October 6, 2009

VIA ELECTRONIC MAIL

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

Re: Political Contributions by Certain Investment Advisers; SEC Release IA-2910; File Number S7-18-09

Dear Ms. Murphy:

The Investment Adviser Association[1] appreciates the opportunity to submit comments on the Commission's proposal, Political Contributions by Certain Investment Advisers.[2] Proposed Rule 206(4)-5 would prohibit investment advisers from seeking to influence the award of advisory contracts by a "government entity" (***e.g.***, public pension plans) through political contributions to or for those officials who are in a position to influence the awards. The Commission's proposed rule is modeled on principles set forth in rules G-37 and G-38 issued by the Municipal Securities Rulemaking Board.[3]

The Commission proposed a substantially similar "pay to play" rule in 1999 for investment advisers that it never adopted.[4] In its 1999 letter, the IAA supported measures to

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the IAA's membership consists of more than 450 firms that collectively manage in excess of $8 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, endowments, foundations, and corporations. For more information, please visit our web site: www.investmentadviser.org.

[2] *Political Contributions by Certain Investment Advisers*, SEC Rel. IA-2910, File No. S7-18-09 (Aug. 3, 2009) ("Proposal").

[3] Proposal at 8-9, 11; MSBR 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.

[4] *Political Contributions by Certain Investment Advisers*, SEC Rel. IA-1812, File No. S7-19-99, 64 Fed. Reg. 43,556 (Aug. 4, 1999) ("1999 Proposal"), available at http://www.sec.gov/rules/proposed/ia-1812.htm. Significant changes in the Proposal from 1999 include a new proposed ban on payments by an adviser to any solicitor to solicit government clients for the adviser and an expanded application of the rule to the management of pooled investment vehicles and other investment products.

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combat pay to play abuses but opposed the MSRB approach as inapt for investment advisers.[5] In May 2000, the IAA (then the ICAA) issued a report on pay to play issues, urging the SEC to adopt a code of ethics rule under the Investment Advisers Act of 1940 ("Advisers Act") that would include a requirement for advisers to adopt policies and procedures reasonably designed to prevent pay to play abuses by the firm or its employees.[6] The report set forth best practice pay to play guidelines for adviser codes of ethics and related policies and procedures.

The IAA continues to support measures to combat pay to play activities, ***i.e.***, the practice of investment advisers or their employees making political contributions intended to influence the selection or retention of advisers by government entities. Pay to play practices undermine the principle that advisers are selected on the basis of competence, qualifications, expertise, and experience. The practice is unethical and undermines the integrity of the public pension plan system and the process of selecting investment advisers. Accordingly, the IAA is in favor of adopting appropriately tailored provisions and remedies under the Advisers Act to prevent pay to play practices.

We respectfully submit, however, that the structure of the MSRB rules is not appropriately tailored to the investment advisory business. In particular, the proposed two-year compensation ban and third-party solicitor ban are inappropriately designed for the targeted abuses, pose difficult compliance challenges, and may be detrimental to public pension plan clients generally. We believe the Commission should make significant changes to the Proposal, which would permit it to accomplish its important goals. Accordingly, the IAA urges the Commission to:

1. Amend the Advisers Act code of ethics rule 204A-1 to prohibit advisers and their employees from engaging in pay to play activities, ***i.e.***, political contributions by investment advisers or their employees made *for the purpose* of obtaining or retaining an advisory contract with government entities, in lieu of the two-year compensation ban, coupled with other requirements; and

[5] *See* Letter from David G. Tittsworth, Executive Director, Investment Counsel Association of America, to Jonathan G. Katz, Secretary, Securities Exchange Commission, re: Political Contributions by Certain Investment Advisers, SEC Rel., IA-1812 (Nov. 1, 1999) ("IAA 1999 Letter"), available at http://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Archived_Comments_Statements/letterscompendium-1999.pdf.

[6] *See Report: Pay-to-Play and the Investment Advisory Profession, and Best Practice Pay-to-Play Guidelines for Adviser Codes of Ethics*, Investment Counsel Association of America (May 15, 2000) ("IAA Report"), at http://www.investmentadviser.org/eweb/docs/Publications_News/PublicDocs_UsefulWebsites/PubDoc/report_PaytoPlay_2000.pdf (Appendices not included). In 2004, the Commission adopted Advisers Act code of ethics rule 204A-1. *See Investment Adviser Codes of Ethics*, SEC Release No. IA-2256; File No. S7-04-04 (July 9, 2004), available at http://www.sec.gov/rules/final/ia-2256.htm. In July 2004, the IAA issued best practices for codes of ethics, including recommended pay to play provisions. *See* IAA Best Practices for Adviser Codes of Ethics, available at http://www.investmentadviser.org/eweb/docs/Publications_News/PublicDocs_UsefulWebsites/PubDoc/IAA_Best_Practices_for_Code_of_Ethics.pdf.

2. Amend the Advisers Act cash solicitation rule 206(4)-3 instead of banning the use of third-party solicitors to solicit government entities; or, alternatively, require that third-party solicitors paid by advisers to solicit government entities be registered with a state or federal financial regulator, among other conditions.

If the Commission nevertheless determines to adopt the compensation ban as proposed, the IAA urges the Commission to make substantial modifications to the proposal to: (1) provide an inadvertent violation exception if certain conditions are met, or amend the exemptive process; (2) increase and expand the ***de minimis*** contribution limits; (3) eliminate or modify the look-back requirement; (4) narrow or clarify the definitions of "executive officer," "official," and "contribution;" (5) clarify the application of the rule to sub-advisers; and (6) modify the proposed recordkeeping requirements.

The Proposed Rule

The Proposal includes three basic prohibitions, along with recordkeeping requirements. First, a two-year "time out" would prohibit an adviser from receiving compensation from a government entity for two years after the adviser or its "covered associate" makes a political contribution to a covered "official" of the government entity that is in a position to influence the award of the advisory business. The SEC notes that an adviser subject to the compensation ban would likely be obliged, at a minimum, to provide uncompensated advisory services for a "reasonable period of time" until the government client finds a successor adviser (unless the contract specifies otherwise).[7] The rule includes two exceptions from the two-year compensation ban: if the covered associate is entitled to vote for the government official, he or she may contribute $250 or less to the official, per election; and if the covered associate is not entitled to vote for an official, but the adviser discovers a contribution within four months of $250 or less to the official, the adviser or covered associate must obtain a return of the contribution within 60 days of discovery.

Second, the proposed rule would prohibit an adviser from paying for third-party solicitors, placement agents, and other consultants to solicit government entities for advisory business. Related persons (parent companies or other owners, subsidiaries, sister companies, and employees of these companies), general partners, executive officers, and employees of the adviser are not included in the solicitation prohibition.

Third, the rule would prohibit the adviser or its covered associates from coordinating (or soliciting any person or PAC to make) any (1) contribution to an official of a government entity to which the adviser is providing or seeking to provide advisory services, or (2) payment to a political party of a state or locality where the adviser is providing or seeking to provide advisory services to a government entity.

[7] Proposal at 27.

I. The Commission Should Amend the Advisers Act Code of Ethics Rule to Prohibit "Pay to Play" Practices Rather than Adopt the MRSB Model

We agree with the Commission that advisers engaged in pay to play practices with respect to public pension plans compromise their fiduciary obligations to the plans. However, we do not agree that the structure of MSRB rule G-37 and rule G-38 is appropriately tailored to the investment advisory business. There are significant differences that are not addressed in the Proposal between the relationship of a government entity as an issuer in selecting a municipal securities dealer and a government pension plan client selecting an investment adviser to manage the underlying assets of the plan for the benefit of the plan and its beneficiaries. Therefore, we urge the Commission to reconsider its proposed approach and instead adopt an amendment to the Advisers Act code of ethics rule to prevent advisers from engaging in pay to play practices.

A. <u>The MSRB Model and the Two-Year Compensation Ban Are Inappropriate for Investment Advisers</u>

As we explained in 1999, significant differences between the municipal securities industry and the investment advisory profession make the MSRB-type rules inappropriate for the investment advisory business. Unlike municipal dealers, investment advisers have a fiduciary duty to and relationship with all their clients, including public pension plan clients. A typical investment advisory relationship is based on providing continuous, ongoing, and independent investment advice, whereas the municipal securities dealer business generally involves a one-time transaction-oriented underwriting of a municipal securities issuance conducted on a particular day. Often, municipal securities business will be provided on a basis other than a competitive bid basis (***e.g.***, negotiated underwriting). In fact, MSRB rule G-37 does not apply to competitive municipal offerings. On the other hand, investment advisory business for public pension plans is typically awarded after a transparent and competitive bidding process, typically through a request for proposal ("RFP") issued by the government client or its consultant. RFPs issued by government clients often include disclosure about contributions made in connection with soliciting or maintaining the business, and the RFP process may help to prevent pay to play abuses.[8]

Because of these differences, the two-year time out framework of the MSRB rules would have more severe and disruptive consequences for investment advisers than it does for municipal securities dealers. MSRB rule G-37 primarily operates to prohibit municipal securities dealers from competing for new business. On the other hand, the Commission has proposed that advisers may not "provide investment advisory services for compensation" to a public pension plan within two years after a prohibited contribution, and may not continue to act as the plan's adviser while receiving compensation from the client.[9] The Commission

[8] ***See*** IAA Report.

[9] Proposed Rule 206(4)-5(a)(1).

notes that an adviser subject to the compensation ban would be required to provide uncompensated advisory services for a reasonable period of time. In most instances, this would result in a remedy of an ultimate termination of the advisory agreement because the adviser would not be financially able to continue its business indefinitely without compensation.

Forcing a termination of an ongoing – and often longstanding – advisory relationship is not appropriate for a fiduciary relationship nor is it tailored to be proportionate to the nature of the violation. The forced termination of the relationship is much harsher for both the government client and the adviser than a ban on "new" transactional business. Often, advisers and their personnel may offer a specific area of expertise sought after by the government client. In many circumstances the adviser chosen by the client may indeed be the most qualified candidate and the selection may have been, and continue to be, in the best interests of the plan's beneficiaries. A forced change may also result in an unexpected and unintended change in performance and/or risk for the public pension plan and its beneficiaries. A forced change would also likely result in additional and unnecessary transactional expenses for the government plans transitioning the management of the plan's portfolio to a new investment adviser, which costs may ultimately harm the beneficiaries of government plans.[10]

The two-year compensation ban will be particularly troublesome for advisers to, and government entity clients with investments in, private funds. Because advisers to private investment funds would be unable to resign from advising the fund as a result of a violation, the government client would have to withdraw its investment in the fund. The operation of the fund may make this practically or legally impossible for the government client, and indeed the client or other investors in the pool may be harmed.[11]

Further, the strict liability imposed by the rule underscores the draconian nature of the proposed sanctions. The compensation ban is ***automatically*** imposed without regard to whether the covered associate made a contribution with intent to influence the selection of the adviser. Advisers are justifiably concerned about the compliance challenges posed by the broad and vague aspects of the rule. Even firms with robust and reasonably tailored compliance policies and procedures (***e.g.***, prohibition on pay to play activities, pre-clearing, reporting, monitoring, and testing) may decide they are unable to tolerate one minor infraction of the proposed rule and ban all contributions. The result would be an unacceptable and unnecessary disturbance to the adviser's business and the management of the public pension plan client's assets, as well as the potential infringement on adviser employees' exercise of political speech.

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[10] *See* IAA 1999 Letter. Often government pension plans hire pension consultants and outside counsel when engaging new investment advisers and negotiating investment management agreements and/or private fund documents.

[11] *See, e.g.,* Connecticut State Treasurer Letter ("[s]evering relationships is not only disruptive, but it can also prove to be quite harmful with long-term agreements in illiquid investments.").

Indeed, even the MSRB has recognized that its two-year time out is not an appropriate remedy in situations involving certain long-term contractual relationships and has provided flexibility in those areas. For example, the MSRB issued an interpretation permitting a municipal securities dealer subject to the ban to continue its underwriting engagement under its current contract.[12] Subsequently, the MSRB issued an interpretation permitting municipal dealers distributing securities such as interests in 529 plans to continue to receive compensation after an engagement has begun, even after a prohibited contribution under rule G-37 is made. The MRSB concluded that a change in investment manager to a 529 plan would be significant, stating that: "The repercussions to an issuer of municipal fund securities or investors in such securities of a sudden change in the primary distributor (and possible concurrent change in the investment manager) resulting from a ban on municipal securities business arising during the term of an existing arrangement often will be significantly greater than in the case of an underwriting or other primary market activity relating to the typical debt offering. Issuers could be faced with redesigning existing programs and investors may need to establish new relationships with different dealers in order to maintain their investments."[13]

The Commission, however, has declined to adopt this type of flexibility, asserting that "it would undermine the deterrent effect of having a two-year time out."[14] We disagree that rigidly applying a two-year compensation ban to a current investment advisory contract is necessary or the only means to deter advisers from engaging in pay to play practices. As discussed below, more appropriate deterrence methods are available that would avoid the extreme consequences of the proposed rule, such as a prohibition in the Advisers Act code of ethics rule and the potential for sanctions and enforcement of violations of the Advisers Act and rules thereunder.

B. The Commission Should Adopt a Code of Ethics Rule Amendment to Prohibit Pay to Play Practices

The Commission seeks comment on whether there are more appropriate, more effective, or less costly alternative models. The Commission acknowledges that many advisers have established restrictions on pay to play practices in their codes of ethics and compliance policies and seeks comment on whether it should amend the Advisers Act code of

[12] *See MSRB Rule G-37 Interpretive Notices, Interpretation of Prohibition on Municipal Securities Business Pursuant to Rule G-37* (Feb. 21, 1997) ("it is consistent with the intent of rule G-37 that a dealer subject to a prohibition on municipal securities business with an issuer be allowed to continue to execute certain issue-specific contractual obligations in effect prior to the date of the contribution that caused the prohibition.")

[13] *See, e.g., MSRB Rule G-37 Interpretive Notices, 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* (Apr. 2, 2002) ("MSRB 2002 Interpretation"), available at http://www.msrb.org/msrb1/rules/notg37.htm.

[14] Proposal at 66, n.189 (discussing MSRB 2002 Interpretation).

ethics rule or compliance program rule to require all registered advisers to adopt policies and procedures designed to prevent them from engaging in pay to play practices.[15]

We continue to believe that amending the Advisers Act code of ethics rule, in conjunction with advisers' obligations under the compliance program rule 206(4)-7 to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, is a more appropriate approach for the investment advisory profession and is a better alternative for achieving the Commission's goal of eliminating pay to play practices.

The code of ethics approach is consistent with constitutional principles that generally favor an individual's ability to participate in the political process. Government regulation of political contributions must be narrowly tailored to advance the compelling government interests asserted.[16] Advisory personnel may wish to make political contributions based on political, religious, or other personal reasons unrelated to obtaining government business. A code of ethics prohibition with a requirement of policies and procedures designed to address pay to play practices would likely be more consistent with constitutional principles. A rule that only targets political contributions made for the purpose of obtaining or retaining business is more narrowly tailored to meet the Commission's objectives of eliminating such practices than the Proposal.

In addition, a prohibition in the code of ethics rule coupled with required policies and procedures and recordkeeping is more consistent with the general approach of the Advisers Act than the Proposal and the strict liability standard. Advisers are required to establish policies and procedures reasonably designed to prevent abuses in areas of potential conflicts of interest. The Commission generally does not impose specific approved policies or procedures for advisers.[17] Rather, the Commission has stated that "[i]nvestment advisers registered with us are so varied that a 'one-size-fits-all' approach is unworkable. By not mandating specific policies and procedures, we leave advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face."[18] This approach should be applied to the Proposal.

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[15] Proposal at 24.

[16] *See Blount v. Securities and Exchange Commission*, 61 F.3d 938, 943 (D.C. Cir. 1995); *see also Nixon v. Shrink Missouri Government PAC, et al.*, 120 S. Ct. 897 (2000) (affirming principles of *Buckley v. Valeo*, 424 U.S. 1 (1976)); *see also*, IAA Report at 14, n.24.

[17] *See, e.g., Proxy Voting by Investment Advisers*, SEC Rel. IA-2106 (Jan. 31, 2003).

[18] *Id; see also Compliance Programs of Investment Companies and Investment Advisers*, SEC Rel. IA-2204 (Dec. 17, 2003) (Compliance Program Rule Release), available at http://www.sec.gov/rules/final/ia-2204.htm#P94_22283.

Accordingly, we urge the Commission to withdraw its proposed rule and propose an amendment to the Advisers Act code of ethics rule 204A-1 to, at a minimum:

1. Prohibit pay to play. Add new subsection (a)(6) to require that advisers' code of ethics include: "(a)(6) Provisions prohibiting you from engaging in 'pay to play' practices, which are defined as 'political contributions by investment advisers or their covered associates made for the purpose of obtaining or retaining advisory contracts with a government entity.'"

2. Require pre-clearance. Add new subsection (d) to read: "You must require your 'covered associates' to obtain your approval before they directly or indirectly make a contribution to an official."[19]

3. Define terms. Add new subsection (e) to include definitions, subject to our comments below.

The rule could require maintenance of appropriate records. The Commission would be able to examine advisers' compliance with the code of ethics rule requirements by reviewing these records and the accompanying recordkeeping rule requirement to retain "record[s] of any violation of the code of ethics, and of any action taken as a result of the violation." A political contribution made with the intent or purpose of receiving or retaining advisory business from a government entity client could be flagged for review by comparing political contributions to officials of that government entity with the timing of an award or renewal of advisory contracts with that government entity.

This code of ethics approach is better designed to prevent pay to play practices while avoiding the significant problems presented by the Proposal, including the inappropriate sanctions framework, the myriad opportunities for inadvertent violations, the limitations on contributions that are not made for the purpose of influencing the award of advisory business, and vague and overbroad definitions, as discussed below.[20]

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[19] Pre-clearance and other appropriate procedures could be included in either a firm's code of ethics itself or in separate policies and procedures in compliance with the compliance program rule 206(4)-7. Advisers may tailor their compliance policies and procedures to the nature and scope of their own operations. *See, e.g.,* Compliance Program Rule Release. *See also,* IAA Report (recommending, in addition to pre-clearance, a prohibition, certification, disclosure, reporting, monitoring, recordkeeping, and appropriate sanctions).

[20] If, however, the Commission determines not to amend the code of ethics rule, we recommend in the alternative that the Commission adopt a separate rule under the Advisers Act to provide that any investment adviser registered or required to be registered under the Advisers Act: adopt and implement written policies and procedures that are reasonably designed to ensure that the contributions by the investment adviser or its covered associates are not made for the purpose of obtaining or retaining advisory contracts with a government entity; include in its written policies and procedures a requirement that its covered associates obtain pre-approval before they directly make any political contribution to an official of a government entity; disclose to government entity clients the contributions made by the firm or its covered associates to the governing body of the government entity; and describe to government clients their political contribution policies and procedures and, upon request,

II. Recommended Modifications to the Proposed Compensation Ban

If the Commission nevertheless determines to adopt a rule based on MSRB rule G-37 and impose a two-year compensation ban, with which we strongly disagree, the Proposal should be modified significantly, as follows:

1. Address Inadvertent Violations

We applaud the Commission for realizing the need for certain exceptions and exemptions to the rule, including the *de minimis* exception, the returned contribution exception, and the exemptive application process as approved by the Commission. However, we are concerned that the Commission has not considered the significance of the sanctions imposed as a result of an adviser's inadvertent violation of the rule. In addition, we are concerned that the exemptive process under the rule will not be sufficiently available for advisers with reasonable policies and procedures that seek to comply with the rule[21] and where the government client does not wish to end its relationship with the adviser. The exemptive process may also be subject to significant delay. As a result, we suggest the Commission consider several alternatives.

A. The Commission Should Adopt an Automatic Exception for Inadvertent Violations

To help alleviate the disproportionate and harsh sanction of a two-year compensation ban, we urge the Commission to provide an exception for inadvertent violations that have no nexus to obtaining the investment advisory business with the government client, as long as the adviser has adopted reasonable policies and procedures to prevent violations of the rule and the government entity wishes to continue the advisory relationship. The proposed text of such an exception is attached as an Appendix. The Commission could also require advisers to maintain appropriate records of any inadvertent violation to document their compliance with the exception.

First, the exception would only apply to inadvertent violations, *i.e.*, violations that are not reasonably known or condoned by the adviser and where the contributor lacked intent to

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furnish a copy of the policies and procedures to the client. We would be pleased to work with the Commission to develop these or similar approaches.

[21] Although the Commission states that in applying proposed rule 206(4)-5(e), it "would apply these exemptive provisions with sufficient flexibility to avoid consequences disproportionate to the situation, while effecting the policies underlying the rule," (Proposal at 71), it also states that it expects that "on average approximately five advisers annually will apply to the Commission for an exemption from the proposed rule." Proposal at 85. It appears that the Commission intends to grant these exemptions sparingly, thereby reducing the usefulness of the exemption.

influence the award of the advisory contract or violate the rule in making the contribution.[22] For example, these may include, but would not necessarily be limited to: contributions to an individual who became an "official" after the contribution was made; contributions to an official where the contributor mistakenly thought that he or she was eligible to vote for that official; contributions by an advisory employee who becomes a "covered associate" by virtue of a corporate merger or reorganization, or through a change in employment responsibilities within the adviser; contributions by an individual made before he or she became a covered associate that were not disclosed to the adviser employer; contributions to an official for whom the contributor cannot vote that are not returned by the official, despite a good faith attempt to obtain a return of the contribution;[23] contributions made by a disgruntled employee as he or she was exiting the firm; or contributions mistakenly made due to misinterpretation or misinformation about who could indirectly influence the selection of the adviser (***i.e.***, who is considered an "official"). These types of infractions under the proposed rule are not indicative of an adviser or its covered associates engaging in pay to play activities.

Second, the exception would require that the government entity (***e.g.***, the board of trustees of a pension plan), other than the official who received the contribution, has received full disclosure by the investment adviser of the inadvertent violation, has elected to continue the advisory relationship, and has consented to a waiver of the compensation ban, based on a determination that doing so is in the best interest of the plan and its beneficiaries.[24] As discussed, a compensation ban may place a public pension plan in the position of having to change its investment adviser, with whom it may have had a satisfactory advisory relationship for years, without any regard to the costs, resource requirements, and time demands that this may place on the government client in order to transfer its advisory business to a new adviser.

Third, the exception would include requirements similar to those factors the Commission would consider in an exemptive application under proposed rule 206(4)-5(e) that would serve to prevent any potential abuse of the rule, including requiring that the adviser: promptly discover the violation; have adopted and implemented reasonable policies and procedures prior to the contribution; and take prompt remedial action once the violation is discovered.

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[22] ***See, e.g.,*** Letter from Subcommittee on Investment Companies and Investment Advisers and the Subcommittee on Private Entities of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association to Jonathan G. Katz, Secretary, SEC re: SEC File No. S7-19-99 (Jan. 5, 2000) (inadvertent violations should be considered those that are not reasonably known or condoned).

[23] ***See, e.g.,*** Letter from the State of Connecticut Office of Treasurer re: File Number S7-18-09 (Sept. 10, 2009) ("Connecticut State Treasurer Letter") ("[u]nder Connecticut's campaign finance laws, once an election is over and the final campaign report is filed (generally 30 to 60 days following the election), contributions cannot be returned.")

[24] For the reasons discussed above, the inadvertent violation exception will be of particular benefit to government entity clients with investments in private funds. ***See*** n.11, ***supra.***

B. The Commission Should Amend the Exemptive Process

As discussed, proposed rule 206(4)-5(e) permits the Commission to grant an exemption to an adviser from the two-year compensation ban after consideration of various factors. The Commission, however, is not required to take action on an exemptive application, no matter how severe the consequences are related to the factual circumstances, within any specific period of time.

As an alternative to an inadvertent violation exception, we strongly urge the Commission to amend the exemptive process to require a response to an exemptive application within 30 days, by delegation of authority to its staff. As discussed above, numerous instances of inadvertent violations likely will need to be addressed through the exemptive process. The process should be streamlined so that advisers will be able to resolve any inadvertent violations in a timely and efficient manner in the best interests of their government clients. Accordingly, we request that those applications not acted upon within 30 days be automatically granted and that compensation may be received and placed in escrow pending resolution of the application process.

2. Raise the Contribution Limit to $1000 for Officials for whom Covered Associates Can Vote and $250 for Any Official

Under the Proposal, advisers would be prohibited from receiving compensation as a result of their covered associates making political contributions above the *de minimis* $250 threshold to officials for whom they can vote, or of any amount to officials for whom they cannot vote (unless the disallowed contribution is returned as described in the proposed rule). We recommend the Commission adjust the *de minimis* amount to $1,000 for contributions to officials for whom a covered associate can vote. A campaign contribution of up to $1,000 as an expression of an individual exercising his or her political speech with respect to his or her own representative is not necessarily indicative of an intent to seek to influence the award of an advisory contract. Moreover, the $250 contribution limit was set in 1994 by the MSRB. We believe a higher level is more appropriate given the passage of time.

In addition, we urge the Commission to permit individuals to make contributions of up to $250 to candidates for whom they are not eligible to vote. Often, employees of an investment adviser may live in one voting district but work in another. For example, an employee who works in a city but lives elsewhere may be affected by issues such as tax policies applicable to individuals working in the city and may wish to express his or her political support for a government official by a campaign contribution. These employees may be legitimately concerned about the political activities in a city or state in which they work, and they should not be barred completely from participating in the political process where their work lives will be greatly impacted.

3. Eliminate or Modify the "Look-Back" Provision

We are concerned about the proposed requirement to "look-back" at the political contributions of a potential advisory employee for a period of twenty-four months prior to the person becoming a "covered associate" of the adviser. The look-back would result in a draconian penalty for the adviser for actions taken by a potential employee of the adviser.[25] Under the Proposal, investment advisers would be required to screen for and eliminate potential employment candidates based upon contributions made for a period of up to twenty-four months before the person would begin employment with the adviser. This requirement may subject advisers to various state and federal employment law claims by prospective or current employees[26] and would be extremely costly and burdensome to implement. Moreover, prospective employees may not recollect the exact amount or nature of their political contributions within the last twenty-four months.

Further, the look-back requirement is not meaningfully tailored to potential abuse. A contribution made while a person was not even considering employment with an adviser, and who could have no idea who the adviser's prospective clients might be, does not demonstrate an intent to influence an award of advisory business to that adviser. This aspect of the proposed rule unfairly penalizes both potential advisory employees and adviser employers. The rule would also limit employee mobility and the ability of advisers to hire or promote high quality employees. We urge the Commission to eliminate this aspect of the proposal or at least reduce the look-back period. At the very most, the rule should require a look-back of a maximum of six months in order to ascertain if any recent political contribution may have been wrongfully offered or intended to influence the award of the advisory contract with the future adviser employer. In addition, advisers should be permitted to rely in good faith on a potential employee's personal certification attesting to his or her contributions during that period.

4. Narrow or Clarify Definitions

Definition of "Executive Officer"

We appreciate the Commission's consideration in the Proposal of the IAA's comments in 1999 to narrow the scope of advisory employees covered by the rule. However, we are concerned that the revised definition of "executive officer" continues to be overbroad in two respects. First, although the Proposal states that the rule would not cover contributions "by

[25] *See* 1999 IAA Letter. *See also*, Connecticut State Treasurer Letter ("[g]overnment investors cannot be placed in the position of potentially losing 50% or more of their capital account because a future hire triggers the retroactive attribution of a campaign contribution," citing its successful method of monitoring campaign contributions.)

[26] For example, a prospective employee may disclose contributions that reflect certain religious or political beliefs and later claim discrimination if he or she is not hired.

the adviser's other executives, such as its controller, its head of human resources, or its director of information services," the proposed definition includes vice presidents in areas of "administration" and "finance." However, areas such as "administration" and "finance" may include executives in accounting, information technology, legal, compliance, human resources, or operations who are not involved directly with or do not solicit public pension plan clients. Moreover, their compensation is not likely tied to obtaining or retaining clients. We therefore recommend revising the first part of the definition of "executive officer" to mean "the president, any vice president in charge of a principal business unit, division or function related to portfolio management, client relations, sales, or marketing . . ."

Second, we are concerned that in addition to vice presidents in charge of business units, "executive officer" may be read too broadly to cover supervisors who are not at the senior level of management and who are not likely to have an economic incentive to make contributions to influence the selection of the adviser by government entities. We therefore request confirmation that the definition of "executive officer" includes only senior-level executive officers who perform, solicit, or supervise any person who performs or solicits, investment advisory services for government entities for the adviser.[27]

Definition of "Official"

The proposed definition of "official" is practically identical to that proposed in 1999 and continues to be too vague and broad. The definition is tied to an "office" rather than a particular official and includes persons who can appoint such officials. Thus, investment advisers cannot simply assume that the person with whom they are in contact is the relevant "official." In fact, the number of people who could be considered "officials" could go well beyond the pension board or administrative officer managing the advisory contract. Without further clarity or delineation by the Commission or some other state database offering consistent guidance to all advisers, an adviser complying with this provision would expend an inordinate amount of time and resources on an ongoing basis trying to determine who can influence the outcome of the award of the advisory business for each government entity all over the country. The significant compliance burden involved in advisers undertaking to identify any "official" for any state or local pension plan, and monitoring state and local elections in all 50 states, may ultimately result in advisers banning all political contributions to avoid the unacceptable consequence of a compensation ban as a result of a mistaken interpretation of who is an "official."

Therefore, the Commission should limit the definition of "official" to those who are required to be directly involved in selecting the adviser, rather than to those who are indirectly involved or have the authority to appoint a person who can directly or indirectly influence the award of the contract. We also request the Commission develop or facilitate development of

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[27] This focus on senior-level officers is consistent with the Commission's consideration in the Proposal of the definition of executive officer in Advisers Act rule 205-3, which refers to officers that exercise policy-making functions. *See* Proposal at 34, n.103.

a centralized and publicly available list of state officials so that advisers are not making their own independent determinations which may not be consistent with other advisers' determinations as to which individual is an "official" in each state or locality. Otherwise, the piecemeal approach of this aspect of the Proposal could lead to inconsistent application and possibly inconsistent enforcement of the rule.[28]

Definition of "Contribution"

The Commission seeks comment on the definition of "contribution" and whether it should include expenses an adviser would incur in organizing or sponsoring a conference at which a government official is invited to attend or is a speaker. We believe that "contribution" should not include such expenses so long as contributions are not solicited by the government official and are not solicited or coordinated by adviser's employees in connection with the event.[29] Otherwise, the rule would chill legitimate and important business communications between advisers and their current and potential government clients that have nothing to do with monetary efforts to assist a government official in getting elected or re-elected. Moreover, pursuant to the compliance program rule requirements, an adviser would implement policies and procedures reasonably designed to ensure that its employees are mindful of the parameters of the proposed rule restrictions, ***i.e.***, the prohibition on soliciting and coordinating contributions at events where government officials attended.[30] An adviser could reasonably take appropriate steps to ensure that the events were not fundraising events.[31]

5. Exclude Sub-Advisory Relationships from the Proposed Rule

We request confirmation that the proposed rule does not apply to sub-advisory relationships. Application of the proposed compensation ban to sub-advisory relationships would be unfair to both the adviser and the sub-adviser, and it would result in significant compliance burdens and complexities. In the situation where an adviser becomes subject to

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[28] If the Commission determines to proceed as proposed, we request the Commission provide guidance on how an adviser would determine which office in each state or locality would be indirectly responsible for, or influence the outcome of, the hiring of an adviser by a government entity.

[29] *See MSRB Interpretation: Reminder of Obligations Under Rule G-37 on Political Contributions and Rule G-27 on Supervision When Sponsoring Meetings and Conferences Involving Issuer Officials* (Mar. 26, 2007). The MSRB notes that it "is not suggesting that dealers curtail their legitimate hosting or sponsoring of meetings or conferences where issuer officials are invited to attend or are featured speakers." It notes, however, that "dealers should consider carefully the true nature of such events and the possible application of Rule G-37 if the meeting or conference involves fundraising activities in support of an issuer official."

[30] In the unlikely scenario of a conference event being determined to be a fundraising event for the government official, then expenses incurred by the adviser for hosting the event could be deemed a contribution. *See id.*

[31] *See id.*

the compensation ban after the adviser has hired a sub-adviser to manage the government client portfolio, a sub-adviser would have no control over and may not know or have reason to know of the adviser's political contributions to the government entity client. In that instance, the sub-adviser should not be affected by the compensation ban applicable to the adviser. Rather, the adviser and sub-adviser should consider the resolution of such a situation during the course of their negotiations of the sub-advisory agreement.

Similarly, the rule should not be applied to ban compensation from the government client to the adviser where the sub-adviser or its covered associate makes a political contribution to a government entity because the adviser would have no control over the sub-adviser and would not know or have reason to know the extent of the sub-adviser or its covered associates' political contributions. In an unlikely situation where there was coordination among the adviser and the sub-adviser, they would violate proposed rule 206(4)-5(d), which would prohibit an adviser from doing anything indirectly, which if done directly, would result in a violation of the rule.

In addition, the Commission seeks comment on whether there are sub-advisory arrangements in which a sub-adviser would not know or be able to influence whether, or which, government entities are being solicited for a covered investment pool, and if so, how it should define those sub-advisers. There are many such arrangements, and we would be pleased to provide more details or information and work with the Commission on this issue.

III. The Commission Should Modify its Proposed Ban on Third-Party Solicitors

Proposed rule 206(4)-5(a)(2)(i) would prohibit advisers from making payments to third-party solicitors for soliciting government clients for investment advisory services on behalf of the adviser. The Commission proposed this ban out of concern that advisers would seek to circumvent the proposed contribution limits by using solicitors to make prohibited contributions. While we understand the Commission's concerns and agree that financial professionals should not circumvent prohibited practices, a complete ban is not appropriately tailored to address these concerns. Therefore, we respectfully request the Commission to consider alternative approaches as discussed below.

In compliance with the Advisers Act cash solicitation rule 206(4)-3, many small and mid-sized investment advisers without the financial resources or expertise to hire in-house marketing employees rely on third-party solicitors to market their advisory services to potential clients on a national basis. The proposed ban would disproportionately affect and harm these small to mid-sized advisory firms by eliminating legitimate potential avenues of new business, while allowing larger advisory firms to rely on their internal employees or affiliates' employees to engage in solicitation activities for the adviser.

We also understand that many public pension plans and their trustees rely on the activities of third parties to conduct due diligence of prospective advisers to help the plans ultimately make investment decisions.[32] Ultimately, the ban may result in the unintended negative consequence that government clients will have fewer advisers with particular expertise from which to choose if information about this segment of advisers is unavailable to them, to the possible detriment of the plans and their beneficiaries.

Instead, existing Advisers Act rules can be leveraged to provide appropriate protections from the potential conflicts of interest related to referrals. Pursuant to the cash solicitation rule, advisers must ensure that solicitors provide clients with a separate disclosure document that includes the nature of the relationship or affiliation, the terms of the solicitor's compensation, and any amount the client will be charged in addition to the advisory fee as a result of the solicitor's arrangement. We recommend that the Commission amend the cash solicitation rule to require the following in the separate written disclosure document: (1) third-party solicitors who solicit or whose employees solicit a government entity client should be required to disclose in writing to the adviser and the government entity client any contributions the solicitor has made to an official of the government entity within the past two years; and (2) third-party solicitors should be required to undertake that they will make no contributions in the future to any official of that government entity while it remains a client of the adviser. To assist in compliance and enforcement, the SEC examination staff would have full access to the disclosure documents.

Supplementing these requirements, the compliance program rule 206(4)-7 requires an adviser's policies and procedures to address, to the extent relevant, marketing advisory services, including the use of solicitors.[33] An adviser must adopt and enforce policies and procedures reasonably designed to ensure that it and its employees comply with the rule and the disclosure requirements in marketing the firm's advisory services. In addition, proposed rule 206(4)-5(d) would prohibit an adviser from doing anything indirectly which could not be done directly, including using a solicitor to make prohibited political contributions to a government official on behalf of the adviser.

We note that several states have opted for the approach of disclosure of the fee arrangement between the third-party solicitor and the adviser rather than a complete ban on the use of placement agents by the public pension plans.[34] We understand that many

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[32] *See, e.g.*, Letter from State of Wisconsin Investment Board to SEC re: File Number S7-18-09 (Aug. 31, 2009) ("Wisconsin Investment Board Letter"); Connecticut State Treasurer Letter.

[33] *See* Compliance Program Rule Release.

[34] *See, e.g.*, California Public Employees' Retirement System ("CalPERS") Statement of Policy for Disclosure of Placement Agent Fees (May 11 2009), available at http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200905/item04a-02.pdf; Wisconsin Investment Board Letter. Government entities may also have policies and procedures in place to monitor and review any potential conflicts of interest arising from an adviser paying a third-party solicitor a referral fee once the government entity becomes the adviser's client, including sharing referral arrangement information with the board's audit committee. *See also*, Government Finance Officers Association, Selection of Investment Advisers for Pension Fund Assets Guidelines (2000), available at http://www.gfoa.org/: "The pension board or administrative officer managing the investment adviser

government entities require investment advisers to disclose any conflict of interest to the plan's board of trustees or to the employees who are charged with the investment decision, as well as whether a placement agent is used and the fees that are paid with respect to the government entity's commitment to a private fund. We recommend the Commission not interfere with the well-considered terms and conditions that fiduciaries of state and local government plans have developed in the hiring of investment advisers to manage their plans or in the context of an investment in a private fund.

In the event the Commission decides to adopt a new rule instead of leveraging existing rules, we respectfully request the Commission amend proposed rule 206(4)-5(a)(2)(i) to: (1) permit payments to third-party solicitors if the third-party is registered or licensed with an appropriate state or federal authority (***e.g.***, state registered investment adviser; SEC-registered investment adviser or broker-dealer; licensed investment adviser representative of SEC-registered investment adviser or registered representatives of SEC-registered broker-dealer; or state or federally chartered and regulated bank); and (2) require disclosure to a government client of any political contributions made to its officials by a regulated third-party solicitor and the amount and nature of the referral fee(s) the third-party receives from the adviser for referring the government entity client. Registered or licensed financial service providers are subject to federal or state regulatory oversight, thereby lessening the opportunity for those entities to engage in "sham" transactions. In addition, the Commission could amend the cash solicitation rule to include a requirement in the written agreement between the adviser and the solicitor that the solicitor commit not to make political contributions with the intent to influence the award of advisory business and commit to disclose political contributions by the solicitor or its relevant employees.

In addition, we request that the Commission clarify several issues with regard to the proposed rule. First, we request the Commission confirm that the proposed ban would not prevent private funds from compensating registered broker-dealers for the placement of the private fund interests in accordance with the federal securities laws governing transaction-based compensation. Often, under private placement agreements, registered broker-dealers are compensated, sometimes out of the adviser's management fee, for placing the private interest transaction under the federal securities laws. This activity, however, would not constitute "solicit[ing] a government entity for investment advisory services" or fall under the definition of "solicit" under the proposed rule and should be excluded.

Second, we seek confirmation that the ban does not affect an adviser to a registered investment company as it relates to distribution arrangements under the Investment Company Act of 1940 ("Investment Company Act"), such as 12b-1 plans and agreements and

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contract should comply with the following ethical considerations: [(i)] adherence to all jurisdiction's and pension board's ethics laws, rules and regulations related to procurement and involvement with contractors, including those related to political contributions, [(ii)] disclosure to pension board of any inherent or potential conflicts of interest in dealing with specific investment advisers prior to taking any official action, and [(iii)] adherence to the GFOA Code of Professional Ethics."

shareholder servicing agreements. These activities likewise would not constitute "solicit[ing] a government entity for investment advisory services" or fall under the definition of "solicit" under the proposed rule. In any event, the Commission should confirm that distribution arrangements for registered investment companies under the Investment Company Act are outside the scope of the Proposal.

Finally, we request confirmation that the proposed rule would not apply to solicitation agreements entered into prior to the effective date of the proposed rule.

IV. The Recordkeeping Rules Should Be More Appropriately Tailored to the Commission's Goals

It is important for investment advisers to maintain records to demonstrate compliance with the proposed rule and to enable the Commission to examine records maintained by advisers to evaluate any potential pay to play practices by the adviser or its covered associates. However, we urge the Commission to tailor the proposed recordkeeping requirements to more appropriately meet the Commission's objectives and to eliminate vague and unnecessary requirements.

Prospective Clients

We oppose the proposed requirement that advisers keep an ongoing, continuously updated list of prospective government clients for which the adviser "is seeking to provide" advisory services.[35] The information is unnecessary for the Commission to determine whether pay to play abuses have occurred because the prospective client would, by definition, not be a current client whose business was obtained by political contributions. In addition, it is unclear how advisers would comply with this requirement. For example, it is not clear whether the rule would require that all communications to prospective clients, including letters, phone calls, and conversations, regardless of whether they are related to marketing, be monitored and provided immediately to an adviser's compliance officer. The compliance burden of continuously compiling and updating this list, with no significant nexus to whether the adviser is retained by the government client, would be significant and would do little to serve the purposes of the proposed rule. However, if the Commission decides to retain this requirement, the requirement should apply annually, not continually, and should include only those clients to which a formal, written proposal has been made.

Indirect Contributions

The proposed rule would require advisers to maintain records of all "direct or indirect" contributions or payments made to "an official of a government entity, a political party of a

[35] Proposed Rule 204-2(a)(18)(i)(B).

state or political subdivision thereof, or a political action committee."[36] Advisers would not necessarily be able to comply with this requirement because it is not clear how advisers would make a determination of what constitutes an "indirect" contribution. Thus, we urge the Commission to eliminate the requirement to maintain records reflecting "indirect" contributions. At the very least, the Commission should clarify that an investment adviser may rely in good faith on self-reporting or certifications by covered associates, who could be asked to list their contributions and certify that they have not made any "indirect" contributions. The adviser should not have to conduct continuous, invasive investigations of a covered associate and their friends and family.

Contributions to Political Action Committees

We request that the Commission eliminate the proposed requirement that investment advisers keep records regarding contributions made by the adviser or its covered associates to a state or local political party or to a PAC because such contributions do not trigger the rule's prohibitions.[37] The proposed rule does not prohibit contributions by the adviser or its covered associates to state or local political parties or PACs. Therefore, there is no compelling need to maintain records of such contributions. Alternatively, we request the Commission permit advisers to maintain certifications from covered associates that the associates have no knowledge of contributions to political parties that are earmarked or known to be provided for the benefit of a particular political official – doing indirectly what the proposed rule would prohibit if done directly – that would trigger the two-year timeout. A certification, in conjunction with the indirect prohibition, would serve to help determine compliance with the rule's prohibition.

Payments

Although the prohibitions of the rule apply only to "contributions," the recordkeeping provisions apply to either "contributions or payments." Unlike the definition of "contribution," the term "payment" is *not* limited to situations involving an attempt to influence elections.[38] Advisers should not be required to maintain records of "payments" that are unrelated to contributions that may be used to influence an election if the payments do not violate the rule. Thus, we request the Commission to remove the word "payment" from the proposed recordkeeping rule amendments.

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[36] Proposed Rule 204-2(a)(18)(i)(D).

[37] *Id.*

[38] Proposed Rule 206(4)-5(f)(7).

Exemption from Recordkeeping Requirement: Total Ban on Employee Contributions

Advisory firms may attempt to avoid the severe sanctions for violations of the rule and the accompanying burdens imposed by the recordkeeping requirements by simply banning all employees or all covered associates from making political contributions. Advisers that utilize this option should be permitted to obtain an annual signed certification from each covered associate stating that he or she has complied with the firm's ban on prohibited contributions. This annual certification should be permitted in lieu of the records required by proposed rule 204-2(a)(18)(ii).

V. Transition Period

The Commission seeks comment on how long advisers would need to develop policies and procedures in order to comply with the proposed rule after it was adopted. If the Commission determines not to amend the Advisers Act code of ethics rule and instead proceed with the proposed rule, advisers will be faced with implementing significant and time-consuming changes. For example, advisers will have to determine which employees are covered associates, evaluate each state and local individual associated with current and potential government entity clients to determine who would be considered an "official", draft policies and procedures to implement requirements of the rule, train employees on compliance with the rule and its prohibitions, and review relevant contracts.[39] In order for advisers to adequately address the significant requirements in the Proposal, the IAA respectfully requests that the Commission provide a compliance date of twelve months.

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[39] We request confirmation that compliance with the rule would be required only with regard to contributions made after the compliance date of the rule.

Conclusion

The IAA strongly opposes pay to play practices by investment advisers or their employees. We commend the Commission for attempting to eliminate these practices. We welcome the opportunity to work with the Commission to craft a rule that is tailored to the nature of the investment advisory profession and is designed to eliminate pay to play practices, while refraining from imposing disproportionate or inequitable remedies.

We appreciate the Commission's consideration of our comments on the proposed rule. Please feel free to contact Karen Barr, General Counsel, or the undersigned if we may provide additional information regarding these or other issues.

Sincerely,

/s/ Monique S. Botkin

Monique S. Botkin
Senior Counsel

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

Mr. Andrew J. Donohue, Director, Division of Investment Management

Appendix

Proposed Rule 206(4)-5

(b) Exceptions.
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(3) Inadvertent violation exception.
An investment adviser that is prohibited from providing investment advisory services for compensation pursuant to paragraph (a)(1) of this section as a result of a contribution made by a covered associate of the investment adviser is excepted from such prohibition, upon satisfaction of the following requirements:
(A) The investment adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution;
(B) Such contribution resulted in an inadvertent violation, meaning violations that are not reasonably known or condoned by the investment adviser and where the contributor lacked intent to influence the award of the advisory contract or violate the rule in making the contribution, as evidenced by the facts and circumstances surrounding such contribution;
(C) The government entity, excluding the official who received the contribution, has received full disclosure by the investment adviser of the inadvertent violation, has determined that a waiver of the compensation prohibition in (a)(1) of the rule is in the best interest of the entity and its beneficiaries, and has consented to a waiver of the compensation prohibition in (a)(1) of the rule;
(D) The investment adviser, before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of this section;
(E) The investment adviser, prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution or that it would result in an inadvertent violation; and
(F) The investment adviser, after learning of the contribution,

(1) has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to attempt to obtain a return of the contribution; and

(2) has taken such other remedial or preventive measures as may be appropriate under the circumstances.