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October 6, 2009

Ms. Elizabeth Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F. Street, N.E.  
Washington, DC 20549-1090

**Re: Political Contributions by Certain Investment Advisers (File No. S7-18-09)**

Dear Ms. Murphy:

The Investment Company Institute<sup>1</sup> supports the goal of the Securities and Exchange Commission's proposal to prohibit "pay-to-play" arrangements, whereby investment advisers make political contributions or related payments to governmental officials to be rewarded with, or afforded the opportunity to compete for, contracts to manage the assets of public pension plans and other government accounts.<sup>2</sup> Maintaining the integrity of the securities markets is critical to Institute members and the over 93 million shareholders they serve to ensure fair, orderly, and efficient markets. We believe, however, that the Commission's proposal significantly overreaches in many ways with respect to the potential conflict of interest raised by political contributions, and therefore should be appropriately tailored to address improper contributions without arbitrarily limiting lawful conduct, imposing costly and impractical compliance challenges, or infringing upon the legitimate exercise of individuals' political rights and expression.

To avoid the deleterious consequences that may flow from the Commission's proposal, while still advancing the Commission's goals of protecting the integrity of government investment decisions, we recommend that the Commission note that registered investment companies ("funds") should have written policies and procedures to prevent pay-to-play practices as part of their compliance with Rule 38a-1 under the Investment Company Act of 1940 ("Investment Company Act").<sup>3</sup> This approach to

<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.2 trillion and serve almost 93 million shareholders.

<sup>2</sup> See Securities and Exchange Commission Release No. IA-2910 (August 3, 2009), 74 FR 39839 (August 7, 2009) ("Release"), available at <http://www.sec.gov/rules/proposed/2009/ia-2910.pdf>.

<sup>3</sup> See Securities and Exchange Commission Release Nos. IA-2204; IC-26299 (December 18, 2003), 68 FR 74714 (December

addressing potential conflicts of interest has served funds and their investors well for many years. As discussed in more detail below, such policies and procedures would be designed to inhibit political contributions by funds made for the purpose of gaining government clients.<sup>4</sup> If the Commission nevertheless determines to adopt the rule as proposed, we recommend numerous changes to better align it with the Commission's stated regulatory goal. Our specific comments on the proposal follow.

## **I. Summary of Recommendations**

### Applicability of Proposed Rule to Funds

- We recommend that, instead of imposing the requirements of the proposed rule on funds, the Commission incorporate into the existing compliance rule, Rule 38a-1 under the Investment Company Act, requirements for funds to have written policies and procedures designed to prevent pay-to-play activity, with attendant recordkeeping requirements.

### Recommended Changes to Proposed Rule

If the Commission determines to include funds within the scope of the proposed rule, we recommend the following changes to the proposed rule to reduce the burdens on funds.

#### *Two-Year Ban for Contributions*

- We recommend, to minimize the negative consequences of the proposed two-year ban, that this provision be applicable only to the award of investment advisory contracts for pension and other employee benefit plans and the advisory personnel involved in such business.
- We recommend that the Commission consider graduated sanctions for pay-to-play activity to more appropriately address the facts and circumstances of questionable conduct and better account for inadvertent contributions that would trigger the proposed ban.
- We recommend that the Commission provide clarity on a number of issues relating to the ban including the meaning of a "reasonable amount of time" with respect to the period an adviser would need to continue to provide advice to an affected government client; the prohibition of the receipt of compensation for pre-existing advisory agreements or contracts; how to identify officials who would be in a qualifying "position of influence" to aid advisers in their compliance efforts; and the scope of the exception for "covered investment pools."

24, 2003) ("Adopting Release"), available at <http://www.sec.gov/rules/final/ia-2204.htm>. The Adopting Release describes the specific topics that the Commission expects to be covered in a fund's compliance policies and procedures; we recommend that the Commission follow the same process here.

<sup>4</sup> We believe the Commission could address pay-to-play activity by advisers, generally, by implementing a similar change to the compliance rules for advisers, Rule 206(4)-7 under the Investment Advisers Act of 1940 ("Advisers Act").

- We recommend a limited, conditional exception to the ban in the case of mergers, acquisitions, and other business combinations where a ban is triggered because a person who made a contribution becomes a covered associate of the new entity and that sub-advisory relationships be excluded from the scope of the proposed rule.
- We recommend that the term “executive officer” be narrowed to include only those executive officers who directly oversee the performance or solicitation of government advisory services.
- We recommend that the “look back” provision in which the ban would continue in effect after a covered associate who made a prohibited contribution left the advisory firm be eliminated or, alternatively, that the look back period be shortened and that advisers be permitted to rely on the representations and certifications of employees and applicants with respect to prior contributions.
- We recommend that the de minimis exception threshold be raised to \$1,000 and that the applicability of the exception be expanded to officials to whom an individual is not entitled to vote.
- We recommend that the exception for returned contributions be expanded to encompass any inadvertent contribution, above the de minimis threshold, that is returned in the time and manner described in the proposal and that the restriction on the number of times an adviser may rely on the exception for inadvertent contributions be eliminated.

#### *Ban on Using Third Parties to Solicit Government Business*

- We recommend that the proposed ban be narrowed to advisers using third-party solicitors who make contributions to government officials that the adviser would be prohibited from making directly.
- We recommend expressly providing in the rule text or adopting release that any payments made in the normal course of business by a fund’s investment adviser to a broker-dealer or any other financial intermediary that distributes fund shares would not be considered a “payment . . . to solicit a government entity” even if such broker-dealer or financial professional or firm maintains a government entity’s account.

#### *Soliciting and Coordinating Contributions and Payments*

- We seek clarity that the rule’s prohibition would not be triggered by contributions to federal incumbents, federal level political parties, or separate segregated funds and that an adviser is not “in control” of a PAC organized, operated, and run by the adviser’s parent, even if advisory employees participate on or in the PAC.

### *Exemptions*

- We recommend that the Commission provide a 30-day period by which it must grant or deny exemptive requests, after which applications not acted upon are automatically granted and delay application of the proposed rule until the Commission acts upon the request for exemptive relief.

### *Recordkeeping Requirements*

- We recommend that any recordkeeping requirements be applied prospectively and only to new accounts that are established after a period of time that would be sufficient to enable funds to redesign their account application forms and systems to capture information regarding the “government entity” status of a shareholder.
- We seek clarity on how funds should conduct searches to discern their shareholders that are government entities or government officials acting in their official capacity to comply with the proposed rule.

### *Transition Period*

- We recommend that the Commission adopt a transition period of at least 12 months to provide fund advisers sufficient time to redesign their new account applications and their internal policies and procedures to capture the required information and that the rule only be applied prospectively to provide funds with sufficient time to comply with the rule.

## **II. The Proposed Rule**

The proposed rule is designed to prevent pay-to-play practices by investment advisers through restrictions on political contributions to government officials who are in a position to influence the award of advisory business. First, the proposal would impose a two-year “time out” on conducting compensated advisory business with a government client after a contribution is made. Second, the proposal would prohibit advisers from paying third parties to solicit government entities for advisory business. Third, it would make it unlawful for an adviser to solicit or to coordinate (1) contributions for a government official to whom the adviser is seeking to provide advisory services or (2) payments to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity. Fourth, the proposal would prohibit an adviser from doing anything indirectly that, if done directly, would violate the proposed rule.

The proposal would generally apply to advisers registered (or required to be registered) under the Advisers Act and advisers exempt from registration under Section 203(b)(3) of the Advisers Act. The proposal also would extend to pay-to-play relationships involving investment pools, including any investment company, as defined in the Investment Company Act, or any company that would



otherwise be an investment company but for the exclusions provided under Sections 3(c)(1), 3(c)(7), or 3(c)(11) of the Investment Company Act. Thus, advisers to funds, hedge funds, private equity funds, and venture capital funds would be subject to the proposal's prohibitions.

### **III. The Proposed Rule is Overly Proscriptive and Inappropriately Designed for the Targeted Abuses**

The Commission's stated regulatory goal in proposing the new rule is to prohibit pay-to-play practices that (1) distort the selection process for advisers by government entities, thereby harming government plan clients, or (2) manipulate the market for advisory services by creating an uneven playing field among advisers.<sup>5</sup> The Institute strongly opposes the use of inappropriate political contributions by advisory personnel to obtain clients. Nevertheless, we believe that the rule as proposed significantly overreaches to achieve that goal, and will have the converse effect of harming government plan and fund participants through costly and disruptive interruptions to their investment advisory services, as well as unnecessarily infringing on market participants' right to participate in the political process. Indeed, most of the cases of pay-to-play practices cited by the Commission in the Release address kickback schemes and other forms of fraud and wrongdoing for which the Commission already has authority to act.<sup>6</sup> In addition, the list of enforcement cases and the discussion in the Release demonstrate that state and local laws and regulations are providing effective recourse for pay-to-play abuses.<sup>7</sup>

#### **A. Pooled Investment Vehicles – Applicability of the Proposal to Funds**

The general pay-to-play prohibitions and recordkeeping requirements would apply to an adviser that manages assets of a government entity through the entity's investment in a fund managed by that adviser. The proposed two-year time out provision, however, would be applicable to an adviser to a fund only when the fund is included in a plan or program of a government entity.<sup>8</sup>

<sup>5</sup> See Release *supra* note 2, at p. 7 (explaining that the proposed rule should prevent practices that are inconsistent with the standards of ethical conduct required of fiduciaries under the Advisers Act).

<sup>6</sup> The Commission has extensive authority to address fraudulent conduct by funds and advisers. For example, fund advisers are subject to a variety of fraud standards, including Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, Section 34(b) of the Investment Company Act, and Sections 206(1), 206(2), and 206(4) of the Advisers Act.

<sup>7</sup> See, e.g., Release *supra* note 2, at pgs. 11-15.

<sup>8</sup> The Institute supports the Commission's limited exception for funds from the proposed rule because of the substantial compliance challenges funds would face in identifying government entities that invest in a fund for cash management or other purposes. The exception does not, however, reduce the compliance burdens for funds. Funds will have to expend the same amount of resources and develop the same type of comprehensive compliance measures to address the other provisions of the proposed rule, particularly the proposed recordkeeping requirements which require funds to identify information regarding shareholders who are government entities.

The inclusion of funds within the scope of the proposed rule is in stark contrast to the Commission's 1999 pay-to-play proposal, which expressly excluded funds.<sup>9</sup> According to the Release, funds should now be subject to the proposed rule because government-sponsored plans have grown enormously in recent years and funds today are used as either funding vehicles for, or investments of, these plans.<sup>10</sup> We understand the Commission's desire to inhibit all possible avenues of pay-to-play activity, but believe that including funds in the proposal is troubling and should be changed in recognition of the existing comprehensive regulatory regime imposed on funds as compared with other covered investment pools, and the practical and operational difficulties of complying with the proposal within the constructs of the existing fund regulatory framework.<sup>11</sup> We therefore recommend that any regulation of pay-to-play activities applicable to funds address such activity through the existing compliance policies and procedures regulatory structure.<sup>12</sup> In doing so, the Commission should explain its concerns and expectations regarding pay-to-play conduct and/or prohibitions, permitting funds to craft the specific policies and procedures appropriate to their particular operations.<sup>13</sup> We also recommend that the Commission modify the proposed recordkeeping requirements applicable to funds, as discussed below.

<sup>9</sup> See Securities and Exchange Commission Release No. IA-1812 (August 4, 1999), 64 FR 43556 (August 10, 1999). The 1999 proposal would have applied only to advisers to private investment companies, defined as investment companies exempt from Commission registration under Section 3(c)(1) or (3)(c)(7) of the Investment Company Act.

<sup>10</sup> The Release notes that the risk to investors in government-sponsored savings or retirement plans from pay-to-play activities is magnified in the context of 529 plans if a state offers only one, or very few, investment options to its participants. See Release *supra* note 2, at pgs. 60-63.

<sup>11</sup> We note that of the various cases of pay-to-play conduct cited in the Release as justification for including funds within the scope of the proposed rule, only one case involved a fund. See Release *supra* note 2, at footnote 164. Moreover, the questionable conduct was redressed by enforcement actions at both the federal and state levels, demonstrating that a sufficient regulatory regime already exists to address improper conduct by funds in this area. Likewise, a remedy presently exists for certain of the conduct described in the Release as the basis for imposing the proposed rule on funds. For example, the Release states that an adviser's participation in pay-to-play activities, such as a kickback scheme, may defraud other investors in a fund by causing certain investors in the fund to pay higher advisory fees. This conduct is prohibited by the Investment Company Act. See Release *supra* note 2, at p. 59.

<sup>12</sup> See Adopting Release *supra* note 3. These policies and procedures must at a minimum address portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives and applicable regulatory restrictions, safeguarding of client assets, the accurate creation of required records, marketing advisory services, including the use of solicitors, and compliance with fund governance requirements.

<sup>13</sup> Consistent with the structure of Rule 38a-1, which does not enumerate specifically required policies and procedures (unlike the Adopting Release), the rule text of Rule 38a-1 would remain unchanged.

## 1. Funds are Subject to a Comprehensive Regulatory Regime

Funds are comprehensively regulated under the federal securities laws.<sup>14</sup> For example, under the Investment Company Act, funds have detailed governance requirements – including an independent board of directors – designed to safeguard the interest of all shareholders, and are subject to ongoing disclosure and reporting requirements that assure the highest possible transparency. We believe that the unique and stringent regime of federal regulation to which funds are subject warrants the use of different pay-to-play regulatory requirements.

Rather than reinventing the wheel and establishing an entirely new regulatory regime for a practice that, though offensive to the public trust, is infrequently committed by funds, we strongly believe that the objective of the proposed rule can be fully served by requiring funds and their advisers to develop compliance policies and procedures to address pay-to-play activities. Rule 38a-1 under the Investment Company Act has already established a rigorous regulatory regime for ensuring the adequacy and effectiveness of fund compliance programs on an ongoing basis. It also has greatly enhanced the internal compliance oversight function played by the fund's board of directors. The board, including a majority of its independent directors, must approve the policies and procedures of the fund and each of its service providers, considering the nature of the fund's exposure to compliance failures. Funds also must designate a chief compliance officer who reports directly to the board and must furnish the board with an annual written report on the operation of the fund's policies and procedures and those of its service providers over the previous year.<sup>15</sup> Though Rule 38a-1 requires the chief compliance officer to meet in executive session with the independent directors at least once a year, it is common for the chief compliance officer to attend every board meeting, often for the entire length of the meeting.<sup>16</sup> It is also common for a board to engage in a frequent dialogue with the chief compliance officer about the board's expectations in relation to extraordinary or significant compliance matters. As part of this process, it is not uncommon for chief compliance officers to periodically make presentations to the board regarding where conflicts of interest may exist and what controls are in place to mitigate them.<sup>17</sup>

We note that the Commission has a successful history of combating conflicts of interest that may result in abusive activities, such as pay-to-play practices, through regulations requiring the

<sup>14</sup> See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated March 2, 2000 (recommending that the Commission retain the proposed exclusion of funds from its 1999 pay-to-play proposal because funds are subject to a comprehensive federal regulatory regime).

<sup>15</sup> Many chief compliance officers provide quarterly reports to their boards. See *Board Oversight of Fund Compliance*, Independent Directors Council, Task Force Report, dated September 2009.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

adoption of specific policies and procedures. For example, through Rule 17j-1 of the Investment Company Act, the Commission requires funds and advisers to implement policies and procedures to address the conflicts of interest raised by personal trading activities of fund and advisory personnel. While the Commission requires the adoption and enforcement of a code of ethics and certain reporting and recordkeeping requirements under those rules, it does not specify the provisions in the code of ethics, providing flexibility to funds and advisers to develop the individual policies and procedures appropriate to their specific operations. Significantly, Rule 17j-1 requires internal enforcement of fund and adviser codes of ethics and leaves the sanctions for particular violations to the determination of each fund or adviser, subject to the SEC's overall examination and enforcement authority. We believe a similar approach under the Commission's compliance rules would be sufficient to combat pay-to-play activity.

## **2. Policies and Procedures Approach is Less Complicated**

Our recommended approach would provide funds the ability, within their existing regulatory framework, to craft policies and procedures to address the Commission's concerns while avoiding several unintended consequences that could arise under the rule as proposed. For example, permitting funds to design policies and procedures tailored to their specific operations would avoid the unintended consequences of a one-size-fits-all rule. The consequences to a fund of violating the rule would far exceed those to other advisers whose penalties could be more discretely tailored and applied to individual clients. Indeed, as discussed further below, we question the practical logistics of how a fund could even satisfy several of the proposed rule's requirements, *e.g.*, the proposed two-year ban penalty. The only approach that seems to avoid raising more issues than it resolves may be for the adviser to waive its advisory fee for the fund as a whole in an amount approximately equal to the fees attributable to the government entity. This approach, however, could prove to be a logistical recordkeeping and accounting nightmare until the fund could liquidate the investment.

Also, as discussed in more detail below, it is unclear what a fund should do if a government entity elects not to – or even refuses to – liquidate its position in the fund. This could result in the government entity, in a sense, being able to hold the fund hostage without the fund having any recourse. This seems most unfair, especially when one considers that the ban could result from a covered person who had nothing to do with soliciting the government entity's business making a political contribution with no nefarious intent in a small dollar amount.<sup>18</sup> There is nothing in the Commission's proposal that aligns the penalty with the offense; with the exception of substantial political contributions that are clearly meant to influence government investment decisions, the Commission's proposal seems analogous to sentencing all offenders to life imprisonment for all offenses, even those that are minor traffic violations. We question the wisdom of such a heavy handed response, particularly as it will impact funds.

<sup>18</sup> As discussed below, the proposal includes a de minimis exception for contributions of \$250 or less to government officials for whom a covered associate is entitled to vote.



## **B. MSRB's Pay-to-Play Rule Fails as Model for Fund and Advisory Relationships**

The Institute questions the Commission's extensive reliance on the MSRB's pay-to-play rules<sup>19</sup> as the framework for the proposed rule. There are significant differences in the relationship of a government entity as an issuer selecting a municipal securities dealer and the relationship of a government client selecting an adviser to manage its assets.<sup>20</sup> For example, municipal securities business may be awarded through a negotiated underwriting, whereas investment advisory business is typically awarded through a transparent, competitive bid process (*e.g.*, a request for proposal, or RFP). Perhaps, most importantly, advisers have a fiduciary duty to act in their clients' best interests, unlike municipal dealers, and are subject to rigorous enforcement of that duty. Termination of a longstanding, ongoing fiduciary relationship between an adviser and its government client once a contribution under the proposal is made also is a much harsher result for both client and adviser than a time-out on transactional business in the municipal securities arena.<sup>21</sup> Quite simply, the advisory industry is too diverse to accommodate the proposal's one-size-fits-all regulatory framework and its insular approach that both ignores the existing regulatory regimes that apply to various categories of advisers and overlooks the severity of consequences for even inadvertent violations of the proposal's very broad prohibitions.<sup>22</sup>

As discussed in more detail below, in relying on the estimates for compliance with the MSRB rules, the Commission significantly underestimates the compliance and recordkeeping burdens

<sup>19</sup> MSRB Rule G-37, *Political Contributions and Prohibitions on Municipal Securities Business* (1994), available at <http://www.msrb.org/msrb1/rules/ruleg37.htm>, and MSRB Rule G-38, *Solicitation of Municipal Securities Business* (1996, amended 2005), available at <http://www.msrb.org/msrb1/rules/ruleg38.htm>.

<sup>20</sup> Although we question the Commission's reliance on the MSRB's pay-to-play rules as the foundation for a pay-to-play rule for funds because of the extremely different nature of these industries and their regulatory regimes, we note that, since the adoption of its rules, the MSRB has provided extensive guidance and clarification to municipal securities participants regarding the scope and application of its rules. Thus, if the Commission proceeds with its rule as proposed, we believe it is critical that the Commission look to the MSRB's guidance and interpretations to provide clarity to the Commission's proposed rule.

<sup>21</sup> The MSRB has issued guidance providing relief for certain advisory relationships under the MSRB pay-to-play rules in recognition of the often long-term duration of the relationships and the negative consequences that flow from their interruption. (*See discussion infra* at p. 12 – “b. Provide Guidance on Pre-Existing Advisory Agreements/Contracts.”)

<sup>22</sup> At the time the MSRB rules were proposed and adopted, there were few restrictions on municipal finance professionals. Since then, many states and local governments have adopted requirements designed to prevent pay-to-play practices and many advisers have adopted policies and procedures to inhibit pay-to-play activities – either as part of their codes of conduct or their compliance practices. These requirements are in addition to the regulatory requirements imposed by the Investment Company Act and the Advisers Act.

associated with the proposed rule.<sup>23</sup> Very few fund advisers have broker-dealer affiliates that underwrite municipal securities and therefore are subject to the MSRB rules. Thus, most advisers, including advisers to funds, will have to build compliance systems.<sup>24</sup> Moreover, because of the small number of municipal finance professionals at each individual firm, including affiliates, municipal securities dealers are able to implement effective and comprehensive compliance programs on a much smaller scale, using, for example, quarterly questionnaires. This would not be the case under the much broader applicability of the proposed rule to the significantly larger group of covered advisory employees. Even expanding an existing compliance program, for those fund advisers with compliance policies and procedures in place for effecting the MSRB rules, would not be the simple “add on” envisioned by the Commission. Under the Institute’s recommendation, however, advisers would be able to craft targeted compliance policies and procedures to accommodate their different business models that are more accurately directed at the pay-to-play conduct underlying the Commission’s concerns.

#### **IV. Recommended Changes to the Proposed Rule**

If the Commission determines to adopt the rule as proposed, we recommend the following changes to the proposal to alleviate many of the costs and burdens that would be placed on funds.

##### **A. Modify Two-Year Ban for Contributions**

The proposed rule would prohibit an adviser, or its covered associates, from providing advice for compensation to a government entity within two years after a contribution<sup>25</sup> to an official of the government entity in a position to influence the selection of an adviser. As discussed above, the Institute is concerned that, in many instances, the two-year ban is likely to be greatly disproportionate to the harm done or the public policy interests the proposal seeks to remedy.<sup>26</sup> We believe a ban is appropriate when (1) firms have clearly embarked on a course of conduct of using political contributions in an effort to obtain investment advisory contracts from government clients and (2)

<sup>23</sup> The Release estimates that ongoing compliance burdens will be between 10 and 1,000 hours as estimated from compliance with the MSRB rules. See Release *supra* note 2, at p. 82-83. The link between these estimates and the advisory industry becomes more attenuated when firms with multiple advisers are considered in the calculation.

<sup>24</sup> In response to the Commission’s request for comment, where applicable, our members do not expect to use existing compliance systems of affiliated broker-dealers because the business lines are separate and the expansive scope of the proposed rule would cast a much wider net requiring a different compliance approach.

<sup>25</sup> We request that the Commission provide clarity regarding “contributions” versus legitimate expenses in the normal course of business, such as business expenses including meals, tickets, and related items that do not violate other local, state, or federal gift and entertainment restrictions.

<sup>26</sup> The Release suggests that the proposed rule does not impose a ban, per se, because an adviser may continue to provide services to a government client at no cost. We believe this claim is devoid of basis in practice and that the proposed rule in effect imposes a ban.

firms have established a pattern of failing to supervise employees in this area. In other cases, the appropriate remedy should be determined based on an evaluation of the facts and circumstances surrounding the contribution. In particular, it should be determined by assessing the contributor's intent.

As proposed, the two-year ban has the potential to harm rather than protect shareholders of a government plan or a fund. For example, existing state and local government clients may be harmed by the forced termination of a mutually beneficial business relationship, despite receiving free services for a period of time, because the government client is subject to the costs associated with selecting a new adviser, and plan beneficiaries are subject to the costs associated with portfolio commissions and other restructuring costs. Consequently, our members believe that the two-year ban will operate as a permanent ban because a government entity will be unlikely to go through the process of identifying and hiring a replacement adviser, and then return to the original adviser after the ban ends. This likelihood is particularly troubling in the case of inadvertent violations of the proposed rule wherein the adviser may lose advisory business immediately or be subject to the ban while it undertakes the exemptive application process with the Commission (discussed below).

In addition, due to the broad definitions in, and far reaching scope of, the proposed rule, we believe the Commission has severely underestimated the compliance costs for the proposed ban.<sup>27</sup> For example, the Release implies that, in order to use the proposed exceptions within the given time frame (four months), an adviser will have to ask all of their covered associates about their political contributions on a quarterly basis. This timeframe is unrealistic for a firm of any size, much less a large firm, firms with multiple advisers, or firms with hundreds of covered associates. Plus, the invasive nature of the necessary inquiries would unduly penalize employees of advisers by limiting their otherwise lawful and appropriate personal and political activities. Because of the extremely harsh penalty involved, the Commission should be mindful of the fact that, due to the transient nature of employees within firms and between firms, many advisers and funds will err on the side of caution in implementing the rule's requirements by adopting procedures that ban *all* contributions from *all* employees who have any potential nexus to a government client. Only by doing so, can these advisers and funds be confident that they will satisfy, for both today and into the future, the recordkeeping and compliance burdens for such a wide-reaching and unforgiving rule.

To minimize the negative consequences of the proposed rule, if the Commission does not amend its compliance rules to allow for a policies and procedures approach as we have suggested, we recommend that the Commission, at a minimum, limit the applicability of the proposed rule to the award of investment advisory contracts for pension and other employee benefit plans and the advisory personnel involved in such business. This limitation would assist advisers in focusing their compliance efforts on those scenarios where contributions may have influenced the award of advisory business.

<sup>27</sup> As discussed above, the Release incorrectly suggests that the compliance burden should be minimized because the proposed rule is modeled after the MSRB rules.

Furthermore, we suggest that the Commission consider graduated sanctions for pay-to-play activity in lieu of the proposed two-year ban, to more appropriately address the facts and circumstances of questionable conduct and better account for inadvertent contributions that would trigger the proposed rule's penalty.

### **1. Provide Guidance Regarding Two-Year Ban**

In addition, we believe the proposal raises a number of questions about which the Commission must provide guidance prior to adopting a rule.

#### **a. Define "Reasonable Amount of Time"**

In an effort to address the disruptive process of suddenly switching advisers midstream and to satisfy advisers' fiduciary duties, the Release states that an adviser would need to continue to provide advice to the affected government client for a reasonable amount of time.<sup>28</sup> We recommend that the Commission provide clarity regarding its interpretation of a "reasonable period of time."<sup>29</sup> It is unclear, for example, what avenues are open to the adviser to speed the dissolution process without breaching its fiduciary duties if the government client does not actively pursue a successor. Some current advisory agreements allow either party to terminate the advisory relationship with 30-days notice while other government client advisory agreements do not permit termination by the adviser at all. We suggest that the Commission consider 30 days to be a "reasonable period of time" under the proposed rule.

#### **b. Provide Guidance on Pre-Existing Advisory Agreements/Contracts**

Although the Release explains that an adviser would be permitted to continue to perform advisory services at no cost for a government entity after an illegal contribution has been made, it fails to provide guidance regarding payments and services for pre-existing contracts and agreements. Instead, the Release merely states that an adviser would be prohibited from providing advisory services to the government client during the ban. We recommend that the Commission provide guidance stating that the prohibition on receipt of compensation applies only to new business following a prohibited contribution.

The MSRB, for example, allows an adviser who has triggered the ban to retain the fee for many pre-existing, specified services provided under a contract or agreement but prohibits acceptance of any new fees, even if the pre-existing advisory agreement contemplated additional unspecified services and

<sup>28</sup> The Release suggests only that a reasonable amount of time means "until the government client finds a successor to ensure its withdrawal did not harm the client, or the contractual arrangement between the adviser and the government client might obligate the adviser to continue to perform under the contract at no fee."

<sup>29</sup> We also recommend that the Commission confirm that a fund may continue to receive advisory fees during the "reasonable period of time" during which it continues to provide services to a government client.



the accompanying fees.<sup>30</sup> In the case of pre-existing, long-term contracts, however, the MSRB has provided greater relief from its pay-to-play rules. The MSRB has recognized the significant repercussions to an issuer of municipal fund securities or investors in such securities of a sudden change in the primary distributor and, possibly, investment manager, resulting from a ban arising during the term of an existing advisory arrangement.<sup>31</sup> The MSRB therefore permits a dealer serving as primary distributor to an issuer, as opposed to a dealer selected to underwrite an issue of debt securities, to continue sales of existing categories of securities for an issuer during the duration of a ban if the basis for determining compensation does not change during that period, even if total compensation increases as a result of net in-flows of cash.<sup>32</sup>

### **c. Provide Guidance on Compliance with Compensation Ban**

The Release seeks comment on the difficulties an adviser to a fund would face to either waive its fee or terminate its relationship with a government client if a two-year ban were triggered, and whether an adviser to a fund could waive its advisory fee for the fund as whole in an amount approximately equal to fees attributable to the government entity. We believe this approach generally would address the senior security<sup>33</sup> and tax issues<sup>34</sup> mentioned in the Release. We note, however, that this universal fee waiver would raise its own administrative and marketing difficulties, as well as place advisers in the unfair position of providing free services but remaining exposed to liability for those services. This is because, for example, the dollar amount of the waived fee may fluctuate from day-to-day based on the entity's assets under management. Moreover, the adviser would need to determine how to apply the amount of this waived fee to all other shareholders in the fund and how it must be disclosed and reflected in the fund's offering documents and sales literature. It would also need to educate all firms distributing the fund regarding the impact of the ban on the fund's operations in order to ensure that they understand how the ban impacts the fund.

<sup>30</sup> MSRB Rule G-37 Interpretive Notice, *Interpretation of Prohibition on Municipal Securities Business Pursuant to Rule G-37*, February 21, 1997.

<sup>31</sup> MSRB Rule G-37 Interpretive Notice, *Interpretation on the Effect of a Ban on Municipal Securities Business under Rule G-37 Arising During a Pre-Existing Engagement Relating to Municipal Fund Securities*, April 2, 2002.

<sup>32</sup> In addition, the MSRB provides that any changes in the services to be provided by the dealer to the issuer throughout the duration of the ban that are contemplated under the pre-existing contractual arrangement are not considered new business (e.g., the addition of new categories of securities within the framework of the existing program) so long as the changes do not result in (1) an increase in total compensation received by the dealer for services performed for the duration of the ban; or (2) in an extension of the term of the dealer in its current role.

<sup>33</sup> Rule 18f-3 under the Investment Company Act would prohibit a fund from waiving fees for one set of shareholders.

<sup>34</sup> Section 562(c) of the Internal Revenue Code (the "preferential dividend rule") would prevent an adviser from, in effect, waiving its advisory fee to the government entity while imposing the fee on the fund's other shareholders. We agree with the staff that a fund-wide waiver of a portion of the adviser's fee resolves this tax issue.

**d. Provide Guidance on Mergers, Acquisitions, and Other Business Combinations**

The Release fails to explain the operation of the proposed rule in connection with mergers, acquisitions, spinoffs, joint ventures, and sub-advisory agreements. For example, it is unclear if the ban can “move” from one firm to another or with a covered associate. If so, we believe the ban would have the ability to unfairly penalize advisers that were not involved in pay-to-play activities. The MSRB has granted limited, conditional exemptions to its rules where a ban is triggered because a person who made a contribution becomes a covered municipal finance professional as a result of a merger or acquisition. We request that the Commission provide similar guidance to advisers to eliminate any uncertainty surrounding these standard business events.

In addition, we recommend that the Commission exclude sub-advisory relationships from the scope of the proposed rule. In the sub-advisory relationship, neither party has control over or reason to know the extent of the other party’s political contributions or its covered associates’ political contributions. Consequently, the relationship does not raise the issue of illicit influence the Commission is seeking to prevent. It also would be extremely difficult to satisfy the compliance mandate when reviewing these relationships because of the complexity of layers between the two parties.<sup>35</sup>

**e. Provide Guidance on a “Position to Influence”**

The proposed ban would be triggered by a contribution to an official of a government entity in a position to influence the selection of an adviser. The Release fails to provide guidance, however, on which government officials would satisfy this provisions. It is likely that relevant officials will differ on a state-by-state, locality-by-locality, and even election-by-election basis, greatly complicating compliance efforts. We therefore request that the Commission provide guidance on how to identify officials who would be in a qualifying “position to influence.”

**f. Provide Clarity on Exception to Ban for “Covered Investment Pools”**

The Commission makes clear in the Release that it intends that the two-year ban would be applicable if a fund “is selected to be an investment option for participants in a 529 plan” but would not be applicable “if a state government invested its pension fund assets in that same fund.”<sup>36</sup> We believe,

<sup>35</sup> We note that similar issues may exist with respect to other types of funds that are part of multi-tiered investment products, such as underlying funds in variable annuities that are offered as investment options in 403(b) and 457 plans. We request that the Commission clarify how the proposed rule would apply to the various categories of multi-tiered products that are currently sold to government sponsored plans.

<sup>36</sup> See Release *supra* note 2, at footnote 185.

however, that there is an inconsistency between the commentary in the Release and the proposed rule text which could result in unintended applications of the proposed rule, and therefore recommend that the Commission clarify the exception.

The definition of “covered investment pool” in the proposed rule states that a fund (and certain other pooled investments) shall be a covered investment pool if it “is an investment or an investment option of a plan or program of a government entity” (emphasis added). “Plan or program of a government entity” would mean any “investment program or plan sponsored or established by a government entity,” including but not limited to 529 plans, 403(b) plans, and 457 plans, “or any similar program.” Unfortunately the definition of “Government entity” also includes the following definition “[a] plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof” which appears to be circular and overlap with the definition of “plan or program of a government entity.” The intent is clearly to cover those investment options that have been pre-selected by the government sponsoring or establishing the plan or program as part of a limited menu of investments from which participants in the plan or program may allocate their account. The reference, however, to “investment” alongside “investment option” in the proposed definition of “covered investment pool” and the somewhat open-ended definition of “plan or program of a government entity” suggest investments in other contexts could be covered, such as funds purchased through an open end brokerage window and money market funds used as cash sweep accounts to receive contributions to a 457 plan. We recommend the Commission make two clarifying changes to the proposed definitions: (1) delete the phrase “investment or” in the definition of “covered investment pool” and (2) modify the definition of “plan or program of a government entity” to refer solely to a plan or program in which participants direct the investment of their account among pre-selected limited investment options.

## **2. Narrow the Definition of Executive Officer**

The proposal would define a covered associate to include, among others, an adviser’s executive officers<sup>37</sup> or other individuals with a similar status or functions who, as a part of their regular duties, perform investment advisory services or supervise someone who performs them. The definition of executive officer would focus on an officer’s scope of authority, compared with the actual influence exercised by an officer, to capture those persons who the Commission believes are likely to have an economic incentive to make contributions to influence the adviser’s selection.

We recommend the Commission narrow the term executive officer to include only those executive officers who directly oversee the performance or solicitation of government advisory

<sup>37</sup> The term executive officer would include the president, any vice president in charge of a principle business unit, division or function, or any other executive officer of the adviser who in connection with his or her regular duties: (a) performs, or supervises any person who performs, investment advisory services for the adviser; (b) solicits, or supervises any person who solicits, for the adviser; or (c) supervises, directly or indirectly, any person described in (a) or (b).

services.<sup>38</sup> This construct would balance the burden of monitoring the large numbers of individuals who would satisfy the proposed definition but would not typically exercise influence as envisioned by the proposed rule.<sup>39</sup> For example, the term “executive officer” is not limited to executive officers who solicit for the purpose of influencing a government entity. As proposed, it extends to executive officers who solicit or supervise any person who solicits for the adviser – regardless of whether they have any incentive or opportunity to attempt to use political contributions to attract investment advisory business or even solicit government entities.

Further, the definition does not provide any explanation of where the supervisory chain stops. For example, it is unclear if an executive officer of the parent company of an adviser would be classified as an executive officer for purposes of the proposed rule if he or she had supervisory authority, even indirectly, over persons employed in the adviser who perform advisory services. This determination is further complicated by the language in the proposed definition expanding the term executive officer to include anyone supervised directly or indirectly. Erring on the side of caution, it is likely that advisers and funds would subject any and all supervisors – even those with no nexus to clients that are government entities – to the proposed rule for fear of inadvertently triggering the ban. To provide some certainty to the proposed definition, we recommend that the supervisory chain stop at the legal borders of the adviser entity.<sup>40</sup>

### **3. Eliminate or Significantly Modify the Look Back Provision**

The proposal would include a “look back” provision in which the two-year ban would continue in effect after the covered associate who made the triggering contribution left the advisory firm. The Institute appreciates the Commission’s interest in preventing advisers from circumventing the proposed rule by channeling contributions through departing employees, or by influencing the selection process by hiring persons who have made political contributions. We believe, however, that

<sup>38</sup> We request that the Commission clarify that the proposed definition of executive officer would not include persons acting in their capacity as independent directors of funds. General board oversight should not constitute supervision, directly or indirectly, of the other individuals in the proposed definition of executive officer.

<sup>39</sup> Notwithstanding the fact that the number of covered associates does not appear to be discernable from the Forms ADV filed with the Commission, according to the Release, of the 1,764 advisers registered with the Commission, the Commission estimates that approximately 1,300 have fewer than five covered associates; 328 advisers have between five and 15 covered associates; and 136 advisers have more than 15 covered associates. Without addressing the accuracy of these estimates, which we believe grossly underestimate the sweep of the proposed rule’s definition of “covered associates,” we believe the Commission’s analysis fails to account for the fact that these are not static pools but would be constantly subject to monitoring to ensure that no one falls through the cracks during the ordinary ebb and flow of employee transitions within and between advisors.

<sup>40</sup> We believe conduct outside the legal border of the adviser that involves an effort by, for example, an adviser’s parent company to circumvent the proposed rule would be captured by the provision in the rule that would prohibit indirect unlawful activity.



the look back provision raises more issues than it resolves and should be eliminated.

The look back provision would unnecessarily limit the flexibility of advisory employees to move between and within advisory firms.<sup>41</sup> This would have the unintended consequence of adversely affecting the quality of services provided to government clients as advisers are inhibited in making promotion, reassignment, and hiring decisions based upon the talent and experience of their employees and prospective employees.<sup>42</sup> In addition, the look back provision imposes unnecessary regulatory costs and burdens because the proposed rule already contains a provision prohibiting an indirect violation of the rule, which would capture the same conduct targeted by the proposed look back provision.<sup>43</sup> Further, the provision sets a level of monitoring and administrative recordkeeping that would be difficult to achieve. For example, would an adviser's compliance obligations under the proposal be met by questioning a newly-employed person as to prior contributions? What would be required to verify the accuracy of the information? Would the new employer be required to confer with, and obtain documentation for a two-year period from, prior employers?

Most importantly, in addition to all of the practical and operational concerns, the over-reaching in the look back provision is unnecessary, unwarranted, and unreasonable. Potential employers should not be subject to a ban on collecting advisory fees or providing advisory services because of conduct perpetrated before the existence of the requisite covered associate relationship giving rising to the Commission's concern about inappropriate influence – *i.e.*, during a period outside of the adviser's control. The proposed rule already would capture any illicit political contributions made by employees on all sides of the equation: departing, new employee, or new covered associate. A departing employee's contribution would be reflected in the application of the proposed ban to the existing employer. A political contribution by a new employee, or new covered associate, would be captured by the new employer because that adviser would be subject to the Commission's proposed rule as well. With respect to the Commission's concern regarding hiring persons who have made political contributions at their previous employer, presumably hiring advisers would be asking candidates about their prior political contributions for purposes of insulating themselves from exposure to the extremely severe penalty in the proposed rule.

<sup>41</sup> Advisers could be exposed to state and federal employment law claims for their efforts to comply with the proposed look back provision.

<sup>42</sup> Another unintended consequence created by the look back provision would arise from the possibility of a disgruntled employee intentionally triggering a ban on his or her way out of the door. It is likely an adviser would file an exemptive application in this scenario. By the time the Commission considered the application, however, it is likely the government entity would have taken its business elsewhere. This potential scenario highlights the fact that, as discussed below, it will be critical to funds that the Commission quickly review and act upon exemptive applications so as not to hamper the legitimate competitive process for advisory business.

<sup>43</sup> The MSRB has recognized this dilemma and frequently grants waivers in similar situations.

If the Commission determines to proceed with this provision, the Institute recommends that a three-month period would be sufficient to prevent circumvention of the proposed rule. In addition, we recommend that advisers be allowed to rely on the representations and certifications of employees and applicants with respect to prior contributions.<sup>44</sup>

#### **4. Expand and Modify the Proposed Exceptions**

The proposed rule would include two extremely limited exceptions for violations of the contribution prohibition. The Institute recommends that the Commission expand these exceptions to balance the severity of the ban with the goal of the proposed rule – to eliminate improper influence on the selection of advisers.

##### **a. Raise the Threshold and Expand the Applicability of the *de minimis* Exception**

The first exception, a *de minimis* exception, would permit each covered employee to make aggregate contributions of \$250 or less, per election, to an elected official or candidate, if the person making the contribution is entitled to vote for the official or candidate. The Commission represents that the \$250 value was selected because it is the number used in the MSRB rules and because it is an amount unlikely to influence the selection process for an adviser. Neither of these reasons is sufficient to justify subjecting advisers and funds to the loss of a client or infringing upon an individuals' right of political expression in such a restrictive manner. The \$250 value was selected in 1994 and, independent of any inflation adjustment, is unreasonably low for 2009.<sup>45</sup>

We believe that the Commission could reasonably conclude that today a larger number, such as \$1,000, would allow employees to more fully participate in the election process without compromising the objectives of the proposal. We also recommend that the *de minimis* exception be extended to include contributions to officials to whom an individual is not entitled to vote.<sup>46</sup> We believe that the identification of a contribution as *de minimis* should allay the Commission's concern regarding the

<sup>44</sup> If an employee or applicant is later found to have misrepresented information regarding his or her contribution, we believe the appropriate remedy would sanction the individual and not the adviser, provided the adviser or fund had policies and procedures in place to address this form of misconduct.

<sup>45</sup> We note that, pursuant to Federal law, individuals may contribute a maximum of \$4800 – *i.e.*, \$2400 for each of the primary and general elections. The states, on the other hand, do not have a uniform code or set of best practices for contributions amount and the allowances vary greatly. Only four states have a limit of less than or equal to \$250 compared with no fewer than 12 states that allow unlimited contributions.

<sup>46</sup> Many advisory and fund employees live in one voting district but work in another. They should be permitted to participate in the political process in the district in which they work through contribution to government officials that are unrelated to pay-to-play conduct.

degree of influence associated with the contribution and also would balance the Commission's concern with a more easily implemented, uniform compliance requirement as well as an individual's right to participate in the political process.

#### **b. Expand Exception for Returned Contributions**

The second exception would allow for certain returned contributions to address situations in which the adviser inadvertently triggers the ban, limited to twice in a 12-month period. This exception would be available only with respect to contributions that do not exceed \$250 and are made by a covered associate of the adviser to officials other than those for whom the associate was entitled to vote at the time of the contribution. We recommend instead that the Commission expand the exception to encompass any inadvertent contribution, above the de minimis threshold (*e.g.*, \$1,000), that is returned in the time and manner described in the proposed rule.

To carry out this recommendation, the Commission should eliminate the restriction on the number of times an adviser may rely on the exception for inadvertent contributions. In the Release, the Commission explained that it provided two exceptions per 12-month period to give each adviser more than one opportunity to refine its compliance procedures to avoid further violations of the proposed rule without providing an opportunity for lax compliance by making multiple exceptions available. Limiting the exception in this way does not fairly recognize either the notion of "inadvertent" contributions or the fact that two exceptions a year in a small firm is significantly different from a firm with a significant number of covered associates. Without this corresponding modification to the exception, we anticipate that larger advisers may find themselves unable to take advantage of this exception in a meaningful way to address inadvertent conduct that, while triggering the rule's prohibitions, does not involve paying to play. As an additional consequence, advisers may have no alternative but to file frequent exemptive applications through the proposed rule's more general exemptive application process.

#### **B. Eliminate or Modify Ban on Using Third Parties to Solicit Government Business**

The proposed rule would prohibit advisers from paying third parties to solicit government clients. We are concerned that the proposed ban on the use of such solicitors is ill-conceived. According to the Release, because of the "apparent difficulties for advisers to monitor the activities of their third-party solicitors," the Commission has proposed to ban advisers from using third-party solicitors to obtain government clients.<sup>47</sup> The Institute believes that this draconian response to what the Commission perceives to be a monitoring difficulty is inappropriate. Instead, we believe the Commission's prohibition should be better tailored to the conduct it seeks to address – advisers

<sup>47</sup> See Release *supra* note 2, at p. 44. The Commission's concern apparently is based on the MSRB's experience with MSRB Rules G-37 and G-38.

utilizing third-party solicitors who make contributions to government officials that, pursuant to the proposed rule, the adviser would be prohibited from making directly. The Commission should then leave to the discretion of the adviser how it enforces this prohibition and require the adviser to maintain records that are reasonably designed to demonstrate compliance with the prohibition.

The Commission should not presume from the MSRB's experience that investment advisers will be unable to enforce and document compliance with this prohibition by their third-party solicitors. And indeed, those investment advisers that are concerned with being able to effectively enforce and document their solicitors' compliance may decide not to utilize such solicitors. However, those investment advisers, including smaller advisers,<sup>48</sup> that rely upon solicitors to conduct or supplement their marketing efforts should not be precluded from continuing to do so if it does not violate the pay-to-play prohibition. While the Commission's approach seems to deem all third-party solicitors guilty of a violation based on their status as a solicitor, our approach gives solicitors the benefit of the doubt, subject to the adviser's oversight and monitoring.

We are also concerned with the unintended consequences that are likely to result from the ban's very broad scope. This is because the rule would prohibit an adviser from paying "*any* person to solicit a government entity for investment advisory services on behalf of an investment adviser."<sup>49</sup> According to the Release, this provision is intended to address concerns with an adviser hiring third-party solicitors to make political contributions that inure to the benefit of the adviser. Of concern is the fact that the proposed rule language sweeps far broader than its intent. Fund advisers, for example, routinely pay broker-dealers and other financial institutions and intermediaries on behalf of the fund to market and distribute fund shares and maintain and service shareholder accounts.

It appears from the Release that the Commission did not intend for the solicitor prohibition to include, for example, fund distributors.<sup>50</sup> However, we are concerned that the proposed third-party solicitor prohibition is so broad that it could be read to include payments made by fund advisers to any of their distribution intermediaries that hold accounts of government entities in covered investment

<sup>48</sup> We understand that it is not uncommon for smaller advisers, due to their limited resources and staff, to retain third parties to market their services or their funds' offerings. A provision prohibiting such solicitors from contacting government officials would put these smaller firms at a competitive disadvantage to firms that have the resources within their organization to make such contacts. While the Release notes that "advisers that currently rely on third-party solicitors to obtain government clients may have to bear the expense of hiring and training in-house staff in order to continue their solicitation activities," this statement overlooks the fact that smaller advisers may not have the resources or staff to accommodate the prohibition in this manner.

<sup>49</sup> See proposed Rule 206(4)-5(a)(2)(i) (emphasis added).

<sup>50</sup> The Release expressly raises the issue of whether the proposal would appropriately curb pay-to-play activities "while still permitting funds to be marketed and distributed to government entities in the ordinary course of business through compensated third parties, such as broker-dealers." See Release *supra* note 2, at p. 69.



pools. To address this concern, we strongly recommend that the Commission expressly provide in the rule text or the adopting release that any payments made in the normal course of business by a fund's investment adviser to a broker-dealer or any other financial intermediary that distributes fund shares is not considered to be a "payment . . . to solicit a government entity" even if such broker-dealer or financial professional or firm maintains a government entity's account.<sup>51</sup>

### **C. Provide Clarity with Respect to Soliciting and Coordinating Contributions and Payments**

The proposal would prohibit an adviser from soliciting any political action committee ("PAC") from making any payment to a political party of a state or locality where the adviser is providing or seeking to provide investment advisory services to a government entity. We support the Commission's efforts to prevent an adviser from influencing the selection process by using others, including PACs, to make contributions or payments to government entities that the adviser could not make directly. We recommend, however, that the Commission provide additional clarity regarding the proposed prohibition. First, we request that the Commission confirm that the prohibition would not be triggered by contributions to federal incumbents, federal level political parties, or separate segregated funds ("SSFs").<sup>52</sup> Second, we request that the Commission confirm that an adviser is not "in control" of a PAC organized, operated, and run by the adviser's parent, even if advisory employees participate on or in the PAC, but the advisory employees do not otherwise control the PAC. We do not believe that contributions in any of these circumstances would raise the concerns the Commission is trying to prevent by prohibiting indirect payments to a political party of a state or locality where an adviser is providing or seeking to provide investment advisory services to a government entity.

### **D. Exemptions**

The proposal would include a provision under which an adviser may apply to the Commission for an order exempting it from the two-year ban. In reviewing an application, the Commission would examine the facts and circumstances presented in the application and consider certain enumerated factors which are similar to those considered by the Financial Industry Regulatory Authority and the MSRB in determining whether to grant an exemption under the MSRB rules. Due to the severity of the penalties in the proposed rule, we urge the Commission to actively issue exemptive relief as

<sup>51</sup> It is likely that neither the fund nor its adviser would have any knowledge of whether a government entity is a client of the broker-dealer or other financial intermediary selling the fund's shares, particularly if the financial intermediary holds an omnibus position with the fund or its adviser. Moreover, funds and their advisers would have no way of knowing whether the broker-dealer has made any political contributions that may have influenced the government entity to invest through the broker-dealer since broker-dealers would not be subject to the proposed rule and, therefore, will not be required to maintain records of their political contributions.

<sup>52</sup> SSFs are commonly referred to as PACs that must file with, report to, and are regulated by the Federal Elections Commission.

appropriate. However, we are concerned that the Commission has, through comments made by Commission staff, already signaled its intention that the exemptive application process be used infrequently.<sup>53</sup> The Commission also must be willing to provide for a prompt response to an exemptive application because delays in the review process will harm the adviser, the plan, and the plan beneficiaries.<sup>54</sup>

We recommend that the Commission commit to a 30-day period by which to grant or deny exemptive requests after which applications not acted upon are automatically granted.<sup>55</sup> In addition, filing an exemptive application should toll application of the proposed rule to an adviser until the Commission acts upon the request.<sup>56</sup> Accordingly, any denial of an application for exemptive relief would affect the prospective status, and not be retroactive to the date of the original filing for the exemptive relief. Finally, because of the severe adverse consequences that may flow from a denial of a request for exemptive relief, the rule should require the Commission's denial to detail with specificity how the contribution is of such a nature or an amount that a reasonable person could believe it was made with the intent to influence the investment decision of a government entity.

#### **E. Eliminate or Modify Proposed Recordkeeping Requirements**

As applied to funds, the recordkeeping requirements of the proposed rule are simply not practical if applied to existing accounts. This is because, as discussed in more detail below, the Commission's proposed recordkeeping requirement assumes a level of knowledge of government entities and fund account shareholders that is not realistic and search capabilities that are not reasonable.

To address this concern, we strongly recommend that the Commission only apply the

<sup>53</sup> See Federal Securities Law Reports Number 2389, "D.C. Bar Panel Discusses SEC's Pay-to-Play Proposal," CCH Incorporated, 2009. In addition, we believe the Commission severely underestimates the frequency with which advisers and funds will need to seek exemptive relief unless the Commission provides guidance and modifies the proposed rule as recommended. The Commission states in the Release that it expects that "on average approximately five advisers annually will apply to the Commission for an exemption from the proposed rule." See Release *supra* note 2, at p. 85.

<sup>54</sup> The Commission suggests that an adviser applying for an exemption could place advisory fees earned between the date of the contribution triggering the prohibition and the date on which the Commission acts on the exemptive application in an escrow account. This approach would inhibit the adviser's ability to seek capital appreciation on these fees for an undetermined length of time. We request that the Commission provide guidance on how an adviser would satisfy its fiduciary obligations in these circumstances.

<sup>55</sup> See, e.g., Securities and Exchange Commission Release No. 34-58092 (July 3, 2008), 73 FR 40144 (July 11, 2008) (requiring the Commission to act on self-regulatory organizations' proposed rule filings within 35 days or to begin disapproval proceedings), available at <http://www.sec.gov/rules/final/2008/34-58092fr.pdf>.

<sup>56</sup> Tolling would avoid disruption of the advisory relationship during the period of uncertainty in which the Commission is reviewing the exemptive application.

recordkeeping requirements prospectively and only to new accounts that are established after a period of time that would be sufficient to enable funds to redesign their account application forms and systems to capture information regarding the “government entity” status of a shareholder. Without providing such accommodation, we have serious concerns about the ability of funds to comply with the proposed recordkeeping requirements, notwithstanding their best efforts. If the Commission does not provide such accommodation, we strongly encourage it, in the adopting release, to outline in a meaningful way how it expects funds to conduct effective searches to discern their shareholders that are government entities or government officials acting in their official capacity.<sup>57</sup>

The difficulty funds will have with the recordkeeping requirements derives from the fact that they currently do not have or maintain a list of “all government entities” that the adviser is either providing services to or seeking to provide services to, nor do they require an account holder to identify when establishing an account whether it is a government entity. Accordingly, to create such a list to comply with the recordkeeping requirement, a fund would need to compare its list of account holders to a list of all government entities. Such a search would necessitate the fund’s adviser first having a list of all government entities and officials that might fall within the proposed definition.

In addition to the 50 state governmental entities, according to the 2002 U.S. Census, there were almost 90,000 units of local government, which includes units of county government or county-equivalent areas, municipalities, townships, school districts, and special districts. These numbers do not include special boards, commissions, unions, or investment pools, plans, or programs that would fall within the proposed definition of “government entity.” Nor do they include the names of accounts that may be held in the name of the government official or agent,<sup>58</sup> which is also a “government entity” under the proposed rule. Because, to our knowledge, a comprehensive list of these entities and officials does not exist, it would be virtually impossible for a fund to conduct an effective search of its records to determine which of its thousands or millions of shareholders might, in fact, be a government entity.<sup>59</sup> In other words, in the absence of a comprehensive, current, and accurate list that the fund could use to search its shareholder records, it would be unable to compile the required list to fulfill the proposal’s

<sup>57</sup> As discussed above, we also recommend narrowing the scope of “executive officer” to facilitate fund advisers’ compliance with the provisions in the recordkeeping requirements relating to covered associates’ contributions and payments.

<sup>58</sup> For example, some local tax collectors establish accounts in their own name such as, John Jones, ABC County Tax Collector.

<sup>59</sup> We are presuming that the only persons and the only accounts that the fund would need to search are those that are held directly with the fund. We recommend that the Commission clarify that, for purposes of the rule, the only shareholders funds need to be concerned with are those that hold their accounts directly with the fund and not through a financial intermediary. Indeed, as discussed above, funds would likely have no access to information on any government entities or other shareholders that hold an account in a covered investment pool through an intermediary. We believe that, if the Commission were concerned with such accounts, it would have included broker-dealers and other financial intermediaries subject to the Commission’s authority in the scope of the proposed rule rather than requiring investment advisers to discern this information.



recordkeeping requirements. Moreover, once created, such list of government entities would have to be regularly updated every time a new board or commission is established by any state, municipality, or unit of local government or a new official elected or appointed.<sup>60</sup>

Based on the variety of governmental entities and officials, and their sheer numbers, we question how a fund could be assured that its search was effective in identifying every government entity investment in a covered investment pool. On a prospective basis, fund advisers could take steps to facilitate the collection of this information but, with respect to existing accounts, for many firms it would be truly impossible.<sup>61</sup> For these reasons, we believe the proposed recordkeeping requirements raise serious concerns for advisers to funds, burdening them with unrealistic and impractical regulatory requirements.

#### **F. Transition Period**

The Commission has sought comment on what would be a sufficient transition period for compliance with the new rule. If the Commission were to adopt the Institute's recommendation that would enable funds and their advisers to satisfy the rule's goal by appending pay-to-play provisions into their existing compliance policies and procedures, we believe this could be accomplished within a relatively short period of time (*e.g.*, six months). This would depend, in part, on any specific requirements the Commission determines to be a part of these policies and procedures (*e.g.*, the scope of "covered persons").

If the Commission elects not to revise its approach to regulating pay-to-play practices as we have recommended, the length of a sufficient transition period would, in large part, depend on the contents of the final rule and the transition period necessary for each substantive element of the rule. For example, if the prohibition on third-party solicitors were enacted as proposed, which we strongly oppose for the reasons discussed above, the necessary transition period for that portion of the rule would be the period necessary to terminate all existing contracts with third-party solicitors. We presume this could be accomplished within a ninety-day period, depending upon the cancellation terms of individual contracts.

<sup>60</sup> Notwithstanding the complexity of this process, the Commission estimates that Commission-registered advisers would incur approximately 3,528 additional hours to comply with the proposed recordkeeping requirements, at a cost of approximately \$222,264 per year. According to the Release, this estimate is based solely on the cost that would be expended on a "compliance clerk" at the rate of \$63 per hour. No doubt, in addition to the "compliance clerk," accomplishing this task – which we are uncertain can truly be accomplished – would necessitate operational and systems personnel to design programs to facilitate a search.

<sup>61</sup> While the Release notes the "it is typical for advisers seeking business from government entities to do so through a request for proposal or similar process, which would typically generate a record," this overlooks the fact that: (1) an RFP would not satisfy the proposed recordkeeping requirements; (2) the rule requires records on *all* government entities, not just those solicited by the adviser; and (3) an RFP search would be an inadequate means to determine even those government entities that were solicited because there may not have been an RFP used in the process. (*See* Release *supra* note 2, at footnote 233.)



The more problematic provision from a transition perspective – and the one that would likely require the most time to complete – is the proposed revision to Rule 204-2, the recordkeeping rule. As previously discussed, these revisions will require every investment adviser, among other things, to develop a list or other record of:

- Every covered associate of the investment adviser;
- All government entities (including all government officials acting in their official capacity) for which the adviser is seeking to provide or providing investment advisory services to;
- All government entities (including all government officials acting in their official capacity) which invest in, or are solicited to invest in, any covered investment pool the adviser is providing investment advisory services to; and
- All direct or indirect contributions or payments made by the investment adviser or any of its covered associated to an official of a government entity, a political party of a state or its political subdivision, or a political action committee including, among other things, the name and title of the contributor and the recipient, and the amount and date of each contribution or payment.

For small firms with few employees, the proposed requirements may be able to be accomplished within a relatively short period of time (*e.g.*, 90 days). However, many advisers to funds may have hundreds of “covered associates” who will be subject to the new rule and millions of accounts to survey to attempt to comply with these recordkeeping requirements. As noted above, funds today do not typically include in an account record whether the holder of the account is a government entity or a government official acting in his or her official capacity. As a result, as currently drafted, advisers to funds would have to search what could be millions of account records to determine which of their accounts are held by government entities or government officials acting in their official capacity. Because this is not information that is currently captured, no period of transition would be sufficient.

To address these concerns, the Institute strongly suggests that the Commission both: (1) adopt a transition period that provides fund advisers sufficient time to redesign their new account applications and their internal policies and procedures to capture the information that advisers would be required to maintain on government entities, government officials, and covered associates under Rule 204-2; and (2) only apply the rule prospectively so compliance is delayed until such time as funds can accomplish these tasks. As regards the prospective application, we additionally recommend that the information on government entities required by Rule 204-2 only apply to those government entities that open an account after the fund has the ability to capture the accountholder’s status as a government entity.<sup>62</sup> This would address our concerns with the inability of funds to conduct effective

<sup>62</sup> We note that, unlike broker-dealers, advisers do not have a legal obligation to update their shareholder account information on a prescribed basis so there would not be a natural opportunity for advisers to collect this information on their existing accountholders.

searches of their existing shareholder accounts to ferret out the government accounts.

Because of the system changes that will be necessary to accommodate collection of this information, the necessary changes to policies and procedures, and the time it will take to determine who is a covered person and educate them regarding their new obligations, we recommend a compliance period of at least twelve months. We note that, in the meantime, as demonstrated through the various enforcement actions cited in the Release for pay-to-play violations, the Commission would not be without recourse against any investment adviser or its associated persons that engages in proscribed conduct.

\* \* \* \* \*

We look forward to working with the Commission as it continues to examine these critical issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 326-5815, or Heather Traeger at (202) 326-5920, Tami Salmon at (202) 326-5825, or Ari Burstein at (202) 371-5408.

Sincerely,

/s/

Karrie McMillan  
General Counsel

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

Andrew "Buddy" Donohue, Director  
Robert Plaze, Associate Director  
Sarah Bessin, Assistant Director  
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