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October 26, 2009

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 "F" Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-18-09
Request for Comment –
Political Contributions by Certain Investment Advisers

Dear Ms. Murphy,

The Committee on Investment Management Regulation and the Committee on Private Investment Funds (the "Committees") of the Association of the Bar of the City of New York (the "Association") are composed of lawyers with diverse perspectives on investment management issues. The Committees include members of private law firms as well as in-house counsel of financial services firms, investment company complexes

and registered and unregistered investment advisers. A list of our respective members is attached as Annex A.

This letter responds to the request of the Securities and Exchange Commission (the "SEC") in Release IA-2910 (August 3, 2009) (the "Release") for comments on a proposed rule (the "Proposed Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") that is designed to eliminate the ability of investment advisers to use political contributions and other items of value to influence governmental officials who are responsible for hiring investment advisers to manage governmental funds. This practice is generally referred to as "Pay to Play."

The Proposed Rule is similar to one proposed by the SEC in 1999, which imposed a two-year "time-out" on the ability of advisers to provide compensated advisory services to a governmental client after making certain political contributions.[1] The Proposed Rule would expand the prior proposal to include advisers exempt from registration, cover advisory services provided by advisers indirectly through registered investment companies and private funds, and prohibit payments by investment advisers to third parties that solicit governmental entities with respect to advisory services and investments in certain pooled investment vehicles.

I. INTRODUCTION

The Association has long supported regulatory efforts to eliminate "Pay to Play" practices. In 1997, the Association took the initiative to recommend a court rule that would have restricted political contributions by lawyers in the public finance arena,

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1 *See* Political Contributions by Certain Investment Advisers, Investment Advisers Release No. 1812 (Aug. 4, 1999) [64 Fed. Reg. 43556 (Aug. 10, 1999)]. The prior proposal, like the Proposed Rule, was modeled on Rules G-37 and G-38 of the Municipal Securities Rulemaking Board (the "MSRB").

noting at the time, "[t]he problem [of "Pay to Play"], whether it is one of perception or reality – must be addressed."[2]

The Committees support the SEC's focus on eliminating "Pay to Play" practices by investment advisers. The Committees recommend, however, that the SEC take a different approach in seeking to meet its regulatory goal. In our view, it would be more appropriate and more effective to enhance advisers' code of ethics and compliance policy rules, which were designed to address ethical issues arising in the investment advisory business, than to establish a new rule modeled on rules G-37 and G-38, which regulate the very different business of municipal underwriting.

As discussed in Part II of this letter, the Committees believe that the approach of the Proposed Rule raises significant, if unintended, issues under the Investment Company Act of 1940 (the "Investment Company Act"), the Internal Revenue Code of 1986 (the "Code") and general fiduciary principles. Part II of this letter also discusses certain issues that we believe that the SEC must take into account in undertaking its required evaluation of the impact of the Proposed Rule on efficiency, competition and capital formation. Among other recommendations, we suggest that, if the SEC determines to proceed with the proposed approach, it should (i) provide for a rebate mechanism rather than a mandatory waiver of management fees in the event that an investment adviser is effectively forced to provide services to a governmental entity without compensation upon a violation of the rule; (ii) clarify that investment advisers would still be entitled to reimbursement for expenses if they continue to provide advisory services after triggering

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2 Arthur Levitt, then Chairman of the SEC, expressed support for the Association. *See* Letter of SEC Chairman Arthur Levitt (Aug. 20, 1996) ("I am encouraged to hear of the efforts made by the Association of the Bar of the City of New York . . . to advance its proposal addressing the issue of pay-to-play as it affects municipal finance lawyers . . . . It would benefit investors, attorneys, municipal officials, and the nation if attorneys joined the dealers on this ethical high ground.")

a two-year "time-out" as a result of making political contributions; and (iii) clarify that payment of Rule 12b-1 fees and other payments to brokers and service providers for bona fide distribution, administration and shareholder services in connection with a fund that is included on a government-sponsored platform would not be covered by the prohibition on third-party solicitation payments.

In Part III of this letter, the Committees recommend that the SEC consider an approach that is similar to that reflected in Rule 204A-1, *i.e.,* the Advisers Act code of ethics rule (as well as Rule 17j-1 under the Investment Company Act), and Rule 206(4)-7, *i.e.,* the Advisers Act compliance policy rule (as well as Investment Company Act Rule 38a-1). As we discuss in more detail below, this approach could include a rule or rule amendments requiring investment advisers to adopt policies and procedures reasonably designed to prevent employees, and solicitors or brokers acting on the adviser's behalf, from making political contributions designed to obtain business for the adviser, as well as related disclosure requirements concerning these policies. The SEC has successfully addressed other regulatory concerns by relying on this type of approach, which enables an adviser to tailor its procedures to its own business, operations and personnel. The SEC has ample experience examining firms in respect of their codes of conduct, compliance procedures and disclosures and, where appropriate, sanctioning firms for failure to adopt and implement reasonable procedures designed to prevent unlawful or unethical practices or failing to supervise their employees to prevent and detect such practices.

If the SEC decides to proceed with its proposed approach, we urge the SEC to modify the Proposed Rule to (i) create a broader, more workable mechanism for advisers to cure noncompliance with the Proposed Rule; (ii) eliminate from the ban on providing

compensated advice political contributions made prior to an individual's becoming a "covered associate" (*i.e.,* contributions by an employee prior to becoming employed by the firm or by an employee who makes the contribution prior to being promoted to "covered associate" status); (iii) exclude registered broker-dealers from the prohibition on payments to third parties for soliciting governmental entities; (iv) address certain transition issues; (v) clarify the scope of the terms "official" and "executive officer"; and (vi) clarify certain other aspects of the application of the Proposed Rule.

II. GENERAL COMMENTS

A. Unintended Consequences of the Proposed Rule for Registered Investment Companies and Private Funds

1. The Two-Year Ban.

The Proposed Rule imposes a two-year ban (the "Two-Year Ban") on the ability of an investment adviser to provide advisory services to a governmental entity for compensation in the event that a "covered associate" or "executive officer" of the adviser makes a political contribution to an "official"[3] of a "government entity." The Two-Year Ban prohibits receipt of compensation by an investment adviser (registered or unregistered) in connection with advisory services provided to a governmental entity either directly, such as through a managed account, or indirectly, through a "covered investment pool." "Covered investment pool" is broadly defined to include any investment company defined in Section 3(a) of the Investment Company Act and any company excluded from the definition of "investment company" under Section 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act.

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3 We discuss the uncertain scope of the proposed definitions in Section IV below and recommend, if the SEC determines to retain its current approach, that the SEC clarify and narrow the terms.

The Two-Year Ban does not apply to a publicly offered, registered investment company unless "it is an investment or an investment option of a plan or program of a government entity," such as a 529 savings plan, a retirement plan authorized by section 403(b) or 457 of the Code or any similar plan or program. Under the Proposed Rule, if an investment adviser violates the Two-Year Ban because, for example, a "covered associate" makes a non-exempt political contribution to an "official" after the adviser's fund has been accepted onto a governmental entity's sponsored retirement platform, the adviser is required to continue to serve as adviser to the fund and, by implication, to maintain the fund on the governmental entity's sponsored platform, without compensation from the governmental entity (a "Mandatory Fee Waiver") for a "reasonable period of time."

(a) Potential Issues Under the Investment Company Act.

In the case of a registered investment company, establishment of a Mandatory Fee Waiver for just one class of investor could cause the fund to violate provisions of the Investment Company Act. The forced waiver of investment management fees would effectively create a preferred class of shares within the fund, which would violate the restrictions of Section 18 of the Investment Company Act.[4]

(b) Potential Issues Under the Code.

The arrangement under which governmental plan investors – but not other investors – receive advisory services for free through the investment company raises

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[4] Assuming the Third-Party Solicitor Ban, discussed below, would prohibit payments out of fund assets to brokers (either directly or through a distributor), that provision may also create issues, potentially, with respect to the creation of a separate fund share class.

federal income tax issues under the Code.[5] The fund would likely be required to treat the governmental client's benefit resulting from the Mandatory Fee Waiver as a preferential dividend. In addition, as a result of the two classes of fund shares, the fund could potentially lose its status as a "regulated investment company" and, thus, lose its ability to provide pass-through tax treatment to investors. Because the SEC does not have jurisdiction to interpret or adopt regulations under the Code, it would not be able to address this unintended result.

(c) Concerns Regarding Fiduciary Duty and Equitable Principles.

By allowing a governmental client to receive advisory services without charge, the Mandatory Fee Waiver arguably provides an unfair advantage to governmental investors as compared to other clients of the affected investment adviser. This result is contrary to basic fiduciary and agency principles, long recognized by the SEC as applicable to investment advisers, which require investment advisers to treat all clients fairly and not favor one client over another.[6]

Imposition of the Mandatory Fee Waiver is also inequitable to investment advisers. In no other context are professionals required to perform services, for which they will be held to fiduciary standards, without compensation. The period of time during which an adviser may have to perform services without compensation could be

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5 As discussed in Part IV below, the SEC may be able to address this concern by substituting for the Mandatory Fee Waiver a requirement that the governmental entity continue to pay management fees to fund advisers but require the fund adviser to rebate the fee to the fund.

6 *See, e.g.,* Restatement of the Law of Agency (Third), Section 3.14 comment b. An agent must ensure that it does not benefit one client to the disadvantage of another. Note that this type of benefit is different from the ability of agents to negotiate different fees for services with different clients. Unlike differential fee arrangements, the Mandatory Fee Waiver is not contingent on arms-length negotiation reflecting the overall relationships between the parties and cannot be specifically disclosed to other clients of the adviser since the Mandatory Fee Waiver would result, in most cases, from an unintentional and unknown (*i.e.*, at the time the arrangement with the governmental investor was established) violation of the Two-Year Ban.

substantial. In the case of a registered fund that is part of a government-sponsored platform, replacement of the investment adviser or the fund as an investment option is not likely to be a quick or easy task. In all likelihood, under these circumstances the fund will be required to be removed from the platform and beneficiaries' investments will need to be transitioned to a replacement fund.[7] This type of transition can take a number of months.

In the context of a managed account, it may take a considerable amount of time to secure a suitable replacement adviser for the investment adviser on whom the Mandatory Fee Waiver is imposed. Moreover, the fiduciary for the governmental client may not have any incentive to act quickly to replace the adviser because the governmental client would be receiving services for free.[8]

An infraction of the Two-Year Ban may continue unheeded for a long period of time in cases where fund investors hold interests in the name of a nominee or the fund relies on omnibus accounting. Under these circumstances, a fund administrator may not be able to identify a governmental investor and alert the adviser until some period of time after the governmental investor has first subscribed for the fund. As a result, an advisor may, unintentionally and inadvertently, violate the Two-Year Ban for a substantial period of time before the violation is discovered and be required to disgorge compensation received after the fact.

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7 Although the Proposed Rule does include a cure provision, the scope of the cure provision is extremely narrow and it would not provide relief for many inadvertent violations. As discussed below, we believe that the cure provisions should be broadened.

8 *See* Release, *supra* note 1 at p. 27 fn. 79 ("Some commenters in 1999 [*i.e.*, in response to the SEC's prior rule proposal] indicated concern that governmental entities that retain advisers who trigger the two-year time out – and would therefore be unable to receive compensation for two years – might try to delay an adviser's ability to withdraw in order to enjoy the benefits of investment advice for free.") This may be more likely where the political contribution was not intended to and, in fact did not, influence the selection of the adviser so that the state officials would not be under any practical pressure to find a replacement.

Finally, even when the violation is promptly identified, it would be very difficult for private equity funds, venture funds and other pooled funds that invest in illiquid assets to permit a governmental investor to withdraw if a "Pay to Play" violation is found. Such funds have fixed terms (typically ten years, with the possibility of extension) and generally do not allow investors to withdraw or redeem their interests. It would not be a realistic solution to require a fund manager to resign under these circumstances since the fund investors select the fund based on the expertise of the investment adviser.[9]

Withdrawal of the governmental investor from a private equity, venture or similar fund would also not be a realistic alternative and could have an adverse effect on other nonwithdrawing investors, including other governmental investors. Among the most significant adverse effects may be that (i) such a withdrawal may require a fire sale of the fund's assets, which are by nature highly illiquid and would likely need to be sold at a significant discount (and generally cannot be structured in a way that limits the impact to the withdrawing investor); and (ii) nonwithdrawing investors would be forced to take a disproportionately larger share of all future investments of the fund and would bear a disproportionately larger share of all expenses of the fund than they had planned for (this effect would be enhanced if the governmental investor was a large investor in the fund). Because of the restrictions on withdrawals inherent in the structure of most private equity and venture funds as well as the liquidity constraints, an adviser may be forced, as a practical matter, to provide services to a governmental investor invested in such a fund for two years without assessing the governmental investor any management or

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[9] Certain closed-end funds and unit investment trusts may face similar issues.

performance fees. As discussed above, this appears to be an inappropriate result given that the manager would be providing bona fide services to the funds.

In order to avoid these inequitable results, at a minimum, the Proposed Rule should be modified to permit the investment adviser to be reimbursed for its expenses during any period in which it serves as adviser without compensation. We note that requiring reimbursement of expenses under these circumstances is consistent with other rules, which provide that an investment adviser is entitled to expenses upon termination of an advisory agreement.[10]

2. Ban on Payments to Third-Party Solicitors.

(a) Ban May Impede Bona Fide Distribution Arrangements.

The Committees do not believe that the ban on payment of compensation to placement agents for "solicitation" (the "Third-Party Solicitor Ban") is appropriate or necessary. Such a prohibition may effectively preclude certain investment advisers from marketing the funds they manage to governmental plans and other entities, which would disadvantage beneficiaries of the governmental entities by limiting their choice of investments. We do not believe that the SEC should prohibit these arrangements if they are fully disclosed and, in the case of a registered investment company, approved by the fund's board of directors. Such a prohibition would disrupt legitimate, longstanding distribution practices. Moreover, in cases where investment advisers otherwise would have paid for distribution, the prohibition could, depending upon the circumstances and the fund's distribution needs, require the fund to adopt a Rule 12b-1 plan and, thus, have

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10 *See, e.g.,* Rule 15a-4(b)(vi)(C)(1) (allowing a person to act as adviser for a fund under an interim contract after termination of a previous contract if, among other requirements, the interim contract contains provisions establishing an escrow account and provides for the adviser to receive the lesser of costs and the escrowed monies if the contract is not approved).

the unintended consequence of requiring that other investors bear the costs of distribution.

Even if the SEC retains a prohibition on payments to third-party solicitors, the ban should be revised so as not to prevent investment advisers from entering into bona fide distribution arrangements with registered broker-dealers. Registered broker-dealers are subject to comprehensive regulation by both the SEC and self-regulatory organizations. Among other things, registered broker-dealers are required to disclose detailed trade information at the point of sale. In addition, registered broker-dealers are subject to frequent examinations by their designated self-regulatory organizations regarding all aspects of their business as well as specific licensing authorization from FINRA to conduct a private placement business. State regulators have additional authority over sales practices of registered broker-dealers and, thus, provide another check against unethical and illegal practices. We believe that the safeguards inherent in the broker-dealer regulatory regime are sufficient to protect against "Pay to Play" practices in connection with use of registered broker-dealers to market funds or advisory services to governmental entities.

(b) Potential Issues Under the Investment Company Act.

The Third-Party Solicitor Ban could be interpreted as precluding payment of Rule 12b-1 fees or other appropriate and lawful payments to brokers for bona fide fund distribution, administration and shareholder services provided under an approved 12b-1 plan or by an adviser pursuant to a contract. At a minimum, existing payment arrangements would require restructuring to the extent that the payments are being made by the investment adviser rather than the fund and its distributor. The impact on

payments from fund assets pursuant to a Rule 12b-1 plan would be contrary to the SEC's intent in adopting Rule 12b-1.[11]

B. The Proposed Rule Raises Competitive and Cost-Benefit Concerns

The Proposed Rule raises serious competitive and business issues, including constraints on the ability of investment advisers to hire and retain qualified employees and the creation of competitive disadvantages for smaller investment advisers and advantages for banks and insurance companies, which are not subject to the rule. Although the Committees typically do not comment on business issues, we believe that it is appropriate in the context of the Proposed Rule to discuss the impact of the Proposed Rule on the efficiency and competitiveness of advisers in the marketplace. In carrying out its rulemaking responsibilities, the SEC is generally required to evaluate the impact of proposed regulations on efficiency, competition and capital formation.[12] The D.C. Circuit, in a recent decision, struck down Rule 151A under the Securities Act of 1933 (the "Securities Act"), relating to treatment of fixed indexed annuity contracts as "securities," and remanded the rule to the SEC on the grounds that the SEC, in adopting the rule, had violated its obligations under Section 2(b) of the Securities Act[13] to evaluate

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11 *See, e.g.,* Transcript of Rule 12b-1 Roundtable (June 19, 2007) at 7 ("in 1980, the Commission adopted Rule 12b-1, to permit funds to use fund assets to finance distribution, subject to the control and supervision of fund directors"). Although the Committee on Investment Management Regulation believes that there may be good reasons for the SEC to reevaluate Rule 12b-1, we do not think that it is appropriate to address these concerns in the context of prohibiting "Pay to Play" practices.

12 *See* Section 202(c) of the Advisers Act. "Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

13 Section 2(b) of the Securities Act, like Section 202(c) of the Advisers Act, requires the SEC, in connection with any rulemaking where it must consider whether an action is necessary or appropriate in the public interest, to also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The language in Section 2(b) is identical to that in Section 202(c) of the Advisers Act.

the impact of the proposed regulation on competition, efficiency and capital formation.[14] In interpreting the SEC's obligations under Section 2(b) of the Securities Act, which are identical to those under Section 202(c) of the Advisers Act, the court noted "Section 2(b) does not ask for an analysis of whether *any* rule would have an effect on competition. Rather, it asks for an analysis of whether the *specific rule* will promote efficiency, competition, and capital formation."(emphasis added)[15]

In light of the statutory mandate, the Committees believe it is important for the SEC to give careful consideration to the following competitive and cost issues in evaluating its Proposed Rule, particularly in light of the availability of alternative approaches that may not impose these costs and the fact that governmental entities have recently taken steps to address "Pay to Play" practices.[16]

- *The impact of the rule on the ability of investment advisers to hire and promote qualified personnel and on individuals to obtain suitable employment.* Investment advisers must be able to hire and promote qualified employees to be able to provide the investment advisory services they offer. The Proposed Rule could limit the ability of investment advisers with governmental entity clients to hire or promote into covered associate positions the most qualified persons, by effectively removing from consideration persons who have directly or indirectly, *e.g.*, through a spouse, made political

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14 *American Equity Investment Life Insurance Co. v. SEC*, 572 F.3d 923 (D.C. Cir. 2009) (holding that the SEC's analysis regarding efficiency, competition and capital formation was arbitrary and capricious). *See also Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) (holding that the SEC violated Section 2(c) of the Investment Company Act by failing to assess adequately the impact of mutual fund governance rules on efficiency, competition, and capital formation).

15 *American Equity, supra* note 14, at 935.

16 *See, e.g.,* California Public Employees' Retirement System Statement of Policy for Disclosure of Placement Agent Fees, http://www.calpers.ca.gov/eip-docs/investments/policies/ethics/disclosure-placement-agent-fees.pdf; 5 ILL. COMP. STAT. 420/4A-101 (2009); 2009 N.Y.A.B. 9029.

contributions within the prior two years to "officials." This could affect not only the ability of an adviser to provide the highest quality of services to its client, but also its competitive position relative to banks and insurance companies, which would not be subject to such restrictions. The Two-Year Ban may also impede the ability of individuals to obtain employment, including as a result of political contributions made exclusively for nonbusiness-related, personal reasons.

- *The Proposed Rule may preclude an adviser from offering its services or products to governmental entities, even in the absence of "Pay to Play" practices.* The SEC has generally interpreted the federal securities laws to require the use of a registered broker-dealer in the marketing process for funds. In limited circumstances, there may be available alternatives, but exceptions are often not available.[17] As a result, under the Proposed Rule, unless an investment adviser has an affiliated broker-dealer, the adviser may not be able to market the funds it manages to governmental entities at all. The effect of the Third-Party Solicitor Ban is likely to be experienced more acutely by smaller firms than larger firms since they are less likely to have the resources to establish a broker-dealer. The Third-Party Solicitor Ban may also disadvantage funds that are not in continuous capital raising mode, such as private equity and venture funds, since it may not be cost effective for those funds to form a broker-dealer affiliate. Finally, the Third-Party Solicitor Ban will disrupt established and legitimate capital raising arrangements. Firms

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[17] Rule 3a4-1 provides a limited safe harbor from the definition of broker under the Securities Exchange Act of 1934 (the "Securities Exchange Act") for associated persons of certain issuers (including funds and their investment advisers).

that rely upon third-parties for client referrals will be required to revise their arrangements which, in some cases, may result in the third party's no longer being willing to work with the adviser and, in some cases, if the adviser's investor base is primarily comprised of governmental entities, may mean that the adviser is not able to stay in business.

- *Significant resources will be required to implement and administer the Rule.* The Proposed Rule raises a number of interpretive questions. Although we have tried to highlight some of these issues in our comments, our expectation is that, if adopted, the Proposed Rule would result in additional questions being raised, which could place a significant demand on the time and resources of investment advisers and their compliance and legal personnel, as well as the SEC Staff to address these issues. We understand, anecdotally, that the MSRB Staff was required to devote substantial time and resources to addressing questions raised by G-37 and G-38. Given the SEC's already full agenda and lean staffing, the Committees respectfully question whether a rule that would require a resource commitment of this magnitude would be the most efficient use of the Staff's time and resources, particularly when the requested interpretive guidance will focus on complex areas of the law outside of the Staff's normal realm of expertise, such as campaign finance law and state and local governmental issues. The Committees believe that adoption of the alternative approach we discuss below would be more effective in terms of eliminating "Pay to Play" practices and more efficient in terms of its use of regulatory resources.

III. ALTERNATIVE APPROACH

The SEC requested comment on alternative approaches to the Proposed Rule. The Committees recommend that the SEC consider an alternative approach that would build on existing codes of ethics, compliance policies and disclosure rules to prevent such practices. Under this approach, the SEC would adopt rules or amend existing rules to require advisers to (i) incorporate into codes of ethics express prohibitions on political contributions by the adviser or its employees if the contributions are designed to influence the selection of the investment adviser; (ii) adopt or modify codes of ethics and compliance policies to prohibit a firm from retaining a placement agent if the use of such placement agent is designed to influence adviser selection based on factors other than the adviser's investment performance and other bona fide qualifications; (iii) adopt and implement policies and procedures designed to detect and prevent political contributions and solicitor payments designed to influence adviser selection; (iv) make specific disclosures and undertakings regarding such policies and procedures in the adviser's Form ADV Part II (or Disclosure Brochure) and in other applicable disclosure documents, such as private placement memoranda; and (v) disclose to the potential governmental client any political contributions that have been made by "covered associates" (or the equivalent category of employees) to relevant "officials" or payments to solicitors with the intent of influencing adviser selection by "officials."[18]

The SEC and the investment advisory profession have substantial experience with this type of approach, including the Advisers Act code of ethics rule and the Advisers Act compliance policies' rule. The rules requiring registered investment advisers to adopt

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[18] This rule could be made applicable to registered investment advisers and advisers exempt from registration under the Advisers Act.

codes of ethics and internal compliance policies already provide an effective way for firms to be able to restrict and police employee political contributions without establishing a flat prohibition. For example, Rule 204A-1 under the Advisers Act (the code of ethics rule) has provided an effective means for addressing potential abuses associated with personal securities transactions by access persons. Under this rule, as well as Rule 17j-1 under the Investment Company Act, the SEC established principles and objectives for registered advisers, registered investment companies and certain service providers to registered investment companies but, ultimately, granted discretion to entities to establish their own policies and procedures to achieve these objectives, subject to required adoption by the firms of appropriate oversight procedures.[19]

Similarly, the compliance policy requirements of Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the Investment Company Act have ensured that an investment adviser has in place (i) appropriate policies that address the range of regulatory issues affecting the adviser's particular business; (ii) an on-going monitoring program to oversee compliance with the policies and procedures; and (iii) an annual review process, under the supervision of the chief compliance officer, to test the adequacy of the policies and procedures and evaluate the effectiveness of their implementation. This approach encourages an investment adviser to establish and

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19 *See* Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2,256, Investment Company Act Release No. 26, 492 (July 2, 2004) ("Codes of ethics must also address personal trading: they must require advisers' personnel to report their personal securities holdings and transactions, including those in affiliated mutual funds, and must require personnel to obtain pre-approval of certain investments."); Prevention of Certain Unlawful Activities with Respect to Registered Investment Companies, Investment Company Act Release No. 11, 421 (Oct. 31, 1980) ("Although entities, in adopting their codes of ethics, may determine to prohibit certain (or all) of the activities discussed above, the Commission recognizes that there may be certain types of personal transactions by access persons which may not create the conflict of interest situations to which Section 17(j) was addressed . . .The broad language of the Rule is intended to permit entities to consider transactions by access persons in the context of their particular business operations when adopting their individual codes of ethics.")

implement a compliance program that is tailored to the adviser's or fund's business practices and needs. In the adopting release relating to these rules, the SEC indicated a belief that the rules would be effective because they called for policies and procedures that were tailored to an adviser's own business rather than imposing a "one size fits all" set of requirements.[20]

There are a number of procedures that investment advisers could adopt as part of a comprehensive compliance program to effectively address and prevent "Pay to Play" practices. Compliance procedures addressing "Pay to Play" might include (i) preclearance of political contributions; (ii) ring-fencing of certain employees from the solicitation and RFP process; (iii) required review by compliance personnel of marketing materials used with governmental entities; (iv) heightened supervisory responsibility for designated employees and executives; and (v) specific monitoring and audit requirements relating to use of third-party solicitors and political contributions by "covered associates" and "executive officers." The SEC could also suggest objective criteria that would be indicative of a political contribution or engagement of a solicitor "designed to influence adviser selection." Examples might include contributions by an employee involved in an RFP process with the governmental entity, contributions to a governmental official at or around the time the governmental entity is intending to engage an investment adviser, and use of a solicitor who is a relative or personal friend of the elected official. As is the case with its other rules, the SEC could also require employees to acknowledge their receipt of

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20 *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26,299 (Dec. 17, 2003) ("Commenters agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose a single set of universally applicable requirement elements. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations.").

the code and of the applicable compliance procedures, and annually certify that they have complied with all of the provisions.

The SEC could also add disclosure requirements regarding an adviser's policies and practices in respect to "Pay to Play" and dealings with governmental clients. While we agree with the SEC that disclosure, standing alone, may not fully address the practices at issue, the role of disclosure should not be minimized. Disclosure is helpful because it allows clients and regulators to scrutinize an adviser's business practices and conduct. Required disclosure imposes discipline on the adviser to maintain appropriate records regarding its business practices and policies and to regularly update those practices and policies. Requiring disclosure of political contributions by the investment adviser and its covered persons to officials of governmental clients may also serve to alert other governmental officials that additional scrutiny of the award of the advisory contract is appropriate.

It is our view that, in combination, these requirements would be a significant deterrent to "Pay to Play" practices involving investment advisers. This approach would avoid the need for advisers to establish a new compliance structure to deal with these issues and would address the problems associated with the Two-Year Ban described above. The SEC also has the tools and authority to enforce these rules and ensure that advisers adopt a code of ethics and compliance procedures sufficient to prevent and detect violations by employees of anti-"Pay to Play" principles. The SEC would, through the examination process, monitor the establishment and administration of such codes, policies and procedures. In appropriate situations, the SEC could bring enforcement actions against an adviser for inadequate procedures and failure adequately to supervise

its employees.[21] Advisers themselves could also be required to adopt appropriate penalties for code of ethics and compliance policy violations by employees, ranging from financial sanctions to suspension or termination of employment.

IV. MODIFICATIONS TO PROPOSED RULE IF ALTERNATIVE APPROACH IS NOT ADOPTED

In the event that the SEC elects not to adopt an alternative approach, there are a number of amendments we believe need to be made to the Proposed Rule in order to make it workable and to avoid unintended legal issues, such as those we have highlighted in this letter.

First and foremost, we believe that the SEC should adopt a simplified, workable remedy for unintentional, immaterial violations. The current exemptions are unnecessarily narrow and would consequently be ineffective in practice.[22] The key requirements for an exemption should be (i) the adviser has reasonable policies and procedures in place to detect prohibited contributions from the adviser's employees; (ii) the adviser acts promptly and uses its best efforts, upon discovery of the violation, to

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21 The SEC has the power to and has brought actions against advisers for failure to adopt adequate procedures even in situations where there was no clear violation of law or other wrongdoing. *See, e.g,,* In re Massachusetts Financial Services Company, Investment Advisers Act Rel. No. 2165 (Sept. 4, 2003)(adviser sanctioned for failing to address in its procedures a situation where the firm received insider information from consultants); In re Putnam Investment Mgmt., LLC, Investment Advisers Act Rel. No. 2192 (Nov. 13, 2003)(mutual fund adviser sanctioned for failing to have adequate procedures to detect and prevent portfolio managers from using material, non-public information about fund portfolio to trade in fund shares or to prevent the distribution of confidential portfolio holdings information).

22 The Proposed Rule provides two exceptions to the Two-Year Ban: (i) a *de minimis* exception and (ii) a returned contributions exception. The *de minimis* exception would allow a covered associate of an adviser that is a natural person to make up to $250 in contributions to an official per election if the covered associate is entitled to vote for the official at the time of the contribution. Under the returned contribution exception, if a covered associate of an adviser makes a contribution that triggers the Two-Year Ban because he or she was *not* entitled to vote for the official at the time of the contribution, the adviser can effectively undo the contribution only if (A) the contribution was less than $250, (B) the adviser discovered the contribution within four months of the date of the contribution, (D) the adviser causes the contributor to re-collect the contribution within 60 days after the adviser discovers the contribution and (E) the adviser does not rely on the exception more than twice in a 12-month period or ever rely on the exception for the same covered associate more than once.

recapture the contribution; and (iii) the adviser takes appropriate disciplinary action against the contributor-employee. The SEC should also evaluate whether the suggested level for the *de minimis* exception should be raised to reflect increases in the cost of living since that level was adopted by the MSRB as part of its "Pay to Play" rules.

The Committees also recommend that the SEC eliminate the application of the Two-Year Ban to contributions made prior to an individual's becoming a covered associate for the applicable adviser (the "Look Back Rule"). In our view, an adviser should also be able to address any possible conflicts arising as a result of previous political contributions made by a new hire or an employee being promoted into covered associate status by ring-fencing the individual so that he or she does not participate in any solicitation or marketing initiatives with respect to governmental clients or prospects of the adviser-employer. This approach would allow the investment adviser to hire and promote personnel based on the qualifications and expertise of the individuals but still address potential "Pay to Play" conflicts and concerns. If the SEC adopts a workable exemption as suggested and eliminates the Look Back Rule for newly hired or promoted covered associates, additional qualifications to the Two-Year Ban should not be necessary.

In addition, the SEC should eliminate application of the Third-Party Solicitor Ban to registered broker-dealers. Registered broker-dealers are subject to a comprehensive regulatory structure involving oversight by the SEC as well as self-regulatory organizations. The structure provides for disclosure of remuneration as well as restrictions on the amount of compensation that a broker-dealer may earn.[23] These

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23 *See, e.g.*, FINRA Rule 2440 and IM-2440.

regulations should mitigate the risk of "Pay to Play" practices. Moreover, in certain cases, investment advisers are effectively required by law to use broker-dealers, such as in connection with placement of interests in funds. These requirements have been vigilantly enforced by the SEC. It seems both inequitable and inefficient for the SEC to have focused, as it has over the past ten years, on requiring advisers to use registered broker-dealers to place fund shares only to penalize the firms that have put such arrangements in place if the investors happen to be governmental entities.

Finally, if the Proposed Rule is adopted, it will be important for the SEC to provide a sufficient transition period for advisers to establish the substantial compliance infrastructure and IT changes that will be necessary to comply with the requirements. Based on the experience of our members, we would recommend a period of at least one year. We also recommend that existing arrangements with solicitors and placement agents be allowed to continue.

In addition to the more general modifications discussed above, the SEC should also address the following issues:

(i) The definitions of "official" and "executive officer" require clarification. "Official" is defined as "any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (i) is directly *or indirectly* responsible for, *or can influence the outcome of*, the hiring of an investment adviser by a government entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity." (emphasis

added). It is likely to be difficult for an adviser to determine whether an official is indirectly responsible for the hiring of an investment adviser, let alone whether that official can "influence" the outcome. The definition should be limited to officials who have direct responsibility for selecting advisers under applicable legislation or executive orders. Similarly, the definition of "executive officer" should be limited to those employees of an investment adviser who oversee marketing to governmental entities. As currently proposed, the term would cover any individual charged with supervising an adviser's investment business or fund distribution, even if the individual or the area supervised by the individual has no responsibility for or interaction with governmental entity clients. The meaning of the term will also require clarification within the context of a diversified financial services firm to make clear that term only applies to employees of the investment adviser.

(ii) The SEC should make clear, either in the final rule or in the adopting release, that political contributions by an adviser (or employees of an adviser) to underlying tiers within a multi-tiered product (*e.g.*, funds underlying a fund of funds, subadvised funds, or underlying funds in a variable annuity used in a 403(b) or 457 plan) do not trigger the Two-Year Ban applicable to the adviser to the top tier, unless the advisers at the two levels have a control relationship.

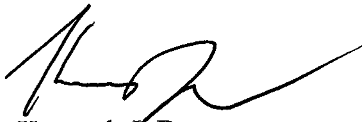
(iii) Clarification is necessary regarding application of the Proposed Rule within the context of a large, diversified company having an investment advisory division. For example, if the company has a political action

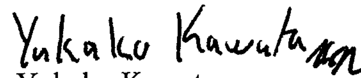
committee ("PAC") for the corporation as a whole, the SEC should clarify that contributions by the corporate PAC would not be affected or restricted by the Proposed Rule.

*   *   *   *   *

The Committees appreciate the opportunity to comment on the Proposed Rule. If we can be of any further assistance in this regard, please do not hesitate to contact Ken Berman, at (202) 383-8050 or kjberman@debevoise.com, or Yukako Kawata, at (212) 450-4896 or yukako.kawata@davispolk.com.

Very truly yours,





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Chair,
Committee on Investment
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Yukako Kawata
Chair,
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Attachment

cc: The Honorable Mary Schapiro, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Andrew J. Donohue, Director
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Annex A

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