ackerman, *supra* note 101 ("Sarah Bessin, assistant director of the SEC's division of investment management, said the hidden nature of pay-to-play contributions makes it difficult to crack down on them without strong

Additionally, the regulation's complete ban on all third-party solicitors is also influenced by the MSRB's experience in implementing a similar prohibition.[171] When initially promulgated in 1996, Rule G-38 only required advisers to disclose agreements with third-party agents.[172] By 2005, however, the MSRB concluded that such an approach was insufficient to deter indirect pay-to-play arrangements and amended Rule G-38 to ban the use of all third parties to solicit government clients.[173] Likewise, the SEC is concerned with potential circumvention of the Proposed Rule and thus believes that a complete prohibition is necessary to deter pay-to-play practices in the public fund advisory selection process.[174]

Furthermore, in the view of the SEC, the regulation would not overly burden advisers because they could continue to use employees, executive officers, or partners to solicit advisory contracts from public funds.[175] The SEC believes that limiting the prohibition only to third-party agents would address pay-to-play concerns without preventing advisers from seeking out government clients.[176] Similarly, the regulation would not cause excessive harm to public funds because they would not be restricted from hiring consultants to recommend which investment advisers best suit their particular strategies and investment portfolios.[177]

---

regulations. . . . 'the nature of pay-to-play is that people are trying to circumvent, people are trying to hide payments,' . . . .").

[171] SEC Release, 74 Fed. Reg. at 39,851-52.

[172] *Id.* at 39,851.

[173] *Id.* at 39,851-52.

[174] *Id.* at 39,852.

[175] SEC Release, 74 Fed. Reg. at 39,853 & n.140. The regulation exempts any related person and, if such related person is a company, any employee of the related person. *Id.* at 39,869 (announcing Proposed Rule 206(4)-5(a)(2)(i)(A)). A "related person" is defined 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." *Id.* at 39,870. (Introducing the text of Proposed Rule 206(4)-5(f)(9)). The regulation also exempts any person that "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 . . . ." *Id.* at 39,869 (presenting the text of Proposed Rule 206(4)-5(a)(2)(i)(B)).

[176] *See* SEC Release, 74 Fed. Reg. at 39,853 (explaining that the regulation will still allow investment advisers to solicit government clients).

[177] *See id.* at 39,853 n.145 ("The proposed rule would not prohibit government entities from retaining "pension consultants" (or other third-parties)

C. The Industry's View

Investment advisers criticize the outright prohibition against the use of third-party agents because it would prevent them from employing placement agents to solicit government clients. "In general, the role of a placement agent is to locate, on behalf of an investment adviser, prospective investors, such as public pension plans, retirement plans and similar government investment accounts . . . ."[178] As a result of the important role that placement agents play in the public fund advisory business, commentators view the absolute ban as overly burdensome to participants in this industry.[179]

Placement agents are highly knowledgeable about the money management business and have a wealth of contacts within this industry.[180] As one commentator stated, "legitimate placement agents and solicitors provide *bona fide* and invaluable services to persons and entities seeking investment advisory services."[181] For instance, these agents offer government entities continuous due diligence on potential investment opportunities and a third-party analysis of the performance and strategy of an investment adviser.[182]

Commentators argue that placement agents play a vital role in raising capital for small investment advisers and new private

---

and paying them to recommend particular investment advisers for the management of public funds.").

178 Letter from Ron S. Geffner, Partner, SadisGoldberg, to Elizabeth M. Murphy, Sec'y, SEC (Oct. 2, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-132.pdf.

179 Additionally, some industry participants believe that placement agents are not a cause of pay-to-play problems. A Pennsylvania State Employees Retirement System spokesperson recently stated pay-to-play arrangements were unrelated to "the fact that a placement agent was involved, but [were instead related to] the fact that there were corrupt employees working for the government." Posting by Laura Kreutzer to WSJ Blogs: Private Equity Beat, http://blogs.wsj.com/privateequity/2009/05/05/placement-agent-ban-barking-up-the-wrong-tree/tab/article/ (May 5, 2009, 15:23 EST).

180 *See* Letter from Simpson Thacher & Bartlett, *supra* note 91 at 3-5.

181 Letter from Jane A. Kanter, *supra* note 92, at 3; *see also* SEC Release, 74 Fed. Reg. at 39,852 n.137 ("Many pension plans rely heavily on the expertise and guidance of their pension consultant in helping them to manage pension plan assets.").

182 Letter from Jane A. Kanter, *supra* note 92, at 3.

equity funds by locating potential investors.[183] One industry participant stated that the ban on placement agents' representation of advisers "would hinder the ability of new firms of all types, including those owned by women and minorities, as well as small and medium-sized private equity firms, to start and expand their businesses."[184] The outright ban on the use of placement agents would disproportionately affect small firms while strengthening the position of large and highly-capitalized advisers because of the unequal ability of small and large firms to market their services to government entities.[185] Large advisers generally have the resources to retain a specialized marketing department or to hire an outside marketing company to advertise their services.[186] On the other hand, small firms usually rely upon third-party placement agents to solicit government entities because they lack the resources to support internal or external marketing agents.[187] Therefore, commentators argue that the proposed ban on the use of all third-party intermediaries would have a disproportionately detrimental impact on the business of small investment advisers.[188]

---

[183] *See* Letter from Christopher J. Dodd, Chairman, U.S. Senate Comm. on Banking, Hous. & Urban Affairs, to Elizabeth, M. Murphy, Sec'y, SEC (Feb. 2, 2010), *available at* http://www.sec.gov/comments/s7-18-09/s71809-256.pdf. ("In some cases, the use of third-party placement agents may be the only cost-effective way for smaller funds to get the attention of public fund managers and thereby raise needed capital. I share the concern that a ban on placement agents could reduce the amount of information available to public funds about the full range of investment opportunities.").

[184] Letter from Stephen A. Schwarzman, Chairman & CEO, Blackstone Group, to Elizabeth, M. Murphy, Sec'y, SEC (Sept. 14, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-75.pdf.

[185] *See* Letter from Jane A. Kanter, *supra* note 92, at 3-4; Letter from Patricia A. Poglinco & Robert B. Van Grover, Seward & Kissel, to Elizabeth M. Murphy, Sec'y, SEC 4 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-224.pdf (arguing that "the Proposed Rule will only exacerbate the challenges facing smaller investment firms" because it will force them to shoulder the full burden of marketing their services and finding clients).

[186] *See* Letter from Jane A. Kanter, *supra* note 92, at 4.

[187] *Id.* at 4.

[188] *See, e.g.*, Letter from Nancy C. Everett to Elizabeth M. Murphy, Sec'y, SEC (Oct. 6, 2009), *available at* http://www.sec.gov/ comments/s7-18-09/s71809-187.htm; Letter from Deborah La Franchi, CEO & President, Strategic Dev. Invs., to Elizabeth M. Murphy, Sec'y, SEC (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-189.pdf; Letter

Likewise, industry participants contend that the ban's effect upon small advisers would, in turn, harm public funds because of the lack of diversity in investment options for government entities.[189] As one commentator stated, the inability to use third party agents would "make it more difficult for state and municipal pension funds to identify the most appropriate managers since, by and large, they largely lack a staff of sufficient size to evaluate every worthy opportunity."[190] Accordingly, the Proposed Rule would reduce competition and result in a narrowing of potential investment options for public funds.[191] Furthermore, "[t]hird-party placement agents and solicitors that solicit government entities on behalf of investment advisers often possess information critical to the effective evaluation of . . . specialized markets or investment strategies."[192] Therefore, the

---

from Markus Trice, Managing Partner, Presidio Partners LLC, to Elizabeth M. Murphy, Sec'y, SEC (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-203.pdf; David J. Wakefield, Managing Partner, Shoreview Indus., to Elizabeth M. Murphy, Sec'y, SEC (Oct. 2, 2009) http://www.sec.gov/comments/s7-18-09/s71809-242.pdf.

[189] *See e.g.*, Letter from Melvyn Aaronson, Sandra March & Mona Romain, Teachers' Ret. Sys. of the City of N.Y., to Elizabeth, M. Murphy, Sec'y, SEC 1 (Oct. 1, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-129.pdf ("In such an environment, only the largest firms, promoted by their in-house staffs, will be able to compete. It is our expectation that fees will rise and investment opportunities will diminish."); Letter from William A. Jacobson, *supra* note 63, at 5; Letter from Stephen A. Schwarzman, *supra* note 184, at 4 (arguing the ban would "chill entrepreneurial opportunity in this area" and prevent public funds from choosing the most appropriate investment advisers).

[190] Letter from Stephen A. Schwarzman, *supra* note 184, at 4.

[191] *See, e.g.*, Letter from T. Britton Harris, Chief Inv. Officer, Teacher Ret. Sys. of Tex., to Elizabeth M. Murphy, Sec'y, SEC (Oct. 12, 2009), *available at* http://www.sec. gov/comments/s7-18-09/s71809-249.pdf; Letter from R. Dean Kenderdine, Executive Dir. & Sec'y to the Bd. of Trs., State Ret. & Pension Sys. of Md., to Elizabeth M. Murphy, Sec'y, SEC (Oct. 5, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-144.pdf; Letter from James R. Meynard, CFA, Executive Dir., Ga. Firefighters' Pension Fund, to Elizabeth M. Murphy, Sec'y, SEC (Sept. 3, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-56.htm; Letter from Patricia A. Poglinco & Robert B. Van Grover to Elizabeth M. Murphy, *supra* note 185, at 4 ("[T]he Proposed Rule would limit, rather than expand, the investment opportunities available to government pension plans.").

[192] Letter from Jane A. Kanter, *supra* note 92, at 4.

ban on the use of placement agents would preclude public funds from fully exploring all options in the investment adviser selection process.[193] Public funds would neither be able to investigate various advisers and the investment vehicles that they offer, nor be able to conduct proper due diligence on each adviser.[194] Moreover, small public funds with limited resources would be the most vulnerable to these dangers.[195] Based on these beliefs, industry participants question the wisdom of prohibiting the use of placement agents and argue that the ban should either be eliminated or vastly restricted.

D. Analysis

Pay-to-play arrangements are often implemented through the use of third party intermediaries and "the most egregious violations of the public trust . . . have come from placement agents and those seeking finder's fees."[196] For example, the recent pay-to-play scandal in New York used third party intermediaries to channel payments between public officials and investment advisers.[197] The SEC has also brought other enforcement actions against pay-to-play schemes featuring third party solicitors in a central role.[198]

Consequently, there exists a clear need to limit the use of third party agents by investment advisers.[199] Although pay-to-play

---

[193] *See id.* One trustee of a pension fund believes that the ban on the use of placement agents "will result in public funds not being presented with the broadest array of investment opportunities and hinder the competitiveness of the investment management marketplace." Letter from R. Dean Kenderdine, *supra* note 191, at 1-2.

[194] Letter from Jane A. Kanter, *supra* note 92, at 4; Letter from Patricia A. Poglinco & Robert B. Van Grover, *supra* note 185, at 4 (stating that government entities will have less "access to smaller, potentially more qualified, investment firms").

[195] Letter from R. Dean Kenderdine, *supra* note 191, at 2 (arguing that banning the use of placement agents would decrease "the productivity of many resource challenged pension funds" and therefore make these funds less profitable for their beneficiaries).

[196] Letter from Bob Edgar, et al., *supra* note 17, at 4.

[197] Sec. Exch. Comm'n v. Henry Morris, et al., *supra* note 8.

[198] In the Matter of Kent D. Nelson, *supra* note 8, at 3; Paul J. Silvester et al., *supra* note 8, at 1 (Mar. 1, 2006); Letter from William A. Jacobson, *supra* note 63, at 3 (citing SEC Release, 74 Fed. Reg. at 39,852).

[199] SEC Release, 74 Fed. Reg. at 39,852 ("[W]e have alleged that third-party solicitors have played a central role in each of the enforcement actions

arrangements essentially amount to run of the mill bribery schemes and can be prosecuted under a variety of laws, the covert and deceptive nature of these practices requires the SEC to take decisive action to deter manipulative conduct.[200] Due to advisers' acumen for deception, the Proposed Rule's restriction of direct contributions by investment advisers can only effectively curb pay-to-play practices if advisers are also restricted from channeling bribes through third party intermediaries.[201] Without such a regulation, investment advisers could easily circumvent the restrictions on making political contributions to officials with influence over the advisory selection process.[202]

Nevertheless, the Proposed Rule's complete ban of all third party agents is too broad and unduly interferes with the efficient operation of investment advisers and public funds.[203] Placement agents play a critical role in the advisory selection process.[204] Furthermore, it is unfair to prevent small advisers from using placement agents when large advisers can continue to solicit government clients with internal staff.[205] As observed by industry participants, an outright ban of placement agents would harm small investment advisers.[206] Moreover, the regulation would restrict the investment

against investment advisers that we have brought in the past several years involving pay to play schemes."); *see* SEC Release, 74 Fed. Reg. at 39,852 n.131.

200 Ackerman, *supra* note 101.

201 "Because 'actors in this field are presumably shrewd enough to structure their relations rather indirectly,' it is important that the Proposed Rule prohibits investment advisers from doing indirectly what they are prohibited from doing directly." Letter from William A. Jacobson, *supra* note 63, at 3 (quoting Blount v. Sec. Exch. Comm'n, 61 F.3d 938, 945 (D.C. Cir. 1995)).

202 SEC Release, 74 Fed. Reg. at 39,852.

203 Letter from William A. Jacobson, *supra* note 63, at 4-5; Letter from Nora M. Jordan et al., *supra* note 92, at 13 (arguing that the proposed rule is "overly expansive and the costs inflicted on both investment advisers and government clients from lack of access to the valuable services provided by most third-party solicitors outweigh any expected benefits to be gained from its adoption"); Letter from Stephen Schwarzman, *supra* note 184, at 4 (comparing the ban on the use of placement agents to closing down Major League Baseball because a few players broke the rules by using steroids).

204 Letter from Simpson Thacher & Bartlett, *supra* note 91, at 3.

205 *See* Letter from Patricia A. Poglinco & Robert B. Van Grover, *supra* note 185, at 4.

206 *See supra* note 188 and accompanying text.

options available to public funds.[207] Although pay-to-play practices are harmful to the beneficiaries of public funds, the ban of placement agents imposes heavy burdens upon the operations of these entities and limits their investment opportunities.[208] As one commentator observed, "While keeping in mind the goal of protecting public pension funds from the consequences of pay-to-play practices, it is important to ensure that public pension funds obtain and retain the best management available."[209]

Accordingly, the SEC should adopt an amendment that would exempt from the prohibition certain placement agents that regularly and lawfully engage as intermediaries between advisers and potential government clients.[210] By allowing the use of placement agents, the regulation would continue to deter against indirect pay-to-play practices while easing the Proposed Rule's burden on industry participants.[211] Although such an amendment would likely reduce the regulation's effectiveness, a narrower restriction is necessary to protect the interests of advisers, placement agents and public funds.

Under this approach, pay-to-play concerns could also be limited by allowing industry participants to only use placement agents that are registered broker-dealers.[212] Restricting the exemption

---

[207] Letter from William A. Jacobson, *supra* note 63, at 4-5.

[208] Letter from Patricia A. Poglinco & Robert B. Van Grover, *supra* note 185, at 4 (arguing that the placement agent ban "would place the burden of seeking advisory business solely on the adviser" and "significantly disadvantage small and emerging investment firms that cannot afford to hire and retain internal marketing personnel and would result in an unfair advantage for large, established investment firms that have ample resources to market their investment services.").

[209] Letter from William A. Jacobson, *supra* note 63, at 1.

[210] Letter from John C. Robertshaw, Managing Dir. and Co-Head, Private Fund Group, Credit Suisse Sec. (USA), to Elizabeth M. Murphy, Sec'y, SEC 2 (Sept. 14, 2009), *available at* http://www.sec.gov/ comments/s7-18-09/s71809-74.pdf.

[211] Letter from Christopher J. Dodd, *supra* note 183, at 1 (arguing that allowing the use of placement agents would improve the Proposed Rule and reduce burdens upon investment advisers "without weakening the protection of investors, taxpayers, retirees, and beneficiaries").

[212] Letter from John C. Robertshaw, *supra* note 210, at 9. The SEC announced that it is open to providing an exemption for registered broker-dealers to act as placement agents. Dan Margolies, *US SEC Mulls Exemptions for Pay-to-Play Proposal*, REUTERS, Feb. 16, 2010, http://www. reuters.com/article/ idUSN1622483020100216. Whether the SEC creates such an exemption, however, would depend upon the promulgation by

to registered broker-dealers would reduce pay-to-play concerns because such placement agents would be subject to other regulatory oversight.[213] Both the SEC and the Financial Industry Regulatory Authority ("FINRA") regulate broker-dealers that act as professional placement agents.[214] The oversight of these regulatory bodies would ensure that registered broker-dealers acting as placement agents refrained from making improper contributions as part of a pay-to-play scheme.[215] Furthermore, these regulatory bodies could impose regulations upon broker-dealers to promote compliance and curtail manipulative practices.[216]

Moreover, the presence of the registered broker-dealers in the advisory business offers a protection that is not available in the municipal securities market.[217] The MSRB adopted a full ban on third party solicitors as part of Rule G-38 because of the pay-to-play practices carried out by unregistered solicitors.[218] In contrast to the conditions that precipitated the MSRB's adoption of Rule G-38, the SEC and FINRA directly regulate broker-dealers that solicit government entities for investment advisers.[219] Thus, it is appropriate to provide investment advisers with a limited ability to use placement agents that are registered broker-dealers. Although this change would not entirely eliminate the danger of pay-to-play practices, it offers sufficient protection against the use of third party agents by investment advisers to channel political contributions or other payments for the purpose of obtaining business from a government entity.[220]

To further reduce the danger that registered broker-dealers acting as placement agents will participate in pay-to-play practices, the SEC could also include a number of auxiliary safeguards in the Proposed Rule. These additional protective measures would increase the regulation's effectiveness without overly burdening investment advisers and public funds. First, the SEC could require that all

---

FINRA of rules designed to prevent pay-to-play practices by registered broker-dealers. *Id.*

213 Letter from Ki P. Hong et al., *supra* note 92, at 23.

214 Letter from John C. Robertshaw, *supra* note 210, at 5.

215 *Id.* at 9; *See* Letter from Ki P. Hong et al., *supra* note 92, at 23

216 *See id.*

217 *Id.*

218 *Id.*

219 *Id.*

220 *See* Letter from John C. Robertshaw, *supra* note 210, at 9.

advisers who employ placement agents to solicit potential government clients to post a bond.[221] The beneficiaries of any public fund harmed by a pay-to-play arrangement would receive a payment from the bond posted by the adviser at the center of the scheme.[222] This requirement would deter advisers from engaging placement agents to channel contributions to public officials.[223]

Second, the SEC could require advisers to disclose which placement agents they employ to solicit government clients and the fees paid to them.[224] Although this approach would not by itself provide adequate protection against indirect contributions intended to procure advisory business,[225] when applied in conjunction with allowing only registered broker-dealers to act as placement agents it would help deter pay-to-play practices. Disclosure would deter advisers from using placements agents to channel payments because authorities could more easily identify the existence of pay-to-play arrangements.[226] Moreover, disclosure requirements would aid public

---

[221] Interview with Cornelius Hurley, Director, Morin Center for Banking and Financial Law, Boston University, in Boston, Mass. (Mar. 19, 2010).

[222] *Id.*

[223] *Id.*

[224] Letter from Monique S. Botkin, *supra* note 91, at 16-17. The California Public Employees' Retirement System currently employs an approach that requires investment advisers to disclose the use of placement agents. Letter from Joseph A. Dear, Chief Inv. Officer, Cal. Public Employees' Ret. Sys. to Elizabeth M. Murphy, Sec'y, SEC 1 (Oct. 6, 2009), http://www.sec.gov/comments/s7-18-09/s71809-217.pdf; s*ee* Letter from James M. McNamee, President, Ill. Pub. Pension Fund Assn., to Elizabeth M. Murphy, Sec'y, SEC (Sept. 29, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-236.pdf (advocating a system of "full disclosure and transparency of fees" rather than a ban of placement agents).

[225] SEC Release, 74 Fed. Reg. at 39,851-52; Letter from Peter T. Clarke, *supra* note 55, at 2 (commenting that the MSRB replaced the prior version of G-38 because of "concerns regarding questionable practices by some consultants and a determination by the MSRB that it would be in the public interest to make the process of soliciting municipal securities business fully subject to the MSRB rules of fair practice and professionalism"); Letter from William A. Jacobson, *supra* note 63, at 3-4. With only a disclosure regime, an investment adviser would still be able to channel contributions through placement agents, even if the adviser disclosed the use of the placement agent. Moreover, the MSRB recently determined that a limitation on the use of placement agents provided greater protection against pay-to-play practices than a disclosure requirement.

[226] Letter from Simpson Thacher & Bartlett, *supra* note 91, at 12.

funds in the due diligence process and help them to avoid advisers that utilized placement agents who are suspected of participating in pay-to-play schemes.[227] Likewise, public funds could more easily identify placement agents with reputation for honesty and legal compliance.[228]

Placement agents play an important role in the public fund advisory selection process. They also, unfortunately, have played a central role in many pay-to-play arrangements. A limited exception from the ban on the use of third-party agents for certain registered broker-dealers in conjunction with additional safeguards would allow placement agents to continue to act as intermediaries while still controlling the risk of pay-to-play schemes.

VI. Restrictions on Soliciting and Coordinating Contributions

The Proposed Rule's final core regulation is a prescription against soliciting and coordinating contributions that are intended as *quid pro quo* exchanges for investment advisory work. In order to prevent manipulation of the advisory selection process in such a manner, this regulation would make it unlawful for any investment adviser or covered associate:

> [t]o 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.[229]

---

[227] *See* Letter from Jack Ehnes, Chief Executive Officer, Cal. State Teachers' Ret. Sys. to Elizabeth M. Murphy, Sec'y, SEC 2 (Oct. 6, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-171.pdf (stating that the California State Teacher's Retirement System has "already taken steps to extend [their] due diligence process for hiring investment managers by requiring even further disclosure of placement agent relationships").

[228] *See id.*

[229] SEC Release, 74 Fed. Reg. at 39,869 (presenting the text for Proposed Rule 206(4)-5(a)(2)(i)).

This prohibition is designed to prevent investment advisers from influencing the public fund advisory selection process by arranging payments to elected officials, candidates and political parties.[230]

The SEC believes that implementing the Proposed Rule's other two core regulations without prescribing the coordination and solicitation of contributions would leave a critical gap in the new regulatory scheme.[231] This belief is based on the MSRB's experience following the adoption of Rule G-37 and Rule G-38. [232] As initially enacted those rules did not prohibit municipal securities underwriters from coordinating and soliciting contributions. [233] Accordingly, municipal securities market participants continued to engage in pay-to-play arrangements by soliciting and coordinating indirect contributions until the MSRB amended Rule G-37 to prohibit such activities in 2005.[234] The experience of the MSRB, therefore, strongly evidences the need for the SEC to adopt this regulation as part of the Proposed Rule.[235] As one commentator observed, "this proposal would close an important gap in which contributions might be made indirectly to government officials for the purpose of influencing their choice of investment advisers."[236]

Moreover, this regulation is designed to prevent advisers from participating indirectly in pay-to-play schemes and does not negatively impact advisers' business interests or impose excessive compliance problems. First, the ability to solicit political contributions is not an essential component of the investment advisory

---

[230] *Id.* at 39,855.
[231] *Id.* at 39,854.
[232] *Id.*.
[233] SEC Release, 74 Fed. Reg. at 39,854.
[234] *Id.; see id.* at 39,854 n.148 (showing examples of attempts to circumvent the MSRB's regulatory regime through solicitation or coordination of contributions).
[235] *Cf.* 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. 52,496, 86 SEC Docket 762, at 16 (Sept. 22, 2005) (finding the amendment to Rule G-37 appropriate "because it will help inhibit practices that attempt, or create the appearance of attempting, to influence the awarding of municipal securities business through an indirect violation of Rule G-37.").
[236] Letter from William A. Jacobson, *supra* note 63, at 5.

business. The regulation therefore does not trigger the same concerns for industry participants as the ban on the use of third-party agents. Second, an adviser could act in accordance with this regulation by adopting internal procedures pursuant to the SEC's compliance rule,[237] which requires advisers to adopt policies designed to prevent violation of the Investment Advisers Act and rules promulgated thereunder.[238] The SEC recognizes that "it may be more difficult for an adviser to monitor solicitation activities (as opposed to direct contribution activity)."[239] Therefore, the design of the regulations provides that an adviser that violates the prescription against soliciting contributions does not face the two-year compensation ban that would result from engaging in direct contributions.[240]

Prohibiting advisers from using coordinated or solicited contributions to engage in pay-to-play arrangements is necessary in order to protect the integrity of the public fund advisory selection process. The Proposed Rule would implement a well-designed and effective method for deterring these types of indirect pay-to-play practices.

VII. Indirect Conduct

Furthermore, in order to close potential loopholes and prevent circumvention of the three core regulations, the Proposed Rule includes a supplementary provision that would prohibit investment advisers from taking any indirect action in contravention of the Proposed Rule.[241] The regulation would make it unlawful for any investment adviser or covered associate "to do anything indirectly which, if done directly, would result in a violation of [the Proposed Rule]."[242] This additional provision protects against circumvention of the rule and makes clear that the SEC is seeking to eliminate pay-to-play practices.[243]

---

[237] SEC Release, 74 Fed. Reg. at 39,855 n.156, 39,860.

[238] Investment Advisers Act Compliance Procedures and Practices, 17 C.F.R. § 275.206(4)-7(2009).

[239] SEC Release, 74 Fed. Reg. at 39,855 n.156.

[240] *Id.*; *compare id.* at 39,868 (presenting the text of Proposed Rule 206(4)-5(a)(1)) *with id.* at 39,869 (supplying the text for Proposed Rule 206(4)-5(a)(2)(ii)).

[241] SEC Release, 74 Fed. Reg. at 39,845.

[242] *Id.* at 39,869 (providing the text for Proposed Rule 206(4)-5(d)).

[243] *See id.* at 39,845, 39,855.

This prohibition of indirect contributions would prevent industry participants from using imaginative methods to evade the three core regulations contained the Proposed Rule.[244] Moreover, the SEC believes that the Proposed Rule must contain the regulation because it is impossible to "anticipate all of the ways advisers and government official may structure pay to play arrangements to attempt to evade the prohibitions of our proposed rule."[245] Accordingly, it is necessary that the Proposed Rule retain the prohibition against indirect violations.

VIII. Conclusion

Pay-to-play practices "violate the public trust when they allow political contributions to play a role in the management of public assets."[246] The hazards of pay-to-play schemes to public funds and the danger they present to the integrity of the advisory selection process require that the SEC establish a salutary rule that can effectively deter public officials and investment advisers from engaging in this manipulative practice.

Implementation of the Proposed Rule with the adoption of certain amendments would introduce a comprehensive and effective framework for curtailing pay-to-play practices in the public fund advisory selection process. First, the two-year compensation ban would offer the most efficient approach to preventing direct pay-to-

---

[244] Letter from Bob Edgar et al., *supra* note 17, at 4.

> We have found that people are most creative in devising ways around regulation, particularly if there are large sums of money involved. Accordingly, Common Cause agrees that the rule should prohibit anything done by an investment adviser or covered association indirectly, that if done directly, would result in a violation of the proposed rule.

[245] SEC Release, 74 Fed. Reg. at 39,845; statement by Mary L. Schapiro, *supra* note 5.

> Finally, and very importantly, the proposals would prohibit an adviser and certain of its executives and employees from doing indirectly acts that would violate the rules if done directly. This provision would prevent advisers from circumventing the rule by directing or funding contributions through third parties, such as attorneys, family members or companies affiliated with the adviser.

[246] Letter from Christopher J. Dodd, *supra* note 183, at 1.

play arrangements. The implementation of a compliance period for this regulation and changes to the returned contribution exception would ease the regulation's burden on advisers. Moreover, by raising the *de minimis* threshold the SEC could avoid infringement of the First Amendment rights of covered associates. Second, the prohibition against soliciting government entities with any third party intermediary would effectively deter pay-to-play practices. Nonetheless, if the SEC could still effectively deter indirect pay-to-play arrangements while still protecting the business interest of investment advisers if it amended the regulation to allow advisers to use placement agents registered as broker-dealers. Additionally, requiring advisers to post a bond and adopting disclosure requirements would limit the dangers associated with allowing placement agents to continue to solicit government clients. Finally, the regulations that prescribe soliciting and coordinating contributions and that prohibit contravention of the Proposed Rule through indirect means are both well designed and necessary. Therefore, the SEC should implement these two regulations as currently drafted.

The SEC has announced a proposal that would make great strides in curtailing pay-to-play practices in the public fund advisory selection process. Nonetheless, the SEC should adopt certain amendments to the Proposed Rule to bolster its effectiveness and limit its impact on industry participants. Such an approach would restore integrity to the process of selecting advisers and protect public fund beneficiaries without unnecessarily burdening investment advisers.