



October 6, 2009

**Via Electronic Mail:** [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: File Number S7-18-09; Political Contributions by Certain Investment Advisers**

Dear Ms. Murphy:

Managed Funds Association (“MFA”)<sup>1</sup> welcomes the opportunity to comment on the Securities and Exchange Commission’s proposal to address “pay to play” practices.<sup>2</sup> We strongly support efforts by both the Commission and state enforcement authorities to punish individuals and entities that engage in improper activities in connection with the selection of firms to manage government assets. In light of recent pay to play cases brought by state and federal authorities, we believe it is very appropriate for the Commission to reconsider its current regulatory framework prohibiting such activity.

The proposals would, among other things, restrict political contributions by an investment adviser and its employees to officials of a government entity for which the adviser provides investment management services, and prohibit an investment adviser from paying a third party firm to solicit a government entity on its behalf. While we generally support the political contribution restrictions, we have a number of concerns about how they will be implemented. To comply with the rules as proposed and avoid the severe penalty for a violation, advisers would likely need to adopt expansive compliance measures. We recommend that the Commission more narrowly tailor its proposals to prevent activities more likely to involve pay to play practices. With respect to the prohibition on the use of third party placement agents, we believe that alternative rules would more effectively address pay to play practices while allowing

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<sup>1</sup> MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

<sup>2</sup> Political Contributions by Certain Investment Advisers, SEC Release No. IA-2910 (August 3, 2009), 74 FR 39840 (August 7, 2009) (“Release”).

all advisers, particularly small and offshore private fund managers, to compete for government clients.

## **I. BACKGROUND**

The SEC requests comment on whether it is appropriate to use the Municipal Securities Rulemaking Board rules G-37 and G-38 as models for proposed Rule 206(4)-5. We recognize the utility of using existing rules as a basis for new requirements under the Investment Advisers Act of 1940 (“Advisers Act”), however, rules G-37 and G-38 should not simply be transposed on the investment management industry since there are fundamental differences between the two industries.

Investment advisory relationships are ongoing and typically long-term, whereas municipal underwritings occur at irregular intervals. As noted in comments to the SEC’s proposal to adopt similar pay to play restrictions in 1999,<sup>3</sup> a two year compensation prohibition would be a more severe penalty for investment advisers than for municipal securities underwriters.

Investment management firms generally do not have personnel dedicated to servicing government clients. As a result, the concept of a “municipal securities professional,” upon which MSRB rule G-37 is based, generally does not have an analog for advisers. Instead, the personnel and characteristics of investment management firms, including their size, resources and investment techniques, are extremely diverse. The proposed rule should continue to allow advisers this needed flexibility in structuring their businesses, and not impose rigid requirements that would unduly burden certain firms from competing effectively in the marketplace.

In addition, unlike municipal underwriters, managers subject to the Advisers Act must designate a chief compliance officer, maintain and enforce a code of ethics, and adopt written compliance policies and procedures to avoid violations of the securities laws. Pursuant to these requirements, advisers already must implement comprehensive compliance systems to prevent employees from engaging in illegal or unethical conduct. The SEC should recognize and utilize these existing requirements in addressing pay to play arrangements through proposed Rule 206(4)-5.

## **II. RESTRICTIONS ON POLITICAL CONTRIBUTIONS**

We are concerned that the proposed rule would impose a disproportionately severe punishment on investment advisers for political contributions by their employees that do not involve pay to play arrangements. Set out below are provisions of the proposed rule that we believe are overly broad and recommended amendments to those provisions.

### **Officials of a Government Entity**

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<sup>3</sup> Political Contributions by Certain Investment Advisers, SEC Release No. IA-1812 (August 4, 1999), 64 FR 43556 (August 10, 1999) (“1999 Release”). *See e.g.*, Letter from Stanley Keller, Chair, Committee on Federal Regulation of the American Bar Association (January 6, 2000).

Under proposed Rule 206(4)-5, an investment adviser would be prohibited from receiving compensation from a government entity if the adviser or a covered associate made a contribution to an “official” of a “government entity.”<sup>4</sup> An “official” would include any person, or election committee for the person, who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office either: (i) is directly or indirectly responsible for, or could influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.

Significantly, the proposed rule would not identify the state and local officials that would be subject to the proposed rule; instead, it would require advisers to make this determination. Each adviser subject to the proposed rule would need to determine each government office that could be responsible for, or influence the outcome of the hiring of an investment adviser, or have the authority to appoint any person responsible for or influential in the outcome of the hiring process.

Because of the severity of the penalty for a mistaken legal analysis or an unintentional employee contribution, an adviser would need to commit significant resources to navigate the myriad laws and regulations governing state and local public plans. Investment advisers generally are not familiar with these laws, and analyzing legal structures for various jurisdictions would be a difficult, time consuming task for even large advisers. Firms could either dedicate significant in-house resources, or, more likely, retain local counsel. Either option would impose a significant and unnecessary burden on an adviser and prevent it from allocating resources to its core advisory function.

As neither the Commission nor individual investment advisers are suited to determine the status or authority of state and local officials, we recommend that the SEC amend the proposed rule to provide a safe harbor from the compensation prohibition for an investment adviser that reasonably relies on a representation by a government official that he or she does not fall within the proposed definition of “official.” State and local entities, rather than investment advisers, are more appropriately situated to determine the legal authorities and obligations assigned to each office in connection with the hiring of an investment adviser. These entities could provide, for example on their website, the necessary certification and underlying laws and regulations to allow an adviser to reasonably rely on its status under the proposed rule. Such a process would ease the compliance burden on advisers and reduce the likelihood that an unintentional contribution would trigger the rule.

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<sup>4</sup> Government entity would mean any State or political subdivision of a State, including:

- (i) Any agency, authority, or instrumentality of the State or political subdivision;
- (ii) A plan, program, or pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof; and
- (iii) Officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

We also recommend that the SEC clarify how the proposed rule would interact with state laws restricting or prohibiting contributions to certain government officials. Certain statements in the Release seem to indicate that advisers would need to comply with existing state laws or regulations in addition to proposed Rule 206(4)-5.<sup>5</sup> If the SEC determines that current rules are insufficient to prevent pay to play practices, advisers would benefit from having a single, uniform set of rules to follow rather than numerous state and local regulations.

In the Release, the SEC requests comment on whether it should expand the compensation prohibition to apply when an adviser or covered associate contributes to others associated with an official (*e.g.*, an official's political action committee, his or her inauguration or transition committee, a local or state political party, or a foundation or other charitable institution). The Commission should not expand the proposed rule to apply to entities or persons other than the government official. Such an expansion would substantially increase the uncertainty of those persons and groups that would fall within the proposed rule. Any pay to play activity of this type would be precluded by the provision prohibiting an adviser from doing anything indirectly which, if done directly, would violate the rule.<sup>6</sup>

The SEC also requests comment on the scope of activities that should be considered "contributions"<sup>7</sup> under the proposed rule. The proposed rule should provide advisers with clear, usable guidelines on the activities that could trigger the rule's prohibitions. We recommend, for example, that the definition of contribution not include expenses incurred in organizing or sponsoring a conference attended by a government official. If the rule were to apply to certain expenses and not others, it could create unnecessary confusion for advisers, government officials and regulators.

### **Covered Associates**

Proposed Rule 206(4)-5 would apply to political contributions made by an investment adviser and its "covered associates."<sup>8</sup> We believe the type of employees covered by the proposed rule is overly broad, and that advisers would need to adopt intrusive policies to prevent

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<sup>5</sup> See Release at 39845 explaining that "[t]he rule would have no effect on State laws, codes of ethics or other rules governing the activities of State and municipal officials or employees of public pension plans over whom we have no regulatory jurisdiction."

<sup>6</sup> Proposed Rule 206(4)-5(d).

<sup>7</sup> Contribution would mean any gift, subscription, loan, advance, or deposit of money or anything of value made for:

- (i) The purpose of influencing any election for Federal, State or local office;
- (ii) Payment of debt incurred in connection with any such election; or
- (iii) Transition or inaugural expenses of the successful candidate for State or local office.

<sup>8</sup> A "covered associate" would include:

- (i) any general partner, managing member or "executive officer," or other individual with a similar status or function;
- (ii) any employee who solicits a government entity for the investment adviser; and
- (iii) any political action committee controlled by the investment adviser or by any aforementioned person.

any unintentional triggering contributions. The SEC should narrow the definition to apply only to those employees who would have reason to engage in pay to play arrangements.

As noted in various comments to the 1999 Release, the persons covered by proposed Rule 206(4)-5 would extend significantly beyond the persons covered by MSRB rule G-37. Rule G-37 is limited to employees of a broker or dealer with a close connection to the municipal securities business. Specifically, it applies only to persons who: (i) are primarily engaged in municipal securities representative activities; (ii) solicit municipal securities business; (iii) are municipal securities principals or sales principals and supervise persons covered by (i) or (ii); and (iv) supervise persons described in (iii), including the chief executive officer.<sup>9</sup>

Proposed Rule 206(4)-5, on the other hand, would include employees performing a variety of functions for an investment adviser, including activities that are separate and distinct from providing services to government clients. The proposed rule would apply broadly to “executive officers,” which would include the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), or any other executive officer of the investment adviser who, in each case, in connection with his or her regular duties: (i) performs, or supervises any person who performs, investment advisory services for the investment adviser; (ii) solicits, or supervises any person who solicits, for the investment adviser, including with respect to investors for a covered investment pool; or (iii) supervises, directly or indirectly, any aforementioned person.<sup>10</sup>

The definition would cover a number of employees not involved with providing services to government clients, including employees responsible for any department, employees who perform advisory services, such as portfolio managers, and employees who solicit clients other than government clients. We believe it is inappropriate to subject these employees to the rule’s contribution restrictions. The rule would restrict employees from making political contributions during their ordinary participation in the political process who do not pose the same types of risks to engage in pay to play practices as individuals whose primary job function is connected to government clients. If these employees actually intended through their political contributions to engage in pay to play activities, paragraph (d) of the proposed rule would prohibit such conduct.

In addition, the proposed definition of “executive officer” would raise complicated interpretive issues. An adviser would need to make difficult determinations about which employees manage a business function, which persons are “executive officers,” and which perform advisory services, as well as which persons may indirectly supervise any such persons. As described below in the discussion of the proposed look-back provision, even if an adviser determined that an employee was not a “covered associate,” his or her political contribution could trigger the prohibition if the employee was promoted to become a covered associate within two years. The proposed rule provides limited guidance to an adviser trying to distinguish which employees it could allow to make political contributions.

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<sup>9</sup> MSRB rule G-37(g)(iv).

<sup>10</sup> Proposed Rule 206(4)-5(f)(4).

To comply with the proposed rule, and for registered advisers to meet their obligations under Rule 206(4)-7, advisers would adopt and implement written policies and procedures designed to prevent any violations. Because advisers would not be able to determine with certainty whether an employee is a covered associate, and because the look-back provision could apply the rule to past actions of any employee that subsequently became a “covered associate,” advisers would likely restrict most or all employees from making any political contributions without obtaining pre-approval from the adviser. Such procedures would be a rational and predictable response to the uncertainty surrounding the scope of the rule and the severe penalty for covered political contributions.

We are concerned that, as a result, the proposed rule would have the effect of broadly restricting political contributions by persons employed in the investment advisory industry. Moreover, because of the look-back provision, persons who work outside of the investment advisory industry (*e.g.*, securities firms, government, academic institutions) who may consider working for an investment advisory firm may opt to refrain from making political contributions to avoid limiting their future employment opportunities. This widespread chilling of political activity would be a disproportionate response to certain advisers engaging in pay to play activities.

The proposed rule may also result in advisers interfering with state or federal laws protecting political activity. Investment advisers would need to make difficult determinations of how best to comply with the proposed rule while not infringing on laws protecting political participation, and we are concerned that advisers lack sufficient resources or experience to make these determinations.

For these reasons, we recommend that the SEC narrow the proposed rule to apply only to employees directly involved in soliciting or providing services to government clients. Covered associates should only include executive officers that are primarily engaged in soliciting or providing investment advisory services to government entities, other employees whose primary job function is to solicit clients for the investment advisory and solicits government entities, and persons who directly supervise such employees. Such a rule would cover employees likely to be involved in pay to play activities and prevent them from making political contributions to government clients (or soliciting others to make contributions). At the same time, it would enable most employees of investment advisers to make political contributions without onerous pre-approval requirements, and allow advisers not to interfere with those employees’ personal political activities.

The proposed rule should not be extended to cover all portfolio managers, nor should it include beneficial owners of the adviser or employees of related companies who solicit government clients for the adviser.<sup>11</sup> It should also not include family members of covered associates. Such other employees and family members would be prevented from engaging in

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<sup>11</sup> We strongly agree with the SEC’s comment in the Release that “covered associates” should not include employees of entities unaffiliated with an investment adviser, such as the employees of a third party placement agent. An investment adviser would not have the authority or capability to monitor and restrict political contributions made by individuals not employed by the adviser.

pay to play activities through the rule's proposed prohibition on indirect violations.<sup>12</sup> To further ensure that other employees, such as portfolio managers, do not engage in pay to play practices, the SEC should require that registered advisers adopt written compliance policies and procedures designed to prevent pay to play activities by all employees. Advisers should review such policies on at least an annual basis and certify that they are reasonably designed to prevent pay to play activities by all employees.<sup>13</sup>

### **Look-Back Provision**

Under the proposed rule's look-back provision, a covered associate's contribution made before his or her employment at the adviser would subject the adviser to the compensation prohibition for two years after the contribution.<sup>14</sup> Even though the individual was not affiliated with the adviser, his or her contribution would be attributed to the adviser. Similarly, an adviser would become subject to the prohibition if an employee made a triggering contribution while at the firm but prior to becoming a covered associate.

We recommend that the SEC eliminate the look-back provision from the proposed rule, and only apply the rule to a contribution made by an employee that was a covered associate at the adviser at the time of the contribution. A look-back provision would be difficult to implement, interfere with an adviser's efforts to recruit qualified personnel, and further chill political activity among investment professionals. Any attempt by an adviser to circumvent the rule by making a restricted political contribution through individuals prior to their becoming a covered associate at the firm would be prohibited by paragraph (d) of the proposed rule.

As described above, we expect that advisers would seek to comply with the proposed rule by adopting compliance policies to broadly limit political contributions by employees, including mandatory pre-approval procedures. The look-back provision would require that an adviser also adopt procedures to ensure that future employees have not made a triggering political contribution in the prior two years. It would be difficult for advisers to implement measures that would provide complete assurance that the individual had not made a triggering contribution. At a minimum, an adviser would need to conduct pre-employment checks to determine whether a potential employee had made a triggering contribution. It is not clear, however, whether an adviser could conduct sufficient pre-employment checks to verify that a potential employee had not made a triggering contribution. A questionnaire or certification, for example, may not provide adequate comfort that hiring a new employee would not trigger the prohibition.

Furthermore, forcing an adviser to investigate a potential employee's political contributions would damage the recruiting process. An adviser would require a potential employee to identify all political contributions he or she had made within the previous two years.

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<sup>12</sup> Proposed Rule 206(4)-5(d).

<sup>13</sup> We do not believe it would be practical for a chief compliance officer to certify that pay to play activities have not occurred. Instead, the SEC should require advisers to adopt and implement appropriate measures to prevent these practices.

<sup>14</sup> Proposed Rule 206(4)-5(a)(1).

Such topics are inappropriate for discussion by an adviser and potential employee, and could lead to hiring decisions based on political considerations rather than relevant performance-based criteria. And if in fact the most qualified candidate had made a triggering political contribution within two years, an adviser probably would not hire that individual.

We expect that the proposed look-back provision would cause investment professionals and others outside the investment advisory industry to broadly refrain from making political contributions that could in the future trigger a prohibition for a potential new employer. The overwhelming majority of these contributions made prior to employment would not involve pay to play activities.

If the SEC nevertheless determines to apply a look-back, we recommend the following amendments to the proposed provision. At a minimum, the provision should be subject to the same limitations as those included in MSRB rule G-37. In particular, paragraphs (b)(ii) and (b)(iii) of rule G-37 include relevant carve outs to the look-back provision for certain “municipal finance professionals.” The SEC should also limit the look-back period for an individual who made a political contribution prior to being employed at the adviser to a reasonable time period, such as six months. Finally, the rule should include a provision permitting a firm to reasonably rely on an employee’s certification that he or she has not made a triggering political contribution within the prior two years.

### **Prohibition on Receiving Compensation**

Proposed Rule 206(4)-5 would penalize an adviser for a triggering political contribution by precluding it from receiving compensation from the government entity for two years. We believe the prohibition could in many circumstances be a disproportionately severe punishment and cause significant operational challenges for investment advisers.

Investors in a private fund organized as a limited partnership subscribe for interests by entering into an agreement with the fund’s general partner. The limited partnership agreement sets out, among other things, the terms of the investment and the duties of each party. While certain core elements are generally consistent among private funds, the structure of each private fund is unique, including compensation arrangements, redemption rights and other provisions. Moreover, many large investors, including public pension plans, receive additional terms and conditions relating to their interest. As a result, government entities invest in private funds subject to a wide range of contractual rights and obligations.

The proposed two year prohibition could raise a number of issues for private fund managers. For example, and as noted in the Release, the terms of a government entity’s investment in a private fund may not permit the entity to immediately redeem its interest. Hedge fund managers and investors agree to limit redemption rights for a variety of reasons, such as to reduce management fees or better align investor liquidity with underlying fund assets. Similarly, fund managers and investors typically agree to limit the percentage of an investor’s assets that it may redeem at any one time to reduce the likelihood that a fund would need to sell assets at inopportune times to meet redemption requests.

Under the proposed rule, if a private fund manager makes a triggering political contribution and the government entity is not permitted to immediately redeem its entire interest, the manager would continue to provide investment services without receiving compensation. Requiring the manager to provide advisory services for free would be a severe and disproportionate punishment to the manager in cases where the contribution did not involve any pay to play activity. Providing advisory services without compensation would also harm other investors in a fund if a manager could not enhance its advisory services,<sup>15</sup> or if investors were then responsible for a higher proportion of fund expenses.

Even if the terms of a government entity's investment in a private fund permitted a manager to immediately redeem the entity's interest,<sup>16</sup> a redemption could raise serious questions regarding the manager's fiduciary duty. In this respect, the SEC in the Release notes that an adviser subject to the compensation prohibition "would likely, at a minimum, be obligated to provide (uncompensated) advisory services for a reasonable period time."<sup>17</sup> While we do not take a view on whether an adviser would be under such a duty, we are concerned that an adviser subject to the compensation prohibition would need to choose between providing services for free, which could raise costs to other investors, or immediately redeeming the government entity. A fund forced to immediately redeem a large investor would need to enhance its liquidity by selling a significant percentage of its assets in a short period. This process would likely harm the fund's performance, and could in some cases lead to investor withdrawals and further liquidity issues of the type that some private funds experienced during the recent market turmoil. Neither the proposed rule nor the Release provides an adviser with guidance to make required choice.

We are also concerned that the prohibition on compensation could raise further interpretive issues for advisers. If a government entity continued as an investor in the fund, the compensation prohibition could have significant effects on compensation arrangements between the manager and other investors. For example, many institutional investors request that their fee is no higher than any other investor, or similar terms, and the compensation prohibition could trigger these existing contractual provisions. Also, following the two year period, a manager would need to determine how to apply its incentive fee structure, which often includes backward-looking provisions that incorporate prior returns. The Release does not describe how a manager would apply these and other contractual provisions in light of the compensation prohibition.

As set out above, the proposed rule would present advisers with significant uncertainty and operational challenges in identifying covered activity and implementing necessary compliance procedures. Because the definitions as proposed are subject to individual interpretation, advisers would need to make difficult determinations to avoid inadvertent

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<sup>15</sup> A manager may need to continue to provide significant services to a government entity, which often require managers to provide them with customized materials and services.

<sup>16</sup> Generally the government entity would also need to consent to a redemption under the terms of its agreement with the private fund manager.

<sup>17</sup> Release at 39847.

triggering contributions while permitting employees to participate in the political process. An adviser with no intention to engage in pay to play activities could easily unintentionally trigger the rule's compensation prohibition, which in turn would subject the adviser to a harsh penalty with potential harmful effects to both the manager and other investors in a pooled investment vehicle.

Accordingly, we recommend that the SEC amend the rule to provide it with flexibility to determine the appropriate penalty for an adviser on a case by case basis depending on the specific facts and circumstances of the violation. In cases where an adviser intentionally made or permitted political contributions as part of pay to play conduct, the SEC could apply the compensation prohibition as proposed. On the other hand, in cases of an unintentional contribution where an adviser had adopted and implemented appropriate compliance policies and procedures to prevent triggering contributions and pay to play activities, the SEC could in its discretion apply a lesser penalty in proportion to the relevant conduct. We believe such a flexible scheme for a violation of the proposed rule would be consistent with the approach taken with many other rules under the Advisers Act, and would more closely align the punishment with the conduct committed.

### ***De Minimis Contributions***

The proposed rule would permit each individual covered associate to make aggregate contributions of \$250 or less, per election, to an elected official or candidate the individual is entitled to vote for without triggering the compensation prohibition.<sup>18</sup> We support the goal of the *de minimis* exception to allow covered associates to participate in the affairs of their local and state government. We believe, however, that a contribution level of \$250 is too low to allow a covered associate meaningful political participation, and recommend that the Commission increase the level to at least \$1,000.

To permit an employee to make a contribution under the *de minimis* exception, an adviser would need to determine if the employee were eligible to vote for the individual. An adviser would need to review state and local voting eligibility requirements, and gather factual information on employees (*e.g.*, location of residence, registered party for primary elections). Such tasks are burdensome and outside the normal scope of advisers' activities.

We recommend that instead, the SEC amend the *de minimis* exception to also include officials and candidates for whom employees are not entitled to vote. Expanding the *de minimis* exception to include other government officials would also recognize the inherent public policy interest in allowing citizens to participate fully in the political process, which includes making contributions to officials in other jurisdictions. In the alternative, the SEC should at a minimum amend the proposed rule to permit an adviser to reasonably rely on a certification by an employee that he or she is entitled to vote for the official or candidate.

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<sup>18</sup> Proposed Rule 206(4)-5(b)(1).

### **Exception for Returned Contributions**

Proposed Rule 206(4)-5 would provide a second exception for contributions made by a covered associate of the investment adviser to officials for whom the covered associate was not entitled to vote at the time of the contributions and which, in the aggregate, do not exceed \$250 to any one official, per election. The adviser must have discovered the prohibition within four months of the date of the contribution and, within 60 days after learning of the triggering contribution, must cause the contribution to be returned to the contributor.<sup>19</sup> An adviser could not rely on the exception more than twice per 12-month period, or more than once for each covered associate during any time period.<sup>20</sup>

We appreciate the Commission providing an exception for cases where a triggering political contribution is either made without the adviser's knowledge or inadvertently approved under the adviser's compliance policies and procedures. As noted, inadvertent contributions would be a serious concern for advisers under the rule as proposed, and advisers would need to allocate significant compliance resources to prevent these contributions.

An inadvertent, returned contribution would not involve pay to play arrangements because it would not be intended to provide a benefit to a government official. We recommend that the SEC extend the exception for returned contributions to cases where the contributed and returned amount is up to \$1,000, regardless of whether the covered associate was entitled to vote for the official receiving the contribution. In the alternative, the SEC could reduce the compensation prohibition for such inadvertent contributions from two years to a much shorter period, such as 60 days. Both modifications would more closely tailor the penalties in the proposed rule with political contributions that could involve pay to play arrangements.

### **Exemption from Proposed Rule**

The proposed rule would also permit an adviser to apply to the SEC for exemption from the two year compensation prohibition. In determining whether to grant the exemption, the SEC would consider a number of factors.<sup>21</sup> While we support the inclusion of an exemptive process, we are concerned that its benefits to advisers might be limited. We understand that market participants have generally had difficulty obtaining waivers from the similar prohibition in MSRB rule G-37, and that those granted are typically only related to the application of the look-back provision. We recommend that the SEC affirm that in cases where an adviser meets all or most of the factors listed in the proposed rule, it will grant the adviser an exemption. This would provide advisers additional assurance that inadvertent contributions would not trigger the

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<sup>19</sup> It is not clear from the Release how an adviser could secure an already made political contribution and return the funds to the contributor. The SEC should describe appropriate steps for an adviser to take to comply with the exception.

<sup>20</sup> Proposed Rule 206(4)-5(b)(2).

<sup>21</sup> Proposed Rule 206(4)-5(e).

prohibition in many cases where the adviser had adopted appropriate compliance policies and procedures.

### **Pooled Investment Vehicles**

Under proposed Rule 206(4)-5, an investment adviser to a “covered investment pool” in which a government entity invests or is solicited to invest would be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity. A “covered investment pool” would include, among other things, a company that relies on the exclusion from the definition of investment company in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.<sup>22</sup> The Rule would prohibit an adviser to a covered investment pool from providing investment advisory services for compensation to a government entity for two years if the investment adviser or any covered associate of the adviser makes a contribution to an official of the government entity.<sup>23</sup>

We are concerned that the application of the proposed rule to a private fund manager could subject the manager to the restrictions on political contributions when the manager does not know that a government entity is, or is being solicited to be, an indirect investor in the fund. While it is generally true that a manager is aware that an investment from a government entity is being solicited when a government entity invests directly in a private fund, a government entity could become an indirect, underlying investor in a private fund through its investment in another financial intermediary, such as a fund of hedge funds or other structure. In these cases, a manager does not know the identities of any underlying investors, including any government entities, nor control which investors were solicited or permitted to invest in the structure.

We believe it would be impractical and not serve to prevent pay to play activity if the proposed rule were to subject private fund managers to the contribution restrictions when a government entity was not a direct investor in a private fund, but rather was an indirect, underlying investor in a structure that itself invested in the fund. A private fund manager typically is not provided, and does not know, the identities of such underlying investors, and therefore would not engage in pay to play activities with respect to the government entity. This situation is akin to the proposal to exempt managers to registered investment companies with publicly offered securities from the rule under certain circumstances because the managers may not be aware that a government entity has made an investment in the company.<sup>24</sup> We believe the same analysis should apply to private fund managers with no knowledge of a government entity that is an indirect, underlying investor through an intermediary, such as a fund of hedge funds. The SEC should amend the proposed rule to apply only to a government entity’s direct investment in a covered investment pool, and not apply if a government entity invests in a private fund through an intermediary. Similarly, the proposed rule should not apply when an adviser manages a private fund through a platform arrangement because the adviser would not

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<sup>22</sup> Proposed Rule 206(4)-5(f)(3).

<sup>23</sup> Proposed Rule 206(4)-5(a)(1).

<sup>24</sup> Release at 39857.

know the identity of the direct investors in the fund, nor would it have the authority to solicit investors for the fund.

### **III. PROHIBITION ON PLACEMENT AGENTS**

In addition to restricting political contributions, the proposed rule would seek to prevent pay to play arrangements through an outright ban on investment advisers engaging third party placement agents to solicit government entities.<sup>25</sup> MFA recognizes the need for increased scrutiny of the activities of entities involved with managing public pension plan assets in light of the recent pay to play scandals. We strongly agree that “practices known as ‘pay to play’ distort the process by which investment advisers are selected and . . . can harm advisers’ pension plan clients, and thereby beneficiaries of those plans, which may receive inferior services and pay higher fees.”<sup>26</sup> Nevertheless, MFA questions whether a ban on advisers engaging third party solicitors is either necessary or appropriate to achieve the goal of abolishing pay to play activity. Such a rule would preclude a substantial amount of useful, legitimate activity, harm competition among private fund managers, reduce resources available to government entities, and significantly alter existing industry practice for advisers soliciting potential government clients. We recommend that the Commission instead adopt alternative measures to increase transparency and restrict investment advisers from engaging placement agents that make political contributions.

An important consequence of a prohibition on the use of placement agents in soliciting government clients would be to disadvantage hedge fund managers, including small and offshore managers, that lack internal personnel to perform marketing activities and rely on third party placement agents to solicit institutional clients. While hedge fund managers may use internal personnel to conduct some marketing activities, such personnel generally have a primary job function, such as portfolio management, that is unrelated to marketing. This limits the amount of time they may devote to marketing. In addition, firms that choose not to register as a broker-dealer are limited as to the nature of client solicitations by their employees. Many firms prefer to engage third party placement agents rather than incur substantial expenses to register as a broker-dealer. As a result, hedge fund manager employees tend to perform only certain marketing functions and these are primarily directed toward small institutions and individuals.

In contrast, for larger, institutional clients, hedge fund managers frequently engage the services of third party placement agents. Third party placement agents perform a variety of services for hedge fund managers, including arranging and attending meetings, reviewing presentation materials, and assisting with responding to requests for proposals and completing due diligence questionnaires. Placement agents experienced in working with pension plans can enhance an adviser’s presentation of its investment advisory services to a government entity and explain how the investment techniques of a particular adviser would fulfill the entity’s investment objectives.

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<sup>25</sup> Proposed Rule 206(4)-5(a)(2)(i).

<sup>26</sup> Release at 39866.

Government entities often use placement agents to assist them with identifying potential advisory firms that would meet their investment objectives, risk management and other investing criteria. Because government entities may not employ personnel with significant experience in alternative investments, and hedge fund managers are not permitted to publicly advertise their services, often government entities have difficulty identifying appropriate managers without the assistance of placement agents. Under the proposed rule, investment advisers would be prohibited from using placement agents to present their services to government entities, eliminating an important resource that many government entities rely on. In this respect, we understand that a number of public pension plans have expressed opposition to the proposed ban because they depend on placement agents to perform these functions.

Because public pension plans are more likely to be familiar with larger, well-known managers, small and offshore managers attempt to level the playing field by engaging third party placement agents to market their services. The proposed rule would prohibit these arrangements and prevent them from effectively competing with larger managers. It could also raise issues for managers that regularly receive capital introduction services from prime brokers or other entities. In addition, the proposed rule would have further anti-competitive effects by permitting investment advisers to directly employ personnel to solicit government entities. Small managers have fewer resources to retain such personnel, and offshore managers would face significant regulatory obstacles in order to structure their marketing efforts to comply with the proposed rule.

We also note that the ban on third party placement agents may directly contradict rules adopted by states and public pension plans governing the use of placement agents. Many states and public pension plans have adopted policies requiring their external managers to disclose information about their relationship with placement agents, including any fees paid to the placement agent for performing solicitation services.<sup>27</sup> As but one example, the California Public Employees' Retirement System ("CalPERS") recently adopted extensive disclosure requirements for external managers that seek to manage its assets. External managers must provide to CalPERS, among other things: (i) a statement of whether the manager compensated a placement agent in connection with an investment by CalPERS; (ii) a resume for each officer of the placement agent; (iii) a description of any compensation to the placement agent; (iv) a description of the services to be performed by the placement agent; and (v) all agreements with the placement agent.<sup>28</sup>

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<sup>27</sup> We understand that the following pension plans and states, among others, require disclosure of placement agent information: CalPERS, CalSTRS, Los Angeles County Employees' Retirement System, Los Angeles City Employees' Retirement System, New Mexico Educational Retirement Board, Teacher Retirement System of Texas, Pennsylvania Public School Employees' Retirement System, the Pennsylvania State Employment Retirement System, Connecticut, Massachusetts, Oklahoma and Washington. We understand that bans on the use of placement agents are limited to the New York State Common Retirement Fund, the New York City Employees' Retirement System, the New Mexico Investment Council, New York and Illinois.

<sup>28</sup> CalPERS Statement of Policy for Disclosure of Placement Agent Fees (May 11, 2009), available at: <http://www.calpers.ca.gov/eip-docs/investments/policies/ethics/disclosure-placement-agent-fees.pdf>.

We believe it is instructive that many policy makers most closely affected by pay to play practices have chosen to require disclosure rather than adopt a ban on placement agents. During the recent pay to play scandals, a number of pension plans revisited their current policies on disclosure and concluded that a tightening was unnecessary.<sup>29</sup> In addition, the citations in the Release to jurisdictions and pension plans supporting a ban on placement agents are solely limited to New York State and its pension plans.<sup>30</sup> Few states have seemed to follow New York's approach. We also point out that the proposed rule could intrude on the discretion of states and public pension plans to adopt appropriate rules to address pay to play practices in their jurisdictions.<sup>31</sup>

## **Recommendations**

We recommend that the SEC not ban advisers from using third party placement agents, but instead adopt alternative measures, such as the following, to prevent pay to play arrangements.

First, the SEC should require that advisers engaging a third party placement agent to solicit a government entity disclose all relevant information about their relationship with the placement agent to government officials involved with the selection process. We recognize that disclosure alone in some cases may not be sufficient to prevent pay to play practices. We believe, however, that increased transparency is an important and necessary requirement to ensure that government entities have access to the information. Disclosure of placement agent relationships would allow government entities to more closely scrutinize the selection process involving any particular investment adviser.

Second, the SEC should consider requiring placement agents to register with the Commission. We note that many placement agents currently rely on certain exemptions under existing securities laws that permit them to conduct their business without SEC registration. As a result, all placement agents do not operate under a uniform set of requirements and instead are governed by various state and federal laws, regulations and policies. Registration with the SEC would provide a consistent set of rules as well as enhanced oversight of the industry.

Third, the SEC should amend Rule 206(4)-3, its cash solicitation rule, under the Advisers Act to require that all written agreements between a registered investment adviser and a solicitor include a provision prohibiting the solicitor from directly or indirectly making a political contribution to any state or local government official with oversight or direct authority to affect the selection of investment advisers for a state or local pension plan. As noted in the Release, it would be impractical for an adviser to monitor and prevent a placement agent from making a triggering political contribution. We believe, however, that a contractual restriction would provide an additional incentive for the placement agent to avoid making such contributions. A

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<sup>29</sup> See e.g., *Some Pensions Plan No Policy Changes on Placement Agents*, WALL STREET JOURNAL (May 5, 2009).

<sup>30</sup> Release at 39843.

<sup>31</sup> The SEC should clarify how proposed Rule 206(4)-5 would affect state laws. See *supra* note 5.

provision of this type is well suited for inclusion in Rule 206(4)-3, which already requires advisers to enter into a written agreement with a solicitor and sets out specific terms the agreement must contain.<sup>32</sup>

Finally, the SEC should amend Rule 204A-1, its code of ethics rule, to require each registered investment adviser to adopt policies and procedures designed to prevent the adviser from engaging in pay to play practices.<sup>33</sup> Such a requirement would provide additional assurance that advisers implement measures to prevent employees from inappropriate activity in connection with a third party placement agent.

#### **IV. ADDITIONAL COMMENTS**

##### **Recordkeeping**

Proposed amendments to Rule 204-2 under the Advisers Act would require a registered investment adviser that has or seeks government clients to make and keep certain records of contributions made by the adviser and its covered associates.<sup>34</sup> As noted above, because the rule as proposed does not provide sufficient guidance about which employees are “covered associates” and employees will regularly become “covered associates” as they assume new positions, we expect that advisers would make and keep records for all or most employees. The rule would add to the already substantial amount of materials that registered advisers must maintain pursuant to Rule 204-2. In addition, because such records are not created during the ordinary course of an adviser’s business, advisers would need to implement procedures to regularly create such records. Such extensive recordkeeping would impose a significant burden on advisers and require that they further intrude on the private political activities of their employees.

We recommend that the SEC not extend the records that must be kept beyond those proposed in the Release, and consider narrowing the requirements. The recordkeeping rules would impose substantial compliance costs for the overwhelming majority of advisers that do not engage in pay to play practices and seek to comply with the proposed rule. The SEC should consider whether the costs of each recordkeeping requirement – for example, that the adviser record all contributions made to a political action committee or political party, even though such contributions are permitted – may outweigh its potential benefit of deterring and uncovering pay to play arrangements.<sup>35</sup>

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<sup>32</sup> We note that under current SEC guidance, the cash solicitation rule would apply to separate account arrangements, but not pooled investment vehicles. Nevertheless, we believe many private fund managers would include the proposed provision in their agreements with placement agents as an industry best practice.

<sup>33</sup> We recommend that the SEC not require an executive officer to certify that the adviser or its covered associates did not participate in pay to play activities. We believe in some cases it could be difficult for an officer to make such a certification, and requiring that advisers adopt and implement policies and procedures would be more appropriate.

<sup>34</sup> Proposed Rule 204-2(a)(18).

<sup>35</sup> Proposed Rule 204-2(a)(18)(i)(D).

### **Transition Period**

All investment advisers subject to the proposed rule would need to adopt and implement policies and procedures to monitor and approve employee political contributions. Many advisers will need to acquire and implement systems to automate the process. Certain advisers would also need to restructure their marketing practices, which may include hiring additional personnel, in response to the prohibition on the use of third party placement agents. The rule should allow for a transition period of at least six months, and up to a year for the placement agent prohibition, to provide sufficient time for advisers to institute these changes.

### **Cost Estimates**

In utilizing its rulemaking authority, it is important for the Commission to analyze the potential costs of new regulations on industry participants. We believe the costs of compliance with proposed rule 206(4)-5 to investment advisers would be significantly higher than estimated in the Release.

The SEC underestimates the number of investment advisers, including private fund managers, that would incur costs to comply with the proposed rule. The Commission estimates that 1,764 registered investment advisers and 231 unregistered advisers may be affected by the proposed rule based on its interpretation of data on Form ADV.<sup>36</sup> The data, however, only includes information on the number of registered advisers with government clients that are not investors in pooled investment vehicles.<sup>37</sup> We believe the estimates of the number of registered and unregistered private fund managers that have or seek government clients are too low.

The SEC indicates, for example, that advisers with government clients or that solicit government clients would incur compliance costs to monitor political contributions.<sup>38</sup> All registered advisers, however, would be obligated under Rule 206(4)-7 to establish appropriate compliance policies and procedures that would include monitoring and pre-approval policies. Advisers would also need to expend resources to identify and interpret the numerous state and local election laws in implementing their policies. In addition, advisers that currently, or may in the future, use third party placement agents to solicit government clients would likely face substantial costs to reorganize their marketing efforts.

Statistics in the Release indicate that large registered advisers are more likely to have an affiliated broker-dealer market their products, and that these advisers would already have implemented procedures to prevent pay to play practices.<sup>39</sup> Private fund managers, however, are

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<sup>36</sup> Release at 39862.

<sup>37</sup> Release at note 216.

<sup>38</sup> Release at 39861.

<sup>39</sup> *Id.*

unlikely to have already adopted similar procedures to comply with MSRB rules G-37 and G-38 because most managers are not involved in municipal underwriting.

For the reasons described above, we expect that advisers would require most of their employees to receive approval prior to making any political contributions. We therefore disagree with statements in the Release indicating that most registered advisers would have fewer than five covered associates, and that most unregistered advisers would have only a small number of covered associates.<sup>40</sup> For the reasons described above, we also believe that the initial and ongoing compliance cost estimates in the Release are far too low.<sup>41</sup>

Finally, the proposed rule would subject certain managers to substantial costs that the SEC should incorporate into its analysis: managers that inadvertently trigger the compensation prohibition would lose fees from a government client; managers that engage placement agents, particularly small and offshore managers, would lose the ability to market their services to government clients or incur significantly higher costs to hire internal marketing personnel; and managers that hire internal personnel could spend substantial amounts to register as a broker-dealer.

## V. CONCLUSION

We support the Commission's efforts to prevent pay to play arrangements and believe the recommendations set out above would deter advisers from making improper political contributions or using third party placement agents for pay to play activities while allowing advisers to more effectively meet their obligations to their clients. We welcome an opportunity to further discuss any of the recommendations made above with Commissioners or its staff if it would assist in your rulemaking efforts. If the Commissioners or staff have any questions or comments, please contact Matthew Newell or the undersigned at (202) 367-1140.

Respectfully submitted,

/s/ Stuart J. Kaswell

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<sup>40</sup> Release at 39862.

<sup>41</sup> *Id.*