Pay-to-Play
and the
Investment Advisory Profession

In the last several years, there has been increased media and regulatory attention on pay-to-play abuses in the financial services industry. As used in this report, "pay-to-play" refers to political contributions by investment advisers made for the purpose of obtaining or retaining advisory contracts with government entities. In 1999, the Securities and Exchange Commission proposed regulations to prevent pay-to-play practices by investment advisers through, in essence, a prohibition on certain political contributions by broad categories of advisory personnel to broad categories of public officials, subject to draconian sanctions.

The ICAA has studied the possibility of voluntary professional measures designed to address pay-to-play practices. As a result of that study, the ICAA has developed suggested best practices to provide guidance on appropriate policies and procedures that are reasonably designed to prevent and detect pay-to-play abuses by firm personnel. We strongly suggest that ICAA member firms incorporate these or other appropriate policies and procedures into their codes of ethics.

At the same time, we have requested the SEC to consider issuing a rule in lieu of its current proposal that would require investment advisers having or seeking state and local government clients to adopt policies and procedures that are reasonably designed to prevent pay-to-play abuses. Additionally, we have strongly suggested that the Commission consider issuing a rule that would require all federally registered investment advisers to adopt a code of ethics. This "code of ethics" approach was first raised by two subcommittees of the American Bar Association in a comment letter on the proposed rule.[1] As discussed below, we believe our alternative approach is better suited to the investment advisory profession than the proposed rule and is consistent with other industry initiatives in this area.[2]

INTRODUCTION AND BACKGROUND

The Securities and Exchange Commission began studying pay-to-play practices in 1993 in the context of the municipal securities market. In response to that study, the Commission approved Municipal Securities Rulemaking Board Rule G-37 in 1994 to prevent broker-dealer participation in pay-to-play practices in the municipal securities business. Rule G-37 generally prohibits broker-dealers from engaging in municipal

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[1] Comment letter of ABA Committee on Federal Regulation of Securities, Subcommittee on Investment Companies and Investment Advisers, and Subcommittee on Private Investment Entities, re: Proposed Rule 206(4)-5 and Proposed Amendments to Rule 204-2 under the Investment Advisers Act of 1940 Regarding "Pay-to-Play" Practices (Jan. 5, 2000), attached at Appendix A; *see also* Legg Mason comment letter re: Release IA-1812, File No. S7-19-99 Political Contributions by Certain Investment Advisers (Nov. 1, 1999) at 5 (suggesting rule requiring advisers to adopt policies and procedures reasonably designed to detect and prevent illegal contributions).

[2] *E.g.*, American Bar Association Model Rules of Professional Conduct, Rule 7.6 (adopted Feb. 14, 2000), attached at Appendix B; *SEC Chairman Praises American Bar Association for Banning Lawyer Pay-to-Play*, SEC Press Release 2000-10 (Feb. 14, 2000); *Levitt Praises Independent Financial Advisers for Adopting Voluntary Pay-to-Play Ban*, SEC Press Release 99-25 (March 1, 1999); *Code of Ethics Solution to Pay-to-Play Under Consideration at SEC*, Fund Action (Feb. 7, 2000).

securities business with a government issuer for two years after the firm or certain employees make a political contribution to an official of the issuer who can influence the selection of the broker-dealer.

In the last few years, the Commission has turned its attention to pay-to-play activities involving public pension plans. The Commission has expressed concern that the selection of investment advisers by such plans has been or could be influenced by political contributions to certain officials. As a result, in August 1999, the SEC issued a proposed rule under the Investment Advisers Act of 1940 to prevent federally registered investment advisers and certain advisers exempt from registration from making political contributions intended to influence the award by public officials of advisory contracts for government entities.[3]

The proposed rule, modeled closely on Municipal Securities Rulemaking Board Rule G-37, would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or any of its partners, executive officers or solicitors make a contribution to certain officials associated with the client. The proposed rule would cover a very broad group of advisory related personnel, government officials, and political candidates. The proposed rule would also amend Rule 204-2 of the Investment Advisers Act to require registered investment advisers to

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[3] *Political Contributions by Certain Investment Advisers*, Release No. IA-1812, File No. S7-19-99, 64 Fed. Reg. 43,556 (August 4, 1999).

maintain detailed records of political contributions made by the adviser, its partners, executive officers, and solicitors.

We previously submitted a detailed comment letter to the Commission concerning the proposed rule.[4] As emphasized in that letter, the ICAA condemns the practice of investment advisers or their employees making political contributions intended to influence the selection or retention of advisers by government entities because it undermines the principle that advisers are selected on the basis of competence, qualifications, expertise, and experience. Other commenters also agreed that making political contributions in order to buy business would be unethical and may undermine the integrity of the public pension plan system. We therefore understand and agree with the Commission's stated goal to eliminate and prevent pay-to-play abuses.

However, as indicated in our comment letter, the ICAA has serious concerns with many aspects of the proposed rule. The Commission received more than 50 comment letters from a wide variety of sources on the proposed rule and most of these letters raise significant objections to the proposal. Most commenters considered the proposed rule to be flawed in several major respects. Commenters raised serious constitutional issues, as well as concerns that the evidence of abuse was not demonstrated, that the penalty imposed was too harsh and inflexible, that the coverage of the rule was too broad, that current federal, state, and local laws adequately address the issue, and that compliance would be difficult, costly, and burdensome.

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4 *See* November 1, 1999 letter from ICAA Executive Director David G. Tittsworth to Jonathan G. Katz, Secretary, Securities and Exchange Commission, attached at Appendix C.

As set forth below, we believe our voluntary standards address many of these concerns, while preserving the goal of preventing pay-to-play abuses. Following is our analysis of relevant issues and our recommendations to investment advisory firms.

First, we explain the differences between the investment advisory profession and the municipal securities business that make a Rule G-37 approach inappropriate and unworkable for investment advisers. Second, we discuss a suggested "policies and procedures" approach to pay-to-play, including the benefits of this approach. And finally, we set forth the ICAA's best practices guidelines for policies and procedures relating to pay-to-play for advisers' codes of ethics.

I. *Differences Between the Investment Advisory Profession and the Municipal Securities Business*

There are significant differences between the investment advisory profession and the municipal securities industry. These differences necessitate a markedly different approach for advisers from the regulatory regime established under MSRB Rule G-37.[5]

The principal difference is that, unlike municipal dealers, investment advisers have a *fiduciary* relationship with each of their clients, including pension plan and other government clients. In these relationships, the plan or entity itself is the client of the

[5] The vast majority of comment letters filed with the SEC on its proposed rule echoed this conclusion.

adviser, *not* the plan fiduciary, officials, or the plan's board members. Additionally, the investment adviser/client relationship is predicated on providing continuous and ongoing independent investment advice, whereas the municipal security business is transaction-oriented.

The process for obtaining public pension plan business differs significantly from municipal bond transactions. Unlike the municipal bond business where one official (often the treasurer) has significant influence over the award of a contract, the public pension process generally is more open and involves more decision-makers, including representatives of plan participants and consultants.[6] For example, CalPERS has noted that its Board has 13 members, including representatives of plan participants, certain elected officials, appointees of the governor and the legislature, and others.[7] Thus, there is less opportunity for one official who receives contributions to influence the selection of an adviser.

In addition to being more open, the bidding process for investment advisory contracts is more competitive and objective than in the municipal securities business.

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[6] Even in the few jurisdictions where control is not dispersed, questions remain about the virtue of pay-to-play restrictions. For example, the treasurer of Connecticut is vested with authority to make final decisions regarding pension plan advisory services. *See The Toughest Job in Pensions*, Institutional Investor (February 2000) at 58 (a larger board of trustees who jointly make decisions "is common in almost every other state"). Connecticut has enacted one of the nation's strictest state statutes prohibiting pay-to-play – perhaps stricter than the SEC's proposal. Conn. Gen. Stat. Section 9-333o (1997). In spite of this rule, a pay-to-play abuse occurred, prompting the current treasurer (who uncovered the scheme) to opine "[i]f someone really wants to commit a crime, you're not going to be able to stop them." *Id.* at 64.

[7] CalPERS comment letter re: Proposed Rule on Political Contributions by Certain Investment Advisers (Nov. 1, 1999) at 2. *See also* MOSERS (Missouri State Employees' Retirement System) comment letter re: Proposed Rules on Pay to Play (File No. S7-19-99) (August 17, 1999); SEC Release IA-1812 at 11.

Pension plan clients usually base decisions on objective criteria such as performance records and investment styles and strategies. In contrast to pension plans' open, objective style, the municipal securities business selection criteria are more subjective and negotiated underwritings account for the vast majority of long-term municipal offerings.[8] Another notable factor in the bidding process is that public pension plan clients, in their requests for proposals, frequently ask advisers bidding for advisory contracts to disclose contributions made in connection with soliciting or maintaining the business.[9] We have found no evidence that similar requests are made in the municipal securities contract process or were made at the time Rule G-37 was proposed.

There are also significant differences between Rule G-37 and the SEC's proposed rule in the number of affected employees and the degree to which such employees are centralized within firms. Covered employees of a firm reporting under Rule G-37 often are centralized in one department dedicated to the municipal securities business, while employees of an advisory firm who might solicit public pension plan business are more dispersed throughout advisory firms with various organizational structures.[10] The potential number of employees affected by the proposed rule is dramatically higher than those who are affected by Rule G-37. Varying advisory firm structures do not lend

[8] *See* comment letter of American Express Asset Management Group re: Pay-to-Play Comments File No. S&-19-99 (Oct. 29, 1999) at 3; comment letter of T. Rowe Price Associates, Inc. re: Political Contributions by Certain Investment Advisers; Release No. IA-1812; File No. S7-19-99 (Oct. 28, 1999) at 3 (citing SEC Release No. 24-33868 (April 12, 1994). *Indeed, MSRB G-37 does not apply to competitive municipal offerings.*

[9] T. Rowe Price comment letter at p. 3.

[10] *See* SIA comment letter re: Proposed Rule 206(4)-5 – File No. S7-19-99 (Oct. 29, 1999), at 2.

themselves to rigid definitions but rather require a more flexible approach, such as the approach discussed below.[11]

Due to the ongoing fiduciary obligations of an adviser – as opposed to the transaction-oriented nature of the municipal securities business – the proposed rule's sanctions for violations are inappropriate and may have undesirable consequences for public pension plan clients and beneficiaries thereof. The potential ramifications of a Rule G-37-type ban for investment advisers could be extremely disruptive to the client, and ultimately to the beneficiaries of the plan, even for minor violations that have nothing to do with pay-to-play abuses. Termination of a longstanding, ongoing fiduciary relationship is a much harsher result for both client and adviser than a time-out on new transactional business. Indeed, the penalty for violating the proposed rule is tantamount to a death penalty for an advisory relationship. It is extremely unlikely that a public pension plan would endure the hardships and disruptions created by a violation of the rule, go through the process of identifying and hiring a replacement adviser, and then return to the original adviser after the two-year ban ends. In all likelihood, the so-called "two-year ban" would operate as a *de facto* permanent ban. The same cannot be said in the municipal finance context.

Importantly, the record before the Commission regarding the number and extent of state and local laws and regulations governing pay-to-play activities related to investment advisers and public pension plans bears no resemblance to the evidence that

[11] We understand that similar considerations led the Commission to adopt a flexible code of ethics approach in the personal trading area under the Investment Company Act.

existed several years ago regarding pay-to-play activities in the municipal securities industry. When Rule G-37 was being considered, there were few state and local laws addressing political contributions to public officials who could influence the award of municipal securities business. In sharp contrast, today there is a multitude of state and local laws regulating pay-to-play activities of investment advisers and public pension plans. A large number of public retirement systems also have adopted written ethical standards to address any abuses.[12] The record before the Commission regarding the manner in which potential pay-to-play abuses in the investment advisory profession are currently covered by state and local laws and regulations, as well as direct evidence that indicates widespread abuses, is far different than the evidence that led to the promulgation of Rule G-37.[13]

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[12] *See, e.g., Systems Who Have Adopted Written Ethics Standards, Either by Statute or Policy, Which Apply to the Retirement Board/Trustees*, Public Pension Coordinating Council 1997 Survey of State and Local Government Employee Retirement Systems.

[13] The ABA subcommittees noted that:

> "MSRB Rule G-37 was the culmination of approximately four years of study and consultation with significant members of the municipal securities industry and bar, a process that began with the MSRB review initiatives of 1990, ultimately leading to two reports, one an MSRB report, *Report of the MSRB on Regulation of the Municipal Securities Market*, and the other a Commission staff report, *Securities and Exchange Commission Staff Report on the Municipal Securities Market*, Sept. 1993. Shortly after the publication of a draft of MSRB Rule G-37, hearings were held before Congress," describing the abuses existing in the municipal securities industry. ABA subcommittees comment letter at n. 2.

Similarly, the comment letter from the National Conference of State Legislatures notes that "[t]he SEC has failed to demonstrate, through empirical data, evidence of problems in the market that would necessitate federal rulemaking in the practice of pay-to-play" and that "[i]n issuing the proposed regulations the SEC has failed to defer, or even consider, state law and rulemaking regarding contributions to state and local officials and state and local campaign rule making." November 1, 1999 letter from Rep. Tim Ford and Rep. Robert Junell to Jonthan G. Katz, Secretary, Securities and Exchange Commission.

Unlike the municipal securities area, many state pension laws subject public pension plan officials to strict fiduciary and ethical restrictions.[14] Such restrictions would be violated if government officials selected an unqualified adviser based on political contributions instead of merit. As the ABA subcommittees have noted, these "statutes would appear to regulate more directly the problems created by pay-to-play practices by prohibiting state and local officials from using state business as leverage to extract campaign contributions."[15]

Because of these distinctions between the investment advisory profession and the municipal securities business, MSRB Rule G-37 does not provide an appropriate structure for addressing pay-to-play problems in the award of advisory contracts by public pension plans. Given the significant differences between the investment advisory profession and the municipal securities industry (including differences in legal and regulatory responsibilities), as well as the tremendous diversity among investment advisers, we believe that additional flexibility is both necessary and desirable to allow advisers to construct appropriate and meaningful policies and procedures on pay-to-play.

II. *An Alternative Approach to the Current Proposal*

To tailor a pay-to-play provision more effectively to investment advisers and to make other constructive rule changes under the Advisers Act, we have recommended to

[14] *See* ABA Subcommittees comment letter at n.19. Many of these state laws governing public pension funds "impose prudence standards and restrictions similar to those found in ERISA." Lemke & Lins, *Regulation of Investment Advisers* (1999) at 2-119.

[15] *Id.*

the Commission an alternative approach along the lines of the ABA Subcommittees' suggestion. We believe the Commission could issue a rule that requires certain investment advisers to adopt policies and procedures reasonably designed to prevent pay-to-play abuses by the firm or its employees.[16] The Commission should define pay-to-play as the practice of an investment adviser or its employees giving political contributions[17] *for the purpose of* obtaining the award or retention of investment advisory contracts by government entities.[18] The Commission obviously would retain its current authority under existing anti-fraud statutes, sections 206(1) and 206(2) of the Advisers Act, to pursue enforcement actions against investment advisers that engaged in pay-to-play abuses.[19]

Ideally, a firm's policies and procedures should be part of its code of ethics. Even though it is not a formal requirement today, we understand that the Commission's inspection staff typically requests such codes from non-mutual fund advisers during inspections, and that many such advisers have adopted codes of ethics. Indeed, in 1995, following the Investment Company Institute's report on personal trading, the ICAA

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16 A firm that does not have or seek to have government entity clients clearly does not need to have pay-to-play policies and procedures. We recommend, however, that all advisers adopt codes of ethics, whether or not the code includes pay-to-play policies and procedures.

17 We urge the Commission to confirm the interpretation of the proposed definition of "contribution" set forth in the ICAA comment letter, *supra* n.4, at p. 8.

18 In its resolution addressing pay-to-play, the American Bar Association explains that "contributions are *for the purpose of* obtaining or being considered for a[n] … engagement … if, *but for* the desire to be considered for the" engagement, the attorney would not have made the contribution. *See* American Bar Association Model Rule 7.6, *supra* n. 2 (emphasis added). We urge the Commission to adopt this definition.

19 The Commission already has determined that certain pay-to-play abuses are "inconsistent with the high standards of ethical conduct required of fiduciaries under the Advisers Act." Release at 19.

issued similar guidelines, which recommended that each investment adviser (including those to whom Rule 17j-1 does not apply) adopt a written code of ethics to address personal trading, use of inside information, gifts, and other situations where a possibility exists for conflicts of interest.[20] The letter accompanying those guidelines noted that many member firms already had developed such codes, consistent with the ICAA *Standards of Practice*. We continue to believe that all advisers should adopt codes of ethics.

To establish policies and procedures reasonably designed to prevent pay-to-play abuses, a firm would adopt a general prohibition against pay-to-play, applicable to all employees. This general prohibition may be accompanied by more narrowly tailored provisions requiring reporting, pre-clearance, record-keeping, or other measures reasonably designed to prevent pay-to-play practices. We have suggested such provisions in our guidelines, discussed below. These provisions may vary depending on the unique characteristics and business structure of each adviser. Firms also would monitor compliance with the requirements of these policies, determining appropriate responses to any covered employee's failure to comply with his or her ethical requirements. Most investment advisers already have a great deal of experience with pre-clearance, monitoring, disclosure, and record-keeping procedures relating to personal trading.

This approach to pay-to-play is desirable for a number of reasons.

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[20] *See* ICAA Guidelines on Personal Investing, attached at Appendix D.

First, for better or worse, the Commission's jurisdiction is limited. *Any* rule that seeks to curb pay-to-play abuses by investment advisers can at best only serve as one component of a much larger web of other laws and activities – including enforcement of various campaign finance laws – designed to prevent similar abuses by public officials, consultants, and other persons who may be involved in influencing decisions to hire or retain investment advisers, broker-dealers, custodians, lawyers, and other providers by a public pension plan. Many commenters expressed concern that the proposed rule would affect only a subset of persons providing investment advisory services to government entities, not to mention firms providing other financial services.[21] Other commenters requested the Commission to clarify its proposal to exclude them from its scope.[22] As Chairman Levitt has noted, the SEC ". . . can only do so much. At the end of the day, the responsibility for maintaining investor confidence rests heavily on the shoulders of market participants . . . ."[23]

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[21] *E.g.* ABA Subcommittees comment letter; AIMR comment letter; ICAA comment letter; SIA comment letter. To hold the entire investment advisory profession to a high standard of integrity, we also encourage investment advisers that are not registered with the Commission, such as hedge fund advisers and state-registered advisers, to adopt guidelines prohibiting pay-to-play abuses.

[22] For example, some commenters urged that the proposed rule be limited to persons who provide "advisory services" such that they are deemed "investment advisers" under the Investment Advisers Act of 1940. One commenter noted that this would exempt from the rule broker-dealers who provide advisory services to public pension plans that are "solely incidental" to brokerage services. Morgan Stanley Dean Witter Management Inc. comment letter re: Proposed Rule 206(4)-5 – File No. S7-19-99 (Nov. 1, 1999) at section VI; *see also* SIA comment letter. This highlights further implications of the Commission's Release No. IA-1845 (Certain Broker-Dealers Deemed Not to Be Investment Advisers). Under the Commission's proposal, broker-dealers who provide non-discretionary advisory services to public pension plans would be exempt from the definition of "investment adviser" under section 202 of the Advisers Act and therefore would not be subject to any pay-to-play regulations under the Act.

[23] SEC Press Release No. 2000-10, *SEC Chairman Praises American Bar Association for Banning Lawyer Pay-to-Play* (Feb. 14, 2000).

Second, we believe our recommended alternative approach is consistent with constitutional principles (and relevant judicial decisions) that generally favor an individual's ability to participate in the political process. Pursuant to these principles, government regulation of political contributions must be narrowly tailored to advance the compelling government interests asserted.[24] A government requirement of policies and procedures designed to address pay-to-play would not likely be held an unconstitutional infringement on First Amendment protections; the responsibility of tailoring policies and procedures would be placed on firms rather than the government. In particular, a rule reaching conduct that is *for the purpose of buying* business is more narrowly tailored to meet the Commission's objective of eliminating such practices than is the current proposal. The American Bar Association recently followed a similar approach in its resolution prohibiting political contributions made "for the purpose of obtaining or being considered for" government engagements.[25]

Third, our alternative approach is consistent with the Federal Election Campaign Act of 1971.[26] Based on the First Amendment and federal regulatory implications of the Commission's proposal for federal campaigns, we suggest that the Commission's proposal not apply to candidates for federal office. Further, while a firm's general policy statement prohibiting political contributions made *for the purpose of* obtaining or

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[24] *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)).

[25] American Bar Association Model Rule 7.6, *supra* n.2; *see also* SEC Press Release No. 2000-10, *SEC Chairman Praises American Bar Association for Banning Lawyer Pay-to-Play* (Feb. 14, 2000).

[26] *See* ICAA comment letter, *supra* n.4, at p. 9 (discussing conflicts between the proposed rule and FECA, as well as policy implications of the proposal for federal campaigns).

retaining government relationships should apply to officials and candidates at all levels, we suggest that firms' more specific procedures may reasonably apply only to officials and candidates at the state and local level.

Fourth, our suggested alternative is consistent with the Investment Advisers Act and other federal securities laws, particularly because it emphasizes the appropriate role of disclosure and related procedures in addressing potential problems rather than imposing a proscriptive, one-size-fits-all rule. Traditionally and historically, the Commission has employed disclosure as the primary means of addressing conflicts of interest. For example, firms are not prohibited from using soft dollars, from "bunching" client trades together in block orders or from selecting brokers using reasonable criteria. Similarly, firm personnel are not prohibited from engaging in personal investing. Instead, firms are required or encouraged to establish reasonable policies and procedures to prevent potential abuses in these areas, to disclose potential conflicts of interest, and to maintain certain records. Increasingly, the Commission has been moving away from technical regulation to a more flexible approach.[27] Thus, a reporting and record-keeping regime for pay-to-play is more consistent with the Investment Advisers Act and other securities laws than is a flat, broad prohibition accompanied by detailed "command-and-control" requirements.

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[27] For example, the Commission recently replaced its detailed regulation of performance fee arrangements with a more flexible approach that acknowledges the ability of advisers and their sophisticated clients to negotiate varying agreements best suited to their relationships. *See* SEC Release No. IA-1731 (July 15, 1998).

Fifth, the suggested approach takes into consideration the significant evidence that state and local laws and regulations are working to curb pay-to-play abuses in cases involving public pension plans, unlike the evidence that existed in the municipal securities area earlier this decade. In the time since Rule G-37 was released, many state and local governments have mandated restrictions or disclosures designed to deter pay-to-play practices. According to our members, many investment advisers already have policies and procedures in place to report contributions under state and local law and to avoid pay-to-play issues. Further, some clients request investment advisers to disclose contributions during the bidding process. Given the laws and procedures that are in place, a code of ethics approach is more appropriate than a Rule G-37 approach.

Sixth, our suggested approach would take the Commission and its staff out of the onerous business of considering exemption requests. Under the current proposal, it is likely that the staff would be inundated with requests for exemptions based both on inadvertent violations and on the desire of advisory personnel to make contributions based on political, religious or other reasons not related to obtaining government business. It is in the public interest that the Commission's limited resources be dedicated to fighting demonstrable problems such as internet fraud, rather than responding to myriad exemption requests.[28]

[28] We understand that the staff of the Division of Investment Management is already flooded with exemption requests under various existing regulations permitting exemptions. *See, e.g.*, SEC News Digests, March 20-31, 2000, Issues 2000-52 through 2000- 61 (during a two-week period, the Division of Investment Management issued notices and granted exemptions under sections 2(a)(9), 3(b), 6(b), (c) & (e), 7(d), 12(d), 15(a), 17(a), (b), (d) & (e), 26(b), and 61(a) of the Investment Company Act).

Finally, our suggested approach would achieve the extremely positive result of encouraging the adoption of codes of ethics by *all* investment advisers. We believe that such a result – in and of itself – would leave a lasting legacy on investor protection.

III. *Best Practice Guidelines for Adviser Codes of Ethics*

The Investment Counsel Association of America has worked with its members to suggest potential policies and procedures that could be included in an investment adviser's code of ethics to prevent and detect any pay-to-play abuses. Our suggested guidelines for an adviser's code of ethics follow:

General Guidelines for SEC-Registered Investment Advisers

A. In 1995, the ICAA encouraged its member firms to adopt a Code of Ethics that would address, among other things, personal trading, gifts, the prohibition against the use of inside information, and other situations where there is a possibility for conflicts of interest.

B. Since that time, the vast majority of ICAA member firms have adopted such a Code of Ethics.

C. The ICAA recommends that any investment adviser that provides investment supervisory services to government entities, or that seeks to provide such services, include in its Code of Ethics a broad prohibition against making political contributions for the purpose of obtaining or retaining advisory contracts with government entities (“pay-to-play”).

D. The ICAA recommends that any investment adviser that provides investment supervisory services to government entities, or that seeks to provide such services, adopt policies and procedures reasonably designed to prevent pay-to-play abuses by the investment adviser and its employees.

E. The ICAA recommends that such policies and procedures be tailored to the investment adviser’s specific circumstances, including, for example, the number of government clients the adviser advises, the amount of revenue derived from government business, the number and type of employees who have significant responsibilities and contact with government clients, the adviser’s marketing efforts with respect to such clients, the firm structure as it relates to the public pension plan and other public entity business, relevant state and local laws and regulations, and other appropriate considerations.

F. The ICAA recommends that an investment adviser be mindful of constitutional issues related to pay-to-play, including an employee’s right to make political contributions based on personal, religious, or political reasons. For example, a policy could be tailored permissibly to exclude from its scope contributions to candidates for federal office or could exclude contributions to officials of public entities that select advisers based on objective criteria and a competitive bidding process. A policy could also exclude contributions to organizations not controlled by the employee, firm, or particular candidate, such as groups supporting minority or female candidates or candidates with certain political positions.

Policies and Procedures Reasonably Designed to Prevent Pay-to-Play Abuses by the Firm and its Employees

The ICAA suggests the following potential compliance procedures, which should be tailored to the adviser's specific circumstances:

A. *Certification of Compliance with Codes of Ethics.* As recommended in 1995 in connection with the ICAA Guidelines on Personal Investing, an adviser's employees should annually certify that they have read, understood, and complied with the firm's Code of Ethics. As part of this certification, employees should also certify that they have not made any political contributions for the purpose of obtaining or retaining the firm's engagement as an investment adviser to a government entity.

B. *Restrictions on Political Contributions.* To prevent pay-to-play abuses, the following alternative approaches are suggested. An adviser could combine aspects of these approaches or develop other equally reasonable approaches:

1. <u>Contribution Ban.</u> An investment adviser may choose to prohibit all or certain of its employees from making political contributions above a certain *de minimis* amount to any person who may influence the selection or retention of an investment adviser by a government entity.

Comment

a. If such an option is approved, the adviser should implement appropriate policies and procedures that reasonably ensure – on a periodic basis – that each employee to whom the prohibition applies is aware of the adviser's policies and procedures, understands them, and agrees to comply with them.

b. Each firm should choose a *de minimis* amount based on its unique facts and circumstances, including the magnitude and type of its government entity business and any applicable state or local law. The firm could decide whether the *de minimis* standard applies to all contributions or is limited to some subset of contributions to officials or candidates.

2. Pre-Clearance. An investment adviser may prohibit contributions by all or certain of its employees in a manner similar to (1) above, unless otherwise pre-cleared with compliance or legal personnel. An employee seeking pre-clearance should certify that the contribution is not made for the purpose of obtaining or retaining the firm's engagement as an investment adviser by the government entity.

3. Disclosure to Clients. An investment adviser may establish an effective system to disclose or offer to disclose any and all firm and employee contribution information material to its current and prospective government clients.

Comment

a. If this approach is used, the disclosure should be made initially at the time the adviser proposes to be retained by the prospective client. If selected by the client, the adviser should make additional disclosure at the time of selection and then periodically thereafter.

b. A committee of senior personnel or the compliance officer should review employee political contribution reports for conflicts of interest or abusive practices, as set forth below in section D.

C. *Reporting of Political Contributions.* Codes of Ethics should establish reporting regimens appropriate to the conceptual approach taken (*i.e.* ban, pre-clearance, disclosure, or other). A firm that establishes a ban on contributions may require only annual certification of compliance with the ban. Firms taking a pre-clearance or disclosure approach may require certain employees to report to the firm their political contributions at the state and local level on a periodic basis or when they occur, or certify that no such contributions were made. A new covered employee should also disclose such political contributions from the time he or she entered into employment negotiations with the adviser.

Comment

1. This reporting policy should be designed to elicit reports from personnel likely to be significantly involved in soliciting government business. The coverage of the policy should be tailored to the structure of each firm. At smaller firms, all officers or solicitors may have substantial involvement in government entity solicitation or marketing.

At mid-sized or larger firms, the universe may need to be defined more narrowly.

2. The policy may require reports of all contributions, contributions in excess of a certain *de minimis* amount, or only contributions (all or in excess of a *de minimis*) to persons who are in a position to influence the selection or retention of the adviser by government entities.

3. Reports by employees should include appropriate details regarding the jurisdiction in which the candidate is seeking public office and the position that the official or candidate holds or is seeking.

4. Each report could include a certification that no contribution was made for the purpose of obtaining or retaining the firm’s engagement as an investment adviser to government clients.

5. The policy should include measures to ensure that the reports are kept confidential.

D. *Monitoring of Political Contribution Disclosure*. Where applicable, firm procedures should include review of political contribution reports in light of the firm's government clients, any pattern of contributions by a particular employee or group of employees, and other relevant factors. The review may include any known external information, such as public contribution reports required by local law in relevant jurisdictions.

E. *Record-Keeping.* Depending on the approach taken, an investment adviser should maintain required records of political contributions and a list (compiled at least annually) of the firm's government clients. For example, an adviser should maintain records of the pre-clearance process if the pre-clearance approach is chosen.

F. *Sanctions for Violations of Code of Ethics Provisions*. An adviser's Code of Ethics should include appropriate sanctions and/or remedies for violations of the adviser's pay-to-play policies and procedures. In this regard, the adviser should consider all relevant facts and circumstances, including whether the violation was inadvertent, any pattern or practice of violations, the size of the contribution, the influence of the official, and any harm caused. These sanctions or remedies could include:

1. Internal actions, based on the various facts and circumstances, including letter of reprimand, fines donated to charity, suspension or termination of the employee.

2. Disclosure to client and/or independent representatives of the client, where appropriate.

We emphasize that our guidelines are not intended to dictate the content of any firm's Code of Ethics. Policies and procedures adopted by an investment adviser should be tailored to meet the facts and circumstances of each adviser. An adviser's policies and procedures may vary depending upon consideration of appropriate factors.

CONCLUSION

The ICAA strongly opposes any practice by which investment professionals try to gain access to business through political contributions. In suggesting our guidelines, we have attempted to address pay-to-play practices without unnecessarily infringing on free speech rights or imposing unnecessary burdens on the investment advisory profession. We hope that this report will prove responsive to the Commission and Congress as they consider the issue of pay-to-play in the context of public pension plans. More important, we trust that our recommendations will provide important safeguards that will help to ensure the integrity of the public pension plan system and the investment advisory profession.

May 15, 2000