SIFMA

Securities Industry and Financial Markets Association

October 5, 2009

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

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association (**"SIFMA"** or **"we"**)[1] appreciates this opportunity to comment on Proposed Rule 206(4)-5 (the **"Proposed Rule"** or the **"Rule"**) which the Securities and Exchange Commission (**"SEC"**) issued for comment on August 7, 2009.[2] SIFMA strongly supports the Proposed Rule's stated goal of eliminating pay-to-play practices from the selection of investment advisers by government entities[3] and applauds the SEC's efforts to address this complicated issue. Like the SEC, SIFMA believes in the importance of preserving a well-functioning market for investment advisers, and supports measures that would prevent distortion of the market as a result of improper political influence.

We are concerned, however, that the Proposed Rule is not reasonably calculated to achieve these important regulatory objectives. An anti-pay-to-play rule in connection with investment advisory services needs to balance competing considerations — it must inhibit the award of investment advisory contracts on the basis of political contributions, while simultaneously protecting the overall functioning of the market and preserving the ability of government entities to identify and select the investment adviser of their choice. A rule that sweeps too broadly, restricting parties' ability to identify qualified advisers or to select their preferred adviser even in cases where there is little to no risk of market distortion will work to the detriment of those government entities the rule is intended to benefit. In addition, a rule regulating pay-to-play must take into account its practical implementation and administration.

---

1 SIFMA is a 501(c)(6) organization that represents the shared interests of participants in the global financial markets. SIFMA members include international securities firms, U.S.-registered broker-dealers and asset managers. The Association represents the industry on regulatory and legislative issues and initiatives, and also serves as a forum for outreach, training, education, and community involvement. SIFMA has offices in New York, Washington D.C., London and Hong Kong, where our sister organization, the Asia Securities and Financial Markets Association, is located.

2 Political Contributions by Certain Investment Advisers, Proposed Rules, 74 Fed. Reg. 39,840 (August 7, 2009) (hereinafter **"NPRM"**).

3 Unless otherwise indicated, the term **"government entities"** will be used in this letter to include any State or political subdivision of a State, as well as any agency, authority, or instrumentality of the State or political subdivision, a pension fund or other pool of assets sponsored or established by a State or political subdivision or any agency, authority or instrumentality thereof.

Particularly in the case of a rule intended to ensure open and undistorted competition for advisers on the merits, over-breadth or problems of administrability may ultimately impair competition by unreasonably excluding competitors and increasing the search costs to consumers of advisory services.

EXECUTIVE SUMMARY

We believe that the Proposed Rule (1) sweeps too broadly, and its prohibition-based pay-to-play framework will disrupt existing regulatory and market structures and limit the options available to government investors; and (2) fails to address key issues relating to compliance, thereby making compliance with the Proposed Rule for many investment advisers unnecessarily costly and impractical.

We have four principal areas of concern with respect to the scope of the Proposed Rule: (1) the ban on the use of third-party solicitors to place fund interests with government entities (**"Proposed Placement Agent Ban"**); (2) the imposition of a two-year ban on receiving compensation for providing investment advisory services to a government entity if a party makes an impermissible political contribution to an official of the government entity (**"Two-Year Ban"**); (3) the prohibition on the use of third-party solicitors in connection with obtaining investment advisory service contracts from government entities (**"Third-party Solicitor Ban"**); and (4) the treatment of advisers to private investment pools in which government entities have invested or were solicited to invest as the equivalent of advisers to government entities (**"Covered Investment Pool Restrictions"**). In each of these areas, the Proposed Rule's reach is more expansive than necessary and ultimately affects productive activity unrelated to pay-to-play concerns.

We also are concerned about certain impracticalities of the Proposed Rule's approach to compliance issues. The Proposed Rule draws heavily from Municipal Securities Rulemaking Board (**"MSRB"**) Rule G-37 and MSRB Rule G-38, the federal pay-to-play and solicitation rules that apply in the context of the municipal securities business. While Rule G-37 and Rule G-38 can provide some guidance in developing a pay-to-play regime in the context of investment advisory services, it is problematic to rely too heavily on the MSRB's framework. There are significant differences between the municipal securities business and the investment advisory business, both in the terms of the legal framework in which each business line functions and in terms of how each business line is organized and operated. As a result, certain compliance issues, such as identifying and then restricting covered personnel, would be more challenging in the investment advisory context under the Proposed Rule than in the municipal securities context under the MSRB rules. In addition, the Proposed Rule fails to fully define terms which advisers need to understand if they are to design effective compliance programs. Most significantly, the Proposed Rule does not include a definition for the term "investment advisory services," even though the provision of such services is the Proposed Rule's central focus, thereby complicating any serious compliance effort.

Accordingly, our concern is that, in its currently proposed form, the Proposed Rule will result in market distortion as its overly broad reach will inhibit the identification of a broad range of investment advisers and, in some cases, may prevent government entities from selecting an adviser of their choice in circumstances where political contributions have had no influence on the selection process. At the very least, by prohibiting the use of third-party solicitors, the Proposed Rule will make it difficult for many investment advisers — particularly small or new investment advisers — to compete meaningfully for the business of government entities. In addition, because of the substantial compliance costs associated with the Proposed Rule and the difficulty that many advisers are likely to have in implementing an effective compliance program, many advisers may choose to not provide advisory services to government entities and covered investment pools (*i.e.*, funds that hold or have solicited public investment) rather than attempt to comply with the Proposed Rule's strictures. Thus, we believe that the Proposed Rule will have the unintended consequence of limiting the universe of potential investment advisers for government entities.

As noted above, SIFMA agrees with the SEC on the importance of addressing pay-to-play and the need to prevent political contributions from subverting the provision of investment advisory services. But we are concerned that the benefits intended by the Proposed Rule will be undercut by the problems with respect to scope and compliance inherent in the Proposed Rule's present form.

Therefore, we respectfully request that the SEC consider the alternative approaches set forth below. We also urge the SEC to work with the industry — perhaps along the lines of the Voluntary Initiative of 1993,[4] which was a precursor to Rule G-37 — to ensure that whatever regime is ultimately adopted is reasonably tailored to the nuances of the asset management industry.

I. THE PROPOSED PLACEMENT AGENT BAN IS INCONSISTENT WITH THE U.S. REGULATORY REGIME FOR BROKER-DEALERS

The primary problem surrounding the Proposed Placement Agent Ban is that the Proposed Rule treats the sale or placement of fund interests[5] as the regulatory and functional equivalent of the solicitation of advisory services. Although not defined, the NPRM uses the term "investment advisory services" throughout to describe, among other things, the solicitation and placement of private fund interests with government entities.[6] There is, however, a significant substantive and regulatory difference between (a) the sale of securities and the solicitation of securities transactions and (b) solicitation for advisory services. The sale and distribution of securities is governed by the Securities Act of 1933 (**"Securities Act"**) and the Securities Exchange Act of 1934 (**"Exchange Act"**), respectively, and the solicitation of advisory services is governed by the Investment Advisers Act of 1940 (**"Advisers Act"**). The Proposed Rule's treatment of both activities as similar functions disrupts and confuses the long-standing regulatory posture of the SEC with respect to broker-dealers and issuers engaged in the placement of their own fund interests.

---

4 On October 18, 1993 seventeen municipal securities dealers agreed to adopt a "Statement of Initiative," providing the political contributions made, in any manner, for the purpose of influencing the awarding of municipal finance business should be prohibited. *See* Municipal Securities Rulemaking Board, Exchange Act Release No. 34-33,868, 59 Fed. Reg. 17,621 (April 13, 1994) n.40 and accompanying text. This initiative between the industry and the SEC helped lay the foundation for current Rule G-37.

5 *E.g.*, limited partnership or membership interests in hedge funds, private equity funds, or venture capital funds.

6 *See, e.g.*, NPRM, 74 Fed. Reg. at 39,845, 39,852–53 (particularly n.137 and accompanying text).

SIFMA believes the SEC's interests would be better served by reasserting its longstanding position under the Exchange Act with respect to the placement of securities and underscoring and amplifying the existing prohibition on the use of ***unlicensed*** intermediaries from any type "finder" or other placement agent activity involving securities transactions, including securities transactions with government entities.[7] This approach would not only be consistent with the existing regulatory regime for broker-dealers (and exempt issuers engaged in the placement of their own securities) but it also would address substantially the interests that the Proposed Rule seeks to serve, including ensuring that the SEC, the Financial Industry Regulatory Authority (**"FINRA"**) and other securities regulators would be able to examine these placement activities. Registered broker-dealers are regularly examined by the SEC and FINRA, and registered broker-dealers therefore could more readily adapt current policies and procedures to include pay-to-play regulations tailored to placement agent activities than investment advisers. Accordingly, SIFMA respectfully submits that placement activities — and the risk of corruption associated with such activities — would be better regulated through ***registered*** broker-dealers.

There is, moreover, no evidence that registered placement agents pose a systemic problem in the pay-to-play arena, and none is provided in the NPRM. Among the examples of pay-to-play enforcement actions identified in the NPRM, the involvement of registered placement agents is more an exception than the rule. Unlike politically connected "finders" or "fixers," institutional placement agents are registered broker-dealers and are authorized to engage in placement agent activities, subject to the strict rules, licensing, and authorization requirements of FINRA,[8] as well as the strict internal policies established by each firm. Under the Proposed Rule, these highly-regulated and knowledgeable intermediaries will be negatively impacted, and in some cases, particularly small broker-dealers which exist primarily as third-party placement agents for smaller funds, may cease doing business. Instead of relying on these registered intermediaries, hundreds, if not thousands, of private firms (who are rarely registered as investment advisers) will be dealing directly with government entities. Put simply, eliminating the use of regulated registered securities professionals in the placement of fund interests could raise, rather than reduce, the potential for corruption in the investment activities of government entities.

Based on the foregoing and for the reasons set forth below, we respectfully request that the SEC reconsider its approach under the Proposed Placement Agent Ban and address the issue by first reasserting and clarifying the requirements under the Exchange Act to use registered and authorized broker-dealers to place fund interests (or rely on an appropriate exemption) and, second, by working with the placement agent sector to create an effective pay-to-play regime applicable to those broker-dealers that place fund interests with government entities.

---

7 *See* Section 15(a) of the Exchange Act, 15 U.S.C. § 78o, and related guidance (*e.g.*, BondGlobe, Inc., SEC No-Action Letter (Feb. 6, 2001); Hallmark Capital Corporation, No-Action Letter (June 11, 2007) (declining to provide no-action relief to finder); and John W. Loofbourrow Associates, Inc., No-Action Letter (June 29, 2006) (declining to provide no-action relief to registered broker-dealer wishing to compensate unregistered finder)).

8 A broker-dealer may only engage in the securities activities authorized by FINRA, as set forth in the broker-dealer's membership agreement and reflected on its Form BD.

A. Regulation of Brokerage Activity Pursuant to the Proposed Placement Agent Ban Arguably Exceeds the SEC's Authority under the Advisers Act

As a threshold matter, we believe that the Proposed Placement Agent Ban may exceed the SEC's statutory authority under Section 206 of the Advisers Act. Section 206(4) authorizes the SEC to adopt "rules and regulations," but expressly requires that such rules be "reasonably designed" to prevent "investment adviser[s]" from engaging in "fraudulent, deceptive, or manipulative" practices.[9] The Proposed Placement Agent Ban, although framed as a regulation of investment advisers, instead appears to regulate the sale of securities by issuers (funds) and the placement of such securities by broker-dealers. Any nexus between inhibiting fraudulent practices by investment advisers and restricting the use of placement agents to place securities of issuers would be so remote as to raise serious questions as to whether it is "reasonably designed" within the meaning of the statute. To the extent that the Proposed Placement Agent Ban seeks to regulate the placement of securities by private funds by prohibiting the use of "placement agents," we believe that there are very serious questions as to whether such regulation is consistent with the SEC's authority under the Advisers Act.

The Advisers Act restricts the definition of investment adviser to certain categories of individuals and entities.[10] As the text[11] and legislative history[12] of the Act make clear, parties who merely engage in the placement of securities do not fall within the statute's definition. The Advisers Act was not adopted to regulate brokerage activity or the activities of issuers of securities, but rather "was designed to apply to those persons engaged in the investment advisory profession — those who provide personalized advice attuned to a client's [investment] concerns."[13] The Advisers Act expressly excludes broker-dealers from the definition of

---

9 15 U.S.C. § 80b-6.

10 *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

11 The Advisers Act expressly defines "investment adviser" as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." 15 U.S.C. § 80b-2(a)(11).

12 *See Lowe v. SEC*, 472 U.S. 181, 190–202 (1985) (discussing the Advisers Act's legislative history at length). In addition, the findings of Congress accompanying the Advisers Act provide that:

> [I]t is hereby found that investment advisers are of national concern, in that, among other things—
>
> 1. their advice, counsel, publications, writings, analyses, and reports are furnished and distributed, and their contracts, subscription agreements, and other arrangements with clients are negotiated and performed, by the use of the mails and means and instrumentalities of interstate commerce;
> 2. their advice, counsel, publications, writings, analyses, and reports customarily relate to the purchase and sale of securities traded on national securities exchanges and in interstate over-the-counter markets, securities issued by companies engaged in business in interstate commerce, and securities issued by national banks and member banks of the Federal Reserve System; and
> 3. the foregoing transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system and the national economy.
>
> 15 U.S.C. § 80b-1.

13 *Lowe*, 472 U.S. at 207–08.

"investment adviser" — and, in fact, goes so far as to exclude broker-dealers that *do* serve as investment advisers, so long as investment advisory activity is only incidental to their brokerage business.[14] Moreover, at the time the Advisers Act was enacted in 1940, securities transactions were already covered by the Securities Act and the Exchange Act expressly regulated the conduct of broker-dealers.[15] The Advisers Act was thus adopted in part to address the problem of fraudulent, deceptive, and manipulative practices in the provision of investment advisory services — a problem that neither the Securities Act nor the Exchange Act previously had reached.[16] Persons who place securities, including private fund interests, therefore cannot be viewed as acting as investment advisers or subject to regulation under the Advisers Act.

The SEC, of course, can regulate the placement of securities and the activities of broker-dealers under the Securities Act or the Exchange Act. Indeed, because such statutes were specifically designed to regulate securities transactions, both Section 17(a) under the Securities Act and the SEC's authority over broker-dealers and markets under the Exchange Act provide the SEC with far better means to accomplish its objective of overseeing conduct in these markets and inhibiting pay-to-pay activities of, or on behalf of, issuers in connection with the sale of securities than the Advisers Act.

B. The Proposed Placement Agent Ban Is Inconsistent with the Exchange Act Requirements for Broker-Dealers and Issuers Placing Their Own Fund Interests

Even if it were within the scope of the SEC's authority under the Advisers Act, the primary problem with the Proposed Placement Agent Ban is that it is inconsistent with the existing regulatory framework under the Exchange Act applicable to placement agent activity. Subject to certain limitations,[17] licensed and properly authorized broker-dealers generally are permitted to place all types of securities, including fund interests, regardless of the purchaser of the securities or the type of the private issuer. The Exchange Act permits the sale of securities by parties other than registered broker-dealers in limited circumstances, but the primary purpose of the U.S. broker-dealer regulatory regime is to ensure the integrity of the markets by requiring that securities transactions are principally handled by licensed broker-dealers who are subject to significant regulatory requirements, examination, and oversight. The Proposed Placement Agent

---

[14] 15 U.S.C. § 80b-2(a)(11)(C) (emphasis added); *cf. Fin. Planning Assoc. v. S.E.C.*, No. 04-1242, 2007 U.S. App. LEXIS 7356 (D.C. Cir. Mar. 30, 2007).

[15] *See Lowe*, 472 U.S. at 190–92.

[16] The SEC cannot expand the definition of investment adviser to encompass parties which place securities. An agency only may define the scope of its authority under a particular statute if (1) the statutory language is ambiguous, and (2) the agency's proposed definition is reasonable. *Chevron U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837 (1984). In this case, given that the text and legislative history of the Advisers Act demonstrate that Congress did not intend the statute to reach brokerage activity, the SEC lacks the authority to adopt a contrary definition.

[17] For example, a broker-dealer would be prohibited from recommending an unsuitable product to a retail investor (*see, e.g.*, NASD Rule 2320) or can be prevented from selling a security to an investor that is not an accredited investor, a qualified purchaser, or Qualified Institutional Buyer (**"QIB"**) in certain private placement transactions (*e.g.*, Rule 506 offerings may only be sold to accredited investors and Rule 144A offerings may only be offered to QIBs). Further, a broker-dealer could not sell certain products such as municipal securities, options, or variable life products without the appropriate licenses and supervisory structure.

Ban, however, conflicts with this robust regulatory regime by forbidding private funds to use registered broker-dealers to place their fund interests with government entities, including public pension funds. As a result of this conflict, the Proposed Placement Agent Ban is likely to create confusion concerning the SEC's requirements regarding the placement of securities and to undermine the existing Exchange Act regulatory structure applicable to broker-dealers.

Section 15(a) of the Exchange Act generally requires any broker-dealer that uses the mails or any means of interstate commerce to effect, induce, or attempt to induce securities transactions to register as a broker-dealer. Section 3(a)(4) of the Exchange Act broadly defines "broker" as any person "engaged in the business" of "effecting transactions in securities" for the account of others (the **"two-part test"**).[18] One of the most significant factors in the SEC staff's analysis regarding whether a person is "effecting" a securities transaction is whether the person in question has been engaged in "solicitation," which the staff has broadly interpreted to mean any affirmative effort intended to induce a securities transaction or to develop an ongoing securities business relationship.[19] The definition of securities is broad, and typically encompasses the sale of a fund interest (frequently limited partnership or membership interests).[20] Therefore, except under the limited circumstances described below, SEC staff generally will view any person who solicits potential investors to purchase fund interests as soliciting a securities transaction and therefore subject to broker-dealer registration.

There are, however, limited circumstances in which a person may place securities without registering as a broker-dealer. The so-called "issuer's exemption" under Exchange Act Rule 3a4-1 provides a safe harbor from broker-dealer registration for employees and other "associated persons"[21] of an issuer who place the issuer's own securities, assuming certain conditions are met.[22] As an "issuer," a private fund would not be considered in the first instance to be acting as

---

18 The staff of the SEC's Division of Trading and Markets is responsible for interpreting Section 15(a) and has historically relied upon the "two-part test" when determining whether a person must register as a broker-dealer. For a person to be a broker-dealer, both parts of the test must be met. The "two-part test" has been clarified by the staff in numerous no-action letters and other guidance to include the solicitation of securities transactions for compensation. *See, e.g.*, note 7, *supra*; *see also* John R. Wirthlin, No-Action Letter (Jan. 19, 1999) (reiterating that receipt of transaction-based compensation is a "hallmark of being a broker-dealer"); GlobalTec Solutions, LLP, No-Action Letter (Dec. 28, 2005); Herbruck, Alder & Co., No-Action Letter (June 4, 2002).

19 While it may be possible for an investment adviser to avoid triggering broker-dealer registration by only engaging in one part of the two-part test, the solicitation of a securities transaction is becoming a more significant factor in the staff's determination as to whether a person is required to register as a broker-dealer. *See, e.g.*, Division of Trading & Markets, "Guide to Broker-Dealer Registration" (Apr. 2008); Dilworth Capital Management, LLC, No-Action Letter (Dec. 9, 2004) (declining to provide no-action relief from register for individual to "selectively market" certain securities); MuniAuction, Inc., No-Action Letter (Mar. 13, 2000) (determining that MuniAuction must register because, among other things, it "solicits issuers and other securities holders to use its auction services . . . .").

20 Section 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10).

21 Exchange Act Rule 3a4-1(c) defines ***"associated person of an issuer"*** as "any natural person who is a partner, officer, director, or employee of: (i) The issuer; (ii) A corporate general partner of a limited partnership that is the issuer; (iii) A company or partnership that controls, is controlled by, or is under common control with, the issuer; or (iv) An investment adviser registered under the Investment Advisers Act of 1940 to an investment company registered under the Investment Company Act of 1940 which is the issuer."

22 Exchange Act Rule 3a4-1 provides that an associated person (or employee) of an issuer who participates in the sale of the issuer's securities would not have to register as a broker-dealer if that person, at the time of

a "broker" in the sale of its own securities because it would be presumed to be engaged in a business other than securities sales and therefore would not be acting in an agency capacity. The issuer would also not be considered a "dealer" under Section 3(a)(3) of the Exchange Act because it would not be "engaged in the business of buying and selling securities for its own account."[23] Natural persons associated with the issuer, however, may be deemed brokers if they are placing the fund interests on behalf of the fund on a regular or periodic basis, *i.e.*, they would be presumed to be engaged in the business of effecting transactions in securities for the account of another. Satisfying the requirements of the issuer's exemption is difficult. Most significantly, it prohibits incentive compensation and can severely limit the type of investor or the amount of time spent by an associated person placing fund interests. It also does not allow funds with affiliated broker-dealers to rely on the safe harbor.[24]

The fact that the issuer's exemption may be available to some funds is not a justification for departing from the Exchange Act's presumption that securities transactions will be effected through registered broker-dealers. The safe harbor was never meant to be a broad-based exemption, but only a limited concession to smaller issuers which are not in regular or continuous distribution.[25] Indeed, the staff indicated in its April 2008 Guide to Broker-Dealer Registration that

> "[t]he so-called issuer's exemption does not apply to the personnel of a company who routinely engage in the business of effecting securities transactions for the company or related companies (*such as general partners seeking investors in limited partnerships*). The employees and other related persons of an issuer who assist in selling its securities may be 'brokers,' especially if they are paid for selling these securities and have few other duties."[26]

In SIFMA's view, the safe harbor is not an optimal solution to achieving good sales practices or ensuring market integrity; nor is it a long-term solution for the marketing of investment pools to government entities.

Among the benefits of using a registered broker-dealer is that it broadens the markets that may be accessed by an issuer, as opposed to relying on relationships cultivated directly by the

---

participation: (1) is not subject to a "statutory disqualification," as defined in Section 3(a)(39) of the Act; (2) is not compensated by payment of commissions or other remuneration based directly or indirectly on securities transactions; (3) is not an associated person of a broker or dealer; and (4) limits its sales activities as set forth in the rule.

[23] *See* Section 3(a)(5)(A) of the Exchange Act, 15 U.S.C. § 78c(a)(5)(A).

[24] Exchange Act Rule 3a4-1(a)(3). As discussed, *infra*, the complete ban on the use of placement agents with certain state government funds subjects an adviser with an affiliated broker-dealer to a regulatory "double-bind" — *i.e.*, it cannot use *any* broker-dealer to places the interests and because of its affiliation with a broker-dealer, the adviser cannot rely on the issuer's exemption. Thus, to place its fund interests with certain state funds, the adviser either violates the state ban on placement agents, or it potentially subjects itself to broker-dealer registration under the Exchange Act.

[25] *See* Persons Deemed Not to Be Brokers, Exchange Act Release No. 22,172 (June 27, 1985) (adopting Exchange Act Rule 3a4-1); *see*, *e.g.*, Compensation Trust Letter (Aug. 27, 1935).

[26] *See* Section II.D.5, *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm#II (emphasis added).

issuer. Consequently, not only does the Proposed Placement Agent Ban conflict with the policies of the Exchange Act, but it also markedly inhibits competition by restricting private funds to marketing their securities to those investors already known to them. Because persons register as broker-dealers for the primary purpose of selling securities and engaging in securities transactions, they commonly develop a broader marketplace for the securities that they sell. A placement agent's ability to better identify and target appropriate investors for a particular security not only fosters market integrity, but enhances market transparency and efficiency. Although broker-dealers are limited by suitability, licensing, or business reasons from selling certain securities to certain investors, the Proposed Placement Agent Ban would be the first time that the SEC has effectively banned the use of registered broker-dealers in connection with the sale of securities. By prohibiting the use of third-party registered broker-dealers to place private fund interests, the Proposed Rule undermines a functioning, previously-established regulatory structure which is focused on preserving market integrity, competition and efficiency, with one that inhibits competition and relies on a regulatory framework that has little to do with the sale or distribution of securities.

Furthermore, the Proposed Placement Agent Ban appears likely to increase the current market confusion and disruption caused by recent state and local initiatives to flatly ban the use of *all* placement agents. Over the past few months, New York,[27] Illinois,[28] New Mexico,[29] and New York City,[30] have banned the use of all types of placement agents, including affiliated, licensed broker-dealers. Moreover, the New York State Attorney General has developed a "Code of Conduct" regarding the use of placement agents, which requires signatories to refrain from using placement agents in any jurisdiction, not just New York.[31] None of these state and municipal bans draws any distinction between registered and unregistered placement agents, and all of these restrictions on placement agents, including the Proposed Placement Agent Ban, directly conflict with the framework of the Exchange Act and with the oversight and supervisory authority of the SEC and FINRA, *see supra*.

---

27 *See* New York State Common Retirement Fund Placement Agent Disclosure Policies and Procedures of the Office of the State Comptroller, April 21, 2009, *available at* http://www.osc.state.ny.us/pension/placementagntdiscl.pdf.

28 *See* 40 ILCS 5/1-145 (effective April 3, 2009).

29 *See* New Mexico State Investment Council Transparency and Disclosure Policy, adopted July 28, 2009, *available at* http://www.sic.state.nm.us/PDF%20files/090729F-POL_TRANSPARENCY_AND_DISCLOSURE_POLICY.pdf.

30 *See* Letter of New York City Comptroller Thompson to Chairman Mary Schapiro, May 12, 2009, *available at* http://www.comptroller.nyc.gov/press/pdfs/05-13-09_SEC-letter.pdf.

31 *See* Press Release dated May 14, 2009. "The code of conduct bans investment firms from hiring, utilizing, or compensating placement agents, lobbyists, or other third-party intermediaries to communicate or interact with public pension funds to obtain investments," *available at* http://www.oag.state.ny.us/media_center/2009/may/may14a_09.html. To date, there are seven signatories to the Code of Conduct, all of whom signed in connection with potential enforcement actions brought by the Attorney General. Those seven entities are HM Capital Partners, Levine Leichtman Capital Partners, Access Capital Partners, Falconhead Capital Partners (http://www.oag.state.ny.us/media_center/2009/sep/sep17a_09.html); Pacific Corporate Group Holdings (http://www.oag.state.ny.us/media_center/2009/july/july1b_09.html); The Carlyle Group (http://www.oag.state.ny.us/media_center/2009/may/may14a_09.html); and Riverstone Holdings (http://www.oag.state.ny.us/media_center/2009/june/june12a_09.html).

SIFMA is concerned that the combined effect of the Proposed Placement Agent Ban and the foregoing state bans will not only subvert the policies underlying the Exchange Act but, in the case of private funds advised by unregistered advisers, will have the effect of removing the only federally regulated party from these transactions.[32] This would leave the SEC and FINRA with no direct authority to inspect or examine the transaction for potential pay-to-play violations. While larger funds with registered advisers and affiliated broker-dealers would still be subject to the examination authority of the SEC, all other funds would be required to place their fund interests themselves, resulting in securities transactions that take place outside the ongoing regulatory scrutiny of the SEC and FINRA.

C. The Proposed Placement Agent Ban is Inconsistent with the Underlying Policy of MSRB Rule G-38

As noted previously, the NPRM states that the Proposed Rule derives, in significant part, from the pay-to-play framework employed by the MSRB in regulating municipal securities business.[33] This is particularly true in the context of the Proposed Placement Agent Ban, for which the NPRM explicitly acknowledges reliance on MSRB Rule G-38 as a model. But the present version of Rule G-38 was proposed in 2004 and adopted in 2005[34] for the express purpose of ensuring that persons soliciting municipal securities transactions were supervised and controlled by registered broker-dealers; in other words, the Rule was aimed at prohibiting the use of consultants that are not licensed representatives of registered broker-dealers In contrast, the Proposed Placement Agent Ban, while nominally similar to Rule G-38,[35] would effectively exclude certain registered broker-dealers from the placement of the securities of covered investment pools.

Before the 2005 amendments, Rule G-38 permitted unlicensed "consultants" to assist registered municipal dealers in obtaining municipal securities business.[36] The pre-2005 rule contained disclosure requirements which were relatively effective in "bringing to light many aspects of dealer practices with respect to the use of consultants to solicit municipal securities

---

32 *See, e.g.*, the Private Fund Investment Advisers Registration Act of 2009, introduced October 1, 2009, which is the fourth bill introduced this year aimed at regulating private funds, including hedge funds and private equity funds. The three prior bills introduced earlier this year were the Hedge Fund Adviser Registration Act of 2009, the Hedge Fund Transparency Act, and (3) the Private Fund Transparency Act of 2009. While Congress and the current Administration's plan to regulate many of these private funds and advisers is in the early stages, it is unclear when and in what form the regulation will be adopted.

33 *See e.g.*, NPRM, 74 Fed. Reg. at 39,841–42.

34 Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change Relating to Solicitation of Municipal Securities Business under MSRB Rule G-38, Exchange Act Release No. 34-52,278, 70 Fed. Reg. 49,342 (Aug. 17, 2005); *see also* Notice of Filing of Proposed Rule Change Relating to Solicitation of Municipal Securities Business under MSRB Rule G-38, Exchange Act Release 34-51,561 (Apr. 15, 2005).

35 MSRB Rule G-38(a) states that "[s]ubject to section (c) of this rule, no broker, dealer or municipal securities dealer may provide or agree to provide, directly or indirectly, payment to any person *who is not an affiliated person of the broker*, dealer or municipal securities dealer for a solicitation of municipal securities business on behalf of such broker, dealer or municipal securities dealer" (emphasis added).

36 *See* Prior Rule G-38, available at http://msrb.org/msrb1/rules/ruleg38_formerconsultants.htm.

business."[37] Nonetheless, the MSRB believed that the dealers' increasing use of unlicensed consultants presented a risk that unsupervised consultants might engage in pay-to-play activities; moreover, the MSRB was concerned with the possibility of sales practice violations resulting from the participation of unsupervised persons incentivized to "close the sale." The MSRB amended Rule G-38 to ensure that solicitors of municipal securities business were subject to regulatory requirements and supervision. More specifically, the MSRB stated in connection with the amendments to Rule G-38 that:

> [t]he MSRB believes that, in order to preserve the integrity of the municipal securities market, the basic standards of fair practice and professionalism embodied in MSRB rules should be made applicable to the process by which municipal securities business is solicited….[38]
>
> The MSRB disagrees that only Rule G-37, and not the other rules of the MSRB, should apply to the activities of solicitors. As noted above, *one of the principal purposes of this proposal was to make the process of soliciting municipal securities business subject to the standards of fair practice and professionalism that apply to the other municipal securities activities of dealers. Imposition solely of Rule G-37 would fall short of this objective*.[39]

The 2005 amendments to Rule G-38 effectively swept all solicitors of municipal business (underwriting, sales and advisory) into the broker-dealer registration regime. Under Rule G-38, solicitors are now supervised by a registered broker-dealer and are required to conform their municipal securities activities to all applicable MSRB rules and securities laws and regulations. For example, when soliciting municipal securities business, the solicitor is subject to MSRB Rule G-17 (basic fair practice rule) and Rule G-20 (gifts and gratuities). The solicitor's municipal securities activities also would be subject to supervision by the appropriate principal as required under MSRB Rule G-27.[40]

Accordingly, to the extent that the Proposed Placement Agent Ban is intended to mirror the purpose of Rule G-38, a more accurate parallel would be to ban the involvement of unregistered persons — rather than non-affiliated persons — from the placement process and thereby ensure that placement activities were subject to comprehensive broker-dealer regulation. Although Rule G-38(a) specifically prohibits a municipal dealer from paying a fee to a non-affiliated person for solicitation of municipal securities business, the policies underlying Rule G-38 were to bring solicitors within the purview of the federal securities laws — not to exclude the involvement of registered broker-dealers, including those registered broker-dealers not affiliated with advisers and private funds.

---

37 *See* Request for Comments on Draft Amendment to Rule G-38 Relating to Solicitation of Municipal Securities Business, MSRB Notice 2004-11 (April 5, 2004) at 2 (**"April 2004 Release"**), *available at* http://www.msrb.org/msrb1/archive/2004/RuleG-38Solicitation.htm.

38 *Id.*

39 *See* Request for Comments on Revised Draft Amendments to Rule G-38 Relating to Solicitation of Municipal Securities Business, MSRB Notice 2004-32 (Sept. 29, 2004) at 18 (**"September 2004 Release"**) (emphasis added), *available at* http://www.msrb.org/msrb1/archive/2004/RevRuleG-38Soliticlation.htm#revised1.

40 *See* April 2004 Release and September 2004 Release.

D. The Proposed Placement Agent Ban Presents Significant Practical Issues for Private Funds, Government Entities, and Broker-Dealers

Finally, in addition to being inconsistent with existing broker-dealer framework under the Exchange Act, the Proposed Placement Agent Ban creates practical obstacles for funds, placement agents, and the government entities seeking to invest in the funds. More specifically, it is likely to (a) hamper the ability of private funds to raise capital in circumstances in which there is no risk of market distortion from political contributions; (b) distort the market for investment advisory services by effectively precluding smaller and newer private equity funds from soliciting government entities; and (c) prevent government entities from relying on placement agent expertise and resources, thereby making it harder for such entities to make optimal investment decisions. Furthermore, because the Proposed Placement Agent Ban extends to advisers of "covered investment pools," it also compromises the distribution of mutual funds, exchange-traded funds (**"ETFs"**),[41] and similar registered investment company products by effectively barring such funds from using unaffiliated distribution networks to sell such products to government entities, *see infra*.

1. <u>The Proposed Placement Agent Ban Is Likely to Hamper the Ability of Private Funds to Raise Capital</u>

The Proposed Placement Agent Ban is likely to have significant anti-competitive effects with respect to private funds, effectively shutting out smaller, emerging investment advisers from the marketplace for investments by government entities. It will be difficult for smaller or emerging firms to maintain internal placement teams — such firms simply cannot justify the cost in light of their limited fundraising. Similarly, internal placement teams require a heightened level of compliance to ensure that members of the marketing team are not operating outside the safe harbor of Exchange Act Rule 3a4-1, (*i.e.*, the **"issuer's exemption"**) *see supra*, and smaller funds typically lack the resources to achieve such a level of compliance. And, while registering an affiliated broker-dealer may perhaps be a theoretical option for investment advisory organizations, it would be a practical impossibility for smaller organizations to establish, adequately staff and run an affiliated, registered broker-dealer.

The Proposed Placement Agent Ban will also effectively preclude smaller and emerging funds from raising capital from government entities, including public pension funds.[42] Because it is extraordinarily difficult, if not impossible, for smaller, emerging groups to raise sufficient capital without directly or indirectly accessing the U.S. public pension system, such an inability to raise money from public sources would likely prevent many smaller funds from raising sufficient capital to remain viable, thereby decreasing available investment opportunities for government entities.

---

[41] Because the Proposed Rule does not use or define the term "placement agent," and reaches any third-party solicitation activity, it is therefore broad enough to cover any brokered transactions, including transactions involving ETFs.

[42] Smaller funds cannot effectively access the pension market without an institutional placement agent. As an example, no small company would attempt to handle its own IPO due to the complexity, the lack of credibility, and distribution channels, and would therefore hire a registered broker-dealer/investment bank to handle the offering. A smaller private equity fund faces the same issues, and therefore requires professional assistance in raising capital, particularly from government entities.

Foreign advisers also may have practical issues with directly seeking advisory business in the U.S. without the assistance of a third-party placement agent, which means that the Proposed Placement Agent Ban would potentially limit their exposure to U.S. pension managers as well. Foreign advisers arguably offer the greatest expertise for selecting securities and investment opportunities in their local markets. A ban on the use of non-affiliated placement agents thus could deny these foreign advisers, many of whom would not in any case be permitted to make political contributions to U.S. politicians,[43] access to potential sources of investment capital from U.S. government entities.[44]

2. Impact on Government Entities Investing in Private Funds

The Proposed Placement Agent Ban is also likely to harm the very entities it is intended to benefit — government investors. All potential investors (including public ones) benefit greatly from opportunities presented by placement agents, as well as the rigorous screening and due diligence processes carried out by institutional placement agents. Investment pools are typically vetted by placement agents on the basis of several qualities including: investment strategy, historical track record, and professional team, among other factors. Prospective investors can therefore dedicate the time and resources to evaluate such opportunities with the confidence that a placement agent has already reviewed the overall quality of the offering.

But the Proposed Placement Agent Ban will burden government entities who seek to invest in investment pools by eliminating their ability to rely on the human capital collectively employed by placement agents. Several of the largest, most sophisticated public pension investors in the United States have explicitly studied the pros and cons of placement agent involvement and with few exceptions, have reaffirmed their intent to continue working with placement agents. Indeed, such leading institutional investors as Mass PRIM, MOSERS, SWIB and CRT already have submitted comments to the SEC regarding the Proposed Rule in support of the continued involvement of registered placement agents in placing securities with government entities.[45]

These institutional investors consistently noted that placement agents assist institutional investors by engaging in significant due diligence on potential investments (particularly in the area of private equity),[46] and in fact, that placement agents act as screening entities for such investors, ensuring that they are presented with high-quality investments that are targeted to the institutional investors' needs.[47] Placement agents also provide institutional investors with

---

43 *See* 2 U.S.C. § 441e.

44 *See* Comment of Simon Walker, The British Private Equity and Venture Capital Association (Sept. 18, 2009) (**"BVCA Comment"**); Comment of Stephen A. Schwarzman, The Blackstone Group (Sept. 14, 2009).

45 *See* Comment of Denise Napier, State of Connecticut Office of the Treasurer (Sept. 10, 2009) (**"Connecticut Comment"**); Comment of Keith Bozarth, State of Wisconsin Investment Board (Aug. 31, 2009) (**"Wisconsin Comment"**); Comment of Michael Travagliani, Massachusetts Pension Reserves Investment Management Board (Aug. 26, 2009) (**"Mass Comment"**); Comment of Stephen R. Myers, South Dakota Investment Council (Aug. 26, 2009) (**"South Dakota Comment"**); Comment of Rick Dahl, Missouri State Employee Retirement System (Aug. 13, 2009) (**"MOSERS Comment"**).

46 *See* Connecticut Comment; South Dakota Comment; Mass Comment; Wisconsin Comment.

47 *See* Mass Comment; Connecticut Comment.

performance-related material on potential investments and manage the communication process between the institutions and the general partners of the prospective investments.[48] As the Chief Investment Officer of the Missouri State Employees Retirement System stated, "limiting the role of placement agents would reduce our ability to access some of the best managers throughout the world and ultimately result in lower investment returns for our members."[49] Moreover, "without the efforts of legitimate placement agents, mid-sized and smaller pension funds would not have known about a number of excellent fund opportunities, especially those from foreign, emerging and women and minority-owned investment funds."[50]

By inhibiting the ability of covered investment pools to solicit a broad range of government entities, the Proposed Placement Agent Ban will reduce the range of investment opportunities presented to government entities and inhibit the ability of government entities to evaluate the various offerings. In particular, it will be particularly difficult to identify foreign-managed funds that do not have an existing U.S. infrastructure. Government entities, including public pension funds and their participants thus would be significantly disadvantaged by the Proposed Placement Agent Ban.

E. Suggested Course of Action Regarding the Placement of Fund Interests and Pay-to-Play Activities

For the foregoing reasons, SIFMA respectfully requests that the ban on paying third-party intermediaries be limited to a reassertion of the existing general SEC prohibition under the Exchange Act against the use of unregistered finders. The pay-to-play and political activity of registered placement agents involved in soliciting government investment could then be directly regulated under the Exchange Act. We believe that combating pay-to-play activities through broker-dealer regulation would be consistent with the stated goals of the SEC, would reduce the ever-increasing market and legal confusion over the registration requirements under the Exchange Act, and would be more manageable from a compliance standpoint. For example, under this approach, all persons engaged in placement activity with government entities would be required to be licensed and supervised by a broker-dealer authorized to engage in placement agent activities. Similar to procedures employed by firms under G-37, these persons could be "ringfenced" by the broker-dealer's compliance department. A tailored policy to avoid pay-to-play would then apply to this "universe" of associated persons, who would also be subject to SEC and FINRA examination and enforcement.

II. A Disclosure-Based Regime Would More Effectively Address Pay-to-Play Issues in Connection with the Provision of Investment Advisory Services Than the Two-Year Ban

The Two-Year Ban under the Proposed Rule prohibits an investment adviser from providing advisory services to a government entity for compensation for two years if one of the "covered associates"[51] of the adviser makes a contribution to an official of the government

48 *See* MOSERS Comment; Connecticut Comment.

49 *See* MOSERS Comment.

50 *See* Connecticut Comment.

51 The Proposed Rule defines "covered associates" broadly to include an adviser's general partners, managing members, executive officers, or other individuals with a similar status or function; employees who solicit a

entity.[52] As with other aspects of the Proposed Rule, the Two-Year Ban is modeled on the pay-to-play rule for the municipal securities market, MSRB Rule G-37.[53] SIFMA, however, is concerned that the Two-Year Ban (despite the effectiveness of its corollary in the municipal securities business context) does not provide the best means to accomplish the SEC's goal of preventing pay-to-play activity in the investment adviser industry.

As discussed further below, SIFMA believes that the SEC's goals would be better accomplished through a disclosure-based pay-to-play regime, in which advisers would regularly disclose to the SEC both their contributions to covered officials and their investment advisory relationships with government entities to which they have made contribution to covered officials. Such an approach will allow the SEC to take prompt action against pay-to-play activity without unnecessarily burdening government entities or placing impractical compliance burdens on investment advisers. Moreover, we would strongly encourage the SEC to take a similar approach to the one taken with respect to Rule G-37, in which the dealer is responsible for identifying contributions to "issuer officials" covered by Rule G-37, and determining whether the two-year ban on municipal securities business applies. We also encourage the SEC to work with the investment advisory industry in formulating the requirements for such a disclosure regime. Rule G-37 is relatively successful today because the SEC worked closely with the industry to develop an effective rule to address pay-to-play in the municipal securities market.[54]

A. A Two-year Ban on Business Comparable to the Ban under MSRB Rule G-37 is Ill-Suited to the Investment Adviser Industry

A prohibition-based pay-to-play regime along the lines of Rule G-37 is unlikely to be an effective mechanism for combating pay-to-play in the investment adviser industry. Although a flat ban on future contracting has proven workable in the context of the municipal securities industry, the significant differences between the municipal securities markets and the investment advisory markets precludes transferring the G-37 framework to the investment adviser context. In addition, because of the Proposed Rule's broad scope and because the rule imposes a strict liability regime, the Proposed Rule is likely to often prevent government entities from selecting or utilizing the investment adviser of their choice, even in cases where political contributions clearly played no role in the creation or maintenance of an investment advisory relationship.

1. <u>The Substantial Differences between the Investment Advisory Business and Municipal Securities Business Make Rule G-37 an Inappropriate Model for an Investment Advisory Pay-To-Play Rule</u>

Rule G-37 was enacted in 1994 in response to on-going concerns of the MSRB and industry participants regarding issues of pay-to-play and improper business dealings involving

government entity on behalf of the investment adviser; and any political action committee (**"PAC"**) controlled by the investment adviser or by any person designated as a covered associate by the adviser. Proposed Rule § 275.206(4)-5(f)(2)(i)–(iii).

52 *See* Proposed Rule § 275.206(4)-5(a)(1). Contributions to officials for whom the contributor is entitled to vote are excepted if they do not exceed $250. Proposed Rule § 275.206(4)-5(b)(1).

53 *See, e.g.*, NPRM, 74 Fed. Reg. at 39,841–42.

54 *See* discussion of the Voluntary Initiative of 1993, note 4, *supra*.

political contributions in the municipal securities markets.[55] Rule G-37 was generally viewed, even by firms engaged in the municipal securities business, as a necessary step to curtail such abuses. In contrast, pay-to-play in the investment adviser industry, to the extent it has occurred, does not appear to be widespread.[56] Investment advisers, however, have a fundamentally different relationship with their clients than broker-dealers have with issuers in the municipal finance business. In contrast to the transactional nature of municipal securities sales and underwriting, investment advisers are fiduciaries and typically have long-term on-going relationships with their clients.

Furthermore, unlike the application of the Proposed Rule to investment advisers, the application of Rule G-37 does not inhibit the range of competitors available to municipal issuers. Rule G-37's two-year ban on principal underwriting (and other municipal securities business) does not require a municipal securities dealer to complete an underwriting engagement for no compensation. Instead, Rule G-37 prohibits a dealer from taking on any new engagements with the relevant jurisdiction for two years following a triggering contribution. For municipal dealers, such a strict liability ban is effective because the services those dealers provide their government clients are primarily on a transaction-by-transaction basis, *i.e.*, a municipal underwriting engagement has a clear beginning and end.

By contrast, an advisory relationship is a fluid relationship, and banning an adviser's compensation mid-stream mostly serves to disrupt the government client's investment strategies. As such, a regime designed to require disclosure of an adviser's political activity, and that of certain of its employees and agents who have contact with government entities, builds on the fiduciary duty the adviser owes, and avoids the potential for significant disruption caused by the forced cessation of the advisory relationship. Moreover, as a result of the close relationship and the duty that investment advisers have to their clients, advisers are extremely sensitive to any activity that would call their integrity into question. Being required to disclose information about political contributions to government clients and potential clients because of their potential to inappropriately influence the adviser selection process therefore would meaningfully deter questionable behavior by advisers.

2. <u>The Broad Scope of the Proposed Two-Year Ban Creates the Substantial Likelihood of Inadvertent Violations and Would Have Negative Impacts on Government Retirement Funds and Their Participants</u>

The scope of the Two-Year Ban has the foreseeable effect of adversely impacting the government entities (and, in the case of public pension plans, the public employees who are beneficiaries of the plans) that the SEC is seeking to protect under the Proposed Rule. As an initial matter, the Two-Year Ban effectively requires a government entity, upon learning of a violation, to sever ties immediately with an investment adviser that is providing continuous advice and guidance on the investment of the retirement assets of a state or municipality's public employees. Investment advisers typically create investment portfolios customized to the specific

---

[55] *See* MSRB Notice of Rule Proposals, Comments Requested Concerning Draft Rule G-37, Concerning Political Contributions in the Municipal Securities Market (Aug. 26, 1993).

[56] *See* NPRM, 74 Fed. Reg. at 39,842–43, n.31–42. The majority of the examples cited did not involve registered investment advisers.

requirements, timing needs, and long term goals of their clients. As the NPRM identifies, the fiduciary nature of the investment adviser's relationship with a government entity poses challenges to a quick disengagement, even purportedly requiring the adviser to continue to advise the government entity without compensation for "a reasonable period of time."[57]

Depending on the length of the relationship in question, there is the potential for significant lag time for a new adviser to become familiar with the specifics of the strategy employed by the previous adviser. As such, the costs of exiting certain investments, the time required for a new adviser to become familiar with the government entity's current investments and individual requirements, and the potential harm to the investment performance of the retirement fund during the transition period raise significant questions about the Two-Year Ban's appropriateness. The affected government entities may be better at assessing both whether contributions were reasonably likely to influence the decision making process, as well as whether termination is an appropriate remedy.

In addition, the Two-Year Ban also has the effect of preventing a government entity from freely selecting among investment advisers based on the entity's requirements and investment objectives.[58] Government entities have a variety of needs and investment objectives based on their respective populations, and not all advisers are able to adequately meet those needs. Inhibiting the ability of government entities to select from all available investment advisers thus could harm such entities' ability to obtain the best return on their investments. In short, employing a prohibitive regime such as the Two-Year Ban will work to the detriment of the persons it is intending to benefit by restricting their ability to exercise their own informed judgment as to the investment of their capital.

B. A Disclosure-Based Regime Is Well-Suited to Address Pay-to-Play Concerns Involving Investment Advisers to Government Entities

Given the foregoing concerns, we propose that, rather than model the Proposed Rule on the prohibition-based approach of Rule G-37, the SEC consider instituting a disclosure-based pay-to-play regime for investment advisers similar to those adopted by some states.[59] Under such an approach, advisers could be required to disclose to the SEC their political contributions to covered officials on a regular basis and such information would be made public. An adviser thus would pay no penalty for making a contribution to a covered official, but could face sanctions for failure to disclose that such a contribution was made. A disclosure-based regime is particularly relevant in the case of investment advisers given the costs and problems associated with terminating such relationships identified above, would also allow government entities the

---

57 *Id.* at n.80.

58 Indeed, in many jurisdictions, government entities select their investment advisers through the RFP process, with competitive bids based on detailed specifications. Under the Proposed Rule, the Two-Year Ban would apply to advisers who had been selected through such a process, where there is little potential for exertion of improper influence.

59 *See, e.g.*, California Public Employees' Retirement System Gift and Political Contribution Disclosure Policy, Cal. Gov't Code § 20152.5; Teacher Retirement System of Texas, Political Contributions; Improper Influence; Placement Agents and Finders, (July 1, 2009), *available at* http://www.trs.state.tx.us/investments/documents/investment_policy_statement_addendum.pdf.

freedom to address pay-to-play issues, while ensuring that the potential distortions of pay-to-play conduct are subject to the light of day.

We would suggest a disclosure regime under which covered advisers would file disclosures with the SEC on a semi-annual or annual basis. In such disclosures, advisers would provide a list of: (1) all political contributions made by the adviser or its covered associates to any covered official during that reporting period; and (2) any government entity to which the adviser provides investment advisory services and where the adviser or its covered associates made a contribution to the entity's covered officials. Such a regime would address the SEC's concerns in adopting the Proposed Rule without unduly limiting the ability of government entities to select the investment strategies and advisers best suited to their needs.[60] We note, however, that any disclosure-based pay-to-play regime needs to be tailored to the structure and activities of the advisory services industry if it is to be effective. To that end, we again would encourage the SEC to work closely with the industry to develop a comprehensive and effective program.

C. The Individuals and Entities Covered by a Pay-to-Play Regime Should Have a Nexus with Government Entities and Officials in Connection with Providing Investment Advice

In addition to adopting a disclosure-based pay-to-play regime, we also would also suggest that some aspects of the Proposed Rule's definitions be revised so as to better target those individuals and entities that interact with government entities in connection with the provision of investment advice. Narrowing the range of employees of an adviser that must be tracked under the proposed disclosure-based regime (or any regime) is of material importance to the effectiveness of any pay-to-play regulation and to properly calibrating the resulting compliance burden.

The Proposed Rule's broad reach stems principally from the fact that it leaves the central term "investment advisory services" undefined. A clear definition of "investment advisory services" is essential to understanding the scope and contours of the Rule's coverage. For example, this term identifies the parties subject to the Two-Year Ban, as the Ban's application is limited to those advisers providing "investment advisory services" to a government entity,[61] and establishes those parties that may not receive payments from advisers because they solicit government entities for "investment advisory services."[62] The Proposed Rule would also cover executive officers of an investment adviser who, as part of their regular duties, perform "investment advisory services" or supervise someone who does so.[63] Whether an entity or individual is subject to the Proposed Rule thus fundamentally turns on the interpretation of this undefined term.

---

[60] Moreover, if the SEC determined that a covered adviser was engaging or attempting to engage in pay-to-play activity as a result of the adviser's disclosure, the SEC has a number of existing remedies at its disposal to appropriately address such corrupt activity. *See*, *e.g.*, Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b); Section 206 of the Advisers Act, 15 U.S.C. § 80b–6.

[61] *See* Proposed Rule § 275.206(4)-5(a)(1).

[62] *Id*. at 5(a)(2).

[63] *Id*. at 5(f)(4).

The overbroad coverage of the Proposed Rule is compounded by the Rule's definition of "executive officer," which at present includes individuals who have *no* contact with government entities and do not supervise anyone who provides advisory services to a government client. The term "executive officer" also covers those who supervise employees who provide investment advisory services.[64] Thus, the Proposed Rule covers contributions from *any* of the firm's investment adviser representatives or supervisors, even if the representative never interacts with government entities, has no role in or incentives related to advice provided to government entities and, for example, only manages the assets of high net worth individuals.

In this respect, the Proposed Rule's coverage is materially broader than that of Rule G-37. While Rule G-37 limits its reach to contributions from "municipal finance professionals," *i.e.*, those "primarily engaged" in municipal securities business,[65] the Proposed Rule covers employees of an adviser who provide or solicit "investment advisory services" without limiting that term to exclude those who do not regularly advise or solicit government entities and lack any nexus to the conduct targeted by the SEC. Such employees neither have the incentive nor the ability to attempt to improperly influence a government entity's selection of an investment adviser, resulting in advisers having to restrict and monitor an unnecessarily large number of employees' political activity to avoid inadvertent violations.[66]

A more appropriate group of covered individuals would include: (1) investment advisers and their employees who "primarily" or substantively provide advisory services to government entities, including those who manage government assets; (2) individuals who are compensated for soliciting government entities for the provision of investment advisory services; and (3) supervisors of the foregoing. Under this more narrow definition of "covered associate," an adviser would need to track only the activity of those who have a nexus to the government entities that would be subject of any attempt to improperly influence the selection of an investment adviser.

A second concern regarding the scope of potential contributors who must be tracked under the Proposed Rule arises with regard to PACs maintained or operated by general partners and managing members of a covered investment adviser. Although the Proposed Rule treats contributions by PACs maintained by these parties as contributions from the covered adviser, it

---

[64] The Proposed Rule defines the term "executive officer" to include anyone who "(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, anyone who falls into the first two categories. Proposed Rule § 275.206(4)-5(f)(4).

[65] *See* MSRB Rule G-37(b)(1), (g)(iv).

[66] SIFMA also notes that restricting contributions from employees who have no such business responsibilities and are not yet covered by the Proposed Rule's scope may run afoul of state labor laws that prohibit unreasonable restrictions on employee's political activities. *See, e.g.*, Cal. Gov't Code § 3203 ("Except as otherwise provided in this chapter, or as necessary to meet requirements of federal law as it pertains to a particular employee or employees, no restriction shall be placed on the political activities of any officer or employee of a state or local agency."); Cal. Lab. Code § 1101 **(**"No employer shall make, adopt, or enforce any rule, regulation, or policy: (a) Forbidding or preventing employees from engaging or participating in politics or from becoming candidates for public office. (b) Controlling or directing, or tending to control or direct the political activities or affiliations of employees.").

is frequently the case that the general partner or managing member of an adviser are separate entities, and the adviser has no control of the general partner or managing member, or their PACs. Rule G-37, by comparison, focuses only on contributions from PACs that are *controlled* by the municipal dealer or covered employee.[67] It is problematic to attribute to an adviser contributions by PACs that are not controlled by that particular adviser, and it unnecessarily raises the potential for inadvertent violations. Limiting the scope of covered PAC contributions to those over which an adviser or its covered employee has control would tie the regime's coverage to those individuals and entities that have connections to the provision of investment advisory services to government entities.

D. The Proposed Rule Extends to Contributions That Have Little Potential to Influence the Selection of Investment Advisers

The other key area of the Proposed Rule that should be narrowed under the proposed disclosure-based regime is the type of political activity that would trigger the need to disclose. Under the Proposed Rule, the solicitation of contributions for a state or local party would trigger potential application of the Two-Year Ban.[68]

The NPRM, however, provides no evidence that the solicitation of contributions for state and local political parties has distorted governmental decision-making regarding the award of investment advisory services contracts or the investment of public funds.[69] The rationale for extending the Proposed Rule is presumably that of "conduiting," *i.e.*, that advisers and their covered employees will use party committees and PACs to circumvent the Two-Year Ban's prohibition on direct contributions to candidates. But the Proposed Rule already addresses such contributions — the Proposed Rule applies to all contributions made by covered associates to the covered officials, regardless of whether such contributions are made directly or indirectly. Requiring investment advisers to track this type of activity therefore unnecessarily increases advisers' compliance burdens, without any showing that such activity is likely to have an impact on the decision-making of government entities.

---

67 MSRB Rule G-37 only prohibits contributions from PACs controlled by the municipal dealer or its covered employees, and does not extend to entities that have controlling interests in the broker-dealer. *See* MSRB Rule G-37(b)(i)(C). There are also questions about how large a role a covered associate must have in directing the contributions of a PAC before it is covered by the Proposed Rule.

68 Proposed Rule § 275.206(4)-5(a)(2)(ii)(B).

69 The restriction on solicitation of contributions to a state or local party, which lacks a *de minimis* exception, also raises First Amendment issues because of its potential adverse impact on covered advisers' First Amendment freedom of association rights. Under the Two-Year Ban, covered advisers and their associates would be prohibited from soliciting others to join their local party and pay minimal membership dues — activity that is clearly entitled to First Amendment protection. *See Roberts v. United States Jaycees*, 468 U.S. 609, 622 (1984) ("[W]e have long understood as implicit in the right to engage in activities protected by the First Amendment a corresponding right to associate with others in pursuit of a wide variety of political, social, economic, educational, religious, and cultural ends.").

E. If the Two-Year Ban is Retained in the Proposed Rule, It Should Be Revised to Narrow Its Scope, Limiting Potential Compliance Challenges and Unintended Consequences

Although Rule G-37 is generally effective and manageable, there remain problematic aspects to the Rule — particularly if applied to the investment advisory industry — that we believe should be addressed by the SEC if it chooses to maintain the Two-Year Ban approach. As discussed, it is SIFMA's view that the Proposed Rule should be revised to remove the Two-Year Ban in favor of a more narrowly-tailored, disclosure-based regime. If, however, the SEC chooses to retain the Two-Year Ban, SIFMA still believes that the Ban should be narrowed along the lines described above and as further discussed below with respect to the issues unique to the Two-Year Ban.

1. <u>The Proposed Look-Back Provision Should Mirror the Similar Provision in Rule G-37</u>

As an initial matter, we suggest that the SEC consider revising the look-back period along the lines of what is currently applicable under MSRB Rule G-37, which employs different look-back periods depending on the responsibilities and potential government interactions of the subject employee. The Proposed Rule's "look-back" provision (pursuant to which the Two-Year Ban can be triggered if a covered employee has made contributions within the previous two years) for new employees of a covered adviser applies even if the new employee's responsibilities with the adviser have little to no relevance to the provision of advisory services to government entities.[70] This blanket two-year look-back treats all employees of investment advisers as equally likely to have interactions with (and therefore potentially influence the decisions of) government entities, and overlooks the differences between the types of interactions employees of investment advisers have with government officials.

A more practical approach would be to create a staggered look-back provision based on an employee's proximity to government advisory business, along the lines of the approach taken under Rule G-37. Although Rule G-37 provides a two-year look-back provision for persons who are primarily engaged in municipal securities business, it established a more limited six-month period for individuals who are only classified as municipal finance professionals because of their supervisory responsibilities. There is no reason a similar approach could not be utilized in the investment adviser context.

In the alternative, and perhaps more appropriate to the investment adviser industry, the SEC might consider a requirement that newly hired individuals who previously had made triggering contributions be walled-off from communicating with officials of government entities to whom they previously contributed for a reasonable period of time.

---

70 *See* Connecticut Comment ("The Office of the Treasurer urges the SEC to abandon 'look back' language that would create a retroactive attribution of campaign contributions to future hires, except where such contributions are intended to circumvent the rule.")

2. <u>The Two-Year Ban Should Contain Specific Exemptions for Certain Types of Contributions</u>

There are certain types of covered contributions in the context of Rule G-37 that are still subject to significant debate and discussion, and therefore may warrant an exemption from the proposed Two-Year Ban. These contributions include: (1) contributions to presidential and vice-presidential candidates up to the Federal Election Commission statutory maximum, even if such candidates hold a covered state or local office at the time of the contribution; (2) contributions from covered advisers to federal PACs and committees from the Two-Year Ban's "indirect violations" prohibition,[71] regardless of whether the recipient committees make occasional contributions to state or local candidates; and (3) contributions from new employees hired (or promoted) by covered advisers, if the new employee or supervisor requests a refund from a covered official within a certain number of days of hiring or promotion, as the time limitations for the exemption for such refund requests under the Proposed Rule are likely to have expired. Without such additional exemptions, the Two-Year Ban may have the unintended consequence of preventing people from changing jobs at a time at which both unemployment and management changes in the financial services industry are at an all-time high.

3. <u>The Amount of the *De Minimis* Exception to the Two-Year Ban Should Be Increased</u>

The SEC specifically requested comment on the amount of the *de minimis* exception to the Two-Year Ban, which mirrors Rule G-37 and is set at $250 for covered officials for whom the contributor is entitled to vote.[72] SIFMA believes that the amount established for a *de minimis* contribution under the Two-Year Ban, which has not changed since Rule G-37's enactment in 1994, should be increased to $1,000[73] and, going forward, be indexed for inflation so that it can be annually re-evaluated and revised as appropriate.

III. THE THIRD-PARTY SOLICITOR BAN IS OVERBROAD AND WILL HAVE ENORMOUS ANTI-COMPETITIVE EFFECTS ON THE ADVISORY SERVICES MARKET

Although it does not conflict with another regulatory scheme as does the Proposed Placement Agent Ban, the Third-Party Solicitor Ban — which would prohibit investment advisers from paying any third-party[74] to solicit investment advisory services business from government entities on the investment adviser's behalf — has similar potential for significantly inhibiting competition and access to the market for investment advisory services for government entities. Third-party solicitors play an important role in facilitating advisory services relationships for certain types of advisers (particularly smaller and foreign advisers) and the

71 Proposed Rule § 275.206(4)-5(d).

72 NPRM, 74 Fed. Reg. at 39,850; Proposed Rule § 275.206(4)-5(b)(1).

73 In light of the current amount being expended in political campaigns, $1,000 is unlikely to have a material impact on a candidate. In the event that the SEC does not want to increase the *de minimis* limit to that amount, we note that simply indexing the $250 *de minimis* limit under Rule G-37 to the consumer price index would result in an amount of approximately $360. At a minimum, this appears to be a more reasonable threshold.

74 The Third-Party Solicitor Ban explicitly prevents payment to any person who is not a "person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser." Proposed Rule § 275.206(4)-5(a)(2)(i)(A), (f)(9).

proposed ban would sharply limit the ability of such advisers to compete for investment advisory relationships with government entities. Although the NPRM provides some examples of misconduct in obtaining investment advisory business from government entities, there was no cited evidence of third-party solicitor involvement or a systemic problem that would warrant a complete ban on the use of third-party solicitors and the resulting disruption to the advisory services market for government entities. Further, the Third-Party Solicitor Ban is patterned after MSRB Rule G-38 and as was discussed above, the purpose of Rule G-38 was not to ban solicitation activity, but to ensure that solicitors would be subject to appropriate regulatory oversight.

Accordingly, SIFMA suggests that, instead of banning third-party solicitors, the SEC should expand its regulation of such parties to require third-party solicitors to disclose their political contributions. The activities of third-party solicitors already are regulated by the SEC under the Cash Solicitation Rule under the Advisers Act,[75] and that rule easily could be modified to incorporate such disclosures.

Banning investment advisers from using third-party solicitors, and requiring that only "related persons" of the adviser solicit government entities for investment advisory services will have substantial anti-competitive effects on medium- and small-sized investment advisers that do not have in-house marketing operations. As a number of commentators on the Proposed Rule have mentioned, reputable third-party solicitors provide substantial services to both institutional investors (including government entities) and smaller investment advisers, including screening advisers for institutional clients, identifying appropriate matches between investment opportunities and investors, and other lawful marketing practices.[76] These services add significant value to the broader investment community and allow smaller advisers the opportunity to provide advisory services to a broader spectrum of investors than if the advisers could not rely on third-parties. More importantly, as commentators have noted, only a handful of large investment advisers have the capacity to handle the marketing of their advisory services using internal personnel.[77] Thus, the principal effect of the proposed Third-party Solicitor Ban would be to give those large investment advisers a substantial competitive advantage in pursuing advisory contracts with government entities.[78]

---

75 17 C.F.R. § 206(4)-3. Under the Cash Solicitation Rule, fees may be paid to unlicensed and unaffiliated third parties provided certain conditions are met, including a requirement that the solicitor provide clients with specific disclosure document containing a description of the solicitation arrangement.

76 *See* Comment of J. Daniel Vogelzang, M Advisory Group (Sept. 18, 2009); *see, e.g.*, Comment of Gary E. Block, The Meridian Group (Aug. 26, 2009) (addressing the impact of Proposed Rule on third-party placement agents); Comment of Stephen Presser, The Monomoy Capital Partners, L.P. (Aug. 25, 2009) (**"Monomoy Comment"**) (same).

77 *See, e.g.*, Comment of Alicia M. Cooney, Monument Group, at 6-7 (Sept. 18, 2009) (**"Monument Group Comment"**); BVCA Comment; Comment of Raymond H. Kraftson, Ariane Capital Partners, LLC (Sept. 17, 2009); Comment of Michael I. Klein, Littlejohn & Co., LLC (Sept. 14, 2009). While these comments address the Proposed Rule on third-party placement agents, the issues highlighted are equally applicable to third-party solicitors of advisory services.

78 The negative impact on foreign investment advisers described in the Proposed Placement Agent Ban section, *supra*, is equally applicable to foreign providers of investment advisory services under the proposed Third-Party Solicitor Ban.

The regulatory objective of inhibiting improper pay-to-play activities could be achieved by making relatively minor modifications to the Cash Solicitation Rule, with which investment advisers employing third-party solicitors must already comply. The Cash Solicitation Rule, which currently requires investment advisers to ensure that solicitors comply with certain undertakings (including disclosure undertakings) in order to receive payment for their activities, could be amended to require that such solicitors also agree to comply with the terms of the disclosure-based regime we recommend in lieu of the Two-Year Ban, *see supra*, disclosing all campaign contributions to prospective government entity advisory clients as well as to the investment advisers themselves.[79] This approach would take advantage of existing regulatory structures already in operation and enable the smaller and medium-size advisers to continue to use their external marketers, allowing them to focus their more limited resources on their advisory business. Although the NPRM states that commentators have indicated that monitoring campaign contributions of advisory service solicitors would be problematic,[80] none of the comment letters yet received have reflected such concerns. To the contrary, as noted above, the comments suggest that the Third-Party Solicitor Ban would present many more difficulties than would result from a disclosure scheme.[81]

IV. THE PROPOSED RULE'S APPLICATION TO COVERED INVESTMENT POOLS RAISES SUBSTANTIAL LEGAL CONCERNS.

It has been widely reported that a few investment advisers sought to ensure investment by government entities in managed private funds by making political contributions to government officials who were in a position to influence the government entities' investment decisions. In this environment, the desire of the SEC to extend the pay-to-play provisions of the Proposed Rule to at least some covered investment pools is understandable. To this end, the Proposed Rule provides, in effect, that a covered investment pool is a virtual alter ego of the adviser:

> [F]or purposes of this section [275.206(4)-5], an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity.[82]

But the relationships between investment advisers and the covered investment pools to which they directly or indirectly provide investment advice are too complex to conclude that it is appropriate to treat covered investment pools uniformly as if they were simply alter egos of their investment advisers. While there are some private funds that are little more than alter egos of their investment managers,[83] many private funds and most registered investment companies do

---

79 In the event the SEC decides retain the Two-Year Ban, we recommend — rather than having an outright ban on the use of third-party solicitors — that the third-party solicitors be required to comply with the Ban's limitations in connection with their receipt of payment from covered advisers.

80 *See* NPRM, 74 Fed. Reg. at 39,852.

81 *See, e.g.*, Monument Group Comment at 13; Comment of Terence M. Crikelair, Champlain Advisors, LLC (Sept. 27, 2009); Comment of Tim Friedman, Preqin (Aug. 28, 2009).

82 Proposed Rule § 275.206(4)-5(c).

83 *See* Thomson Advisory Group L.P., No-Action Letter (Dec. 15, 1993).

not easily fit into this rubric and the application of the Proposed Rule to such investment pools would be highly problematic.

The Proposed Rule defines "covered investment pools" broadly to include traditional private funds (companies exempt from the definition of "investment company" under Section 3(c)(1) and 3(c)(7) of the Investment Company Act) and registered investment companies (except that for purposes of the Two-Year Ban, a registered investment company is included "only if [the registered investment company] is an investment or an investment option of a plan or program of a government entity.")[84]

The application of the Proposed Rule to registered investment companies is completely impractical. Most registered investment companies are required to have a board of directors or trustees comprised of a majority that is independent of the fund's investment adviser and distributor. Moreover, such investment companies are required to be distributed using registered broker-dealers. Some investment companies in fact are sold on securities exchanges in transactions required to be intermediated by broker-dealers. Application of the Proposed Placement Agent Ban for sales of exchange-traded investment company securities to government entities thus would not only be impractical, but unlawful. Furthermore, in the case of investment companies with redeemable securities, the distributor typically distributes the investment company's securities through selling agreements with broker-dealers exploiting different distribution channels. For example, as shown in Figure A below, a government entity could purchase shares of a registered investment company through a third-party distributor without the adviser to the registered investment company knowing that the government entity had done so.

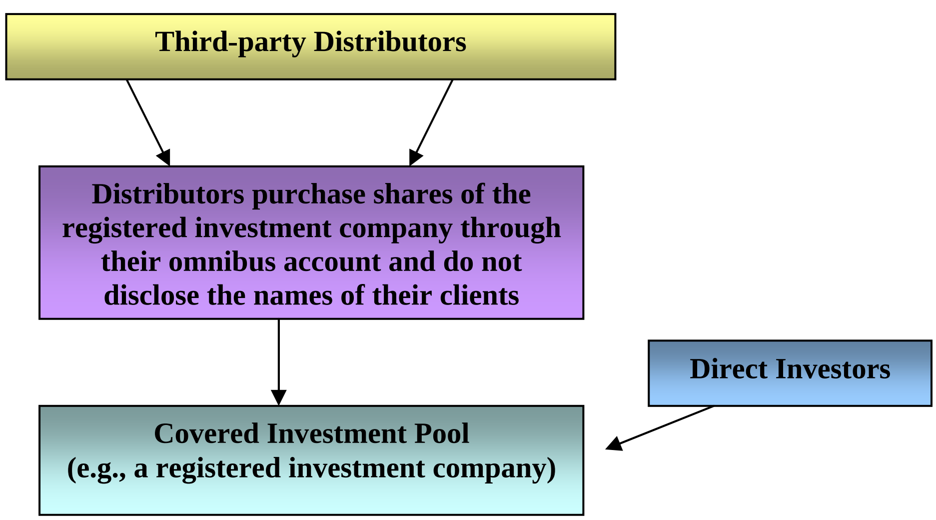

Figure A

These selling agreements provide for compensation payable to the selling broker-dealer on the sale of the investment company's shares regardless of whether the purchaser is a government entity. In addition, the investment company's adviser or affiliated principal underwriter/distributor may enter into revenue-sharing arrangements with broker-dealers that

[84] Proposed Rule § 275.206(4)-5(f)(3).

provide for access to the firm's financial advisors, inclusion on the firm's order entry platform and other marketing support services. These revenue-sharing arrangements may be calculated based on sales of fund shares or fund assets or may be payable as a fixed annual amount and may be based, in part, on sales or assets that are attributable to purchases by a government entity. The application of the Placement Agent Ban in the case of a sale to a government entity would render such a distribution arrangement unlawful under Section 275.206(4)-5 of the Proposed Rule, even though it would be required under the Exchange Act and the Investment Company Act. Indeed, to comply with the Proposed Rule, compensation arrangements would have to exclude any payments based on sales of fund shares that are attributable to purchases by a government agency plan — an exclusion which is simply not possible in the context of distribution arrangements that make payments as a flat amount regardless of actual sales or assets.

Moreover, to the extent that a downstream selling agent includes the securities of a registered investment company as an investment option in a government entity-adopted IRS Section 403(b) plan (relating to a group annuity contract program for employees of a public school) or a government entity established IRS Section 529 plan (a qualified tuition program established and maintained by a State or agency), the investment adviser would potentially become subject to the Two-Year Ban. This would be the case even though the investment adviser has no role in the sale of the interest in the registered investment company or its inclusion as an option in the Section 403(b) plan or the Section 529 plan and did not itself arrange a sale of the securities to a government entity or designation of the registered investment company as a Section 403(b) plan or Section 529 plan option.

Compliance with the Proposed Rule can be almost as problematic in the case of certain private funds. For example, as described in Figure B, an investment adviser to a sub-fund in a fund-of-funds might be subject to the Proposed Rule despite the fact that the investment adviser has no role in the distribution of the fund-of-funds.

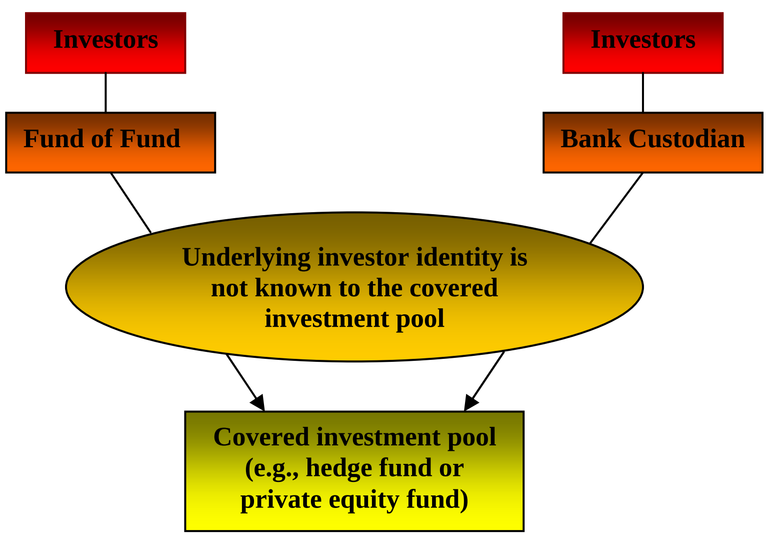

Figure B

Application of the Proposed Rule to an adviser of a sub-fund in such circumstances would burden political activity and prove costly, but would not in any way advance the purpose of the Proposed Rule. Similarly, a sub-adviser to a private fund could be adversely affected by application of the Proposed Rule notwithstanding its lack of influence over distribution of the securities of the private fund and the absence of any coherent nexus between its political activity and the distribution of the private fund as to which it is a sub-adviser; nonetheless, under the Proposed Rule, it appears that sales of securities of such private fund would be viewed as the provision of advisory services to any government entity investor in the fund.

In short, the effects of the Proposed Rule on registered investment companies and certain private funds prohibit or disrupt activities without establishing a coherent nexus to pay-to-play concerns. The gravity of such effects and the very remote benefits give rise to significant questions as to whether extension of the Proposed Rule to covered investment pools is reasonably designed to prevent investment adviser fraud or warrants the additional burden on the exercise of the advisers' (and their employees') First Amendment rights. In addition, because the nexus between certain advisers and the investing government entity is so remote, complying with Covered Investment Pool Restrictions raises significant practical issues — for example, it is not clear how the investment adviser could be held responsible for violations over which it has no direct control — and the application of the Two-Year Ban in such circumstances is highly problematic.

We therefore suggest that the Covered Investment Pool Restrictions be modified in two ways. First, we suggest that the Proposed Rule should not apply in the case of investment advisers to investment companies and private funds in which the private fund is not the virtual alter ego of the investment adviser. Second, we suggest that to the extent the Proposed Rule applies to a covered investment pool, the rule be modified so that it is better aligned with the SEC's goal of preventing distortion of government entity decision-making by political contributions. To that end, we would propose revising Covered Investment Pool Restrictions to require disclosure of the political contributions to covered officials by advisers to covered investment pools, instead of prohibiting such contributions.[85]

A. Extending the Proposed Rule's Restrictions to Covered Investment Pools Is Inconsistent with the SEC's Authority Under the Advisers Act and the First Amendment Limits on the Regulation of Political Activity

As a threshold matter, the Covered Investment Pool Restrictions raise legal concerns under both the Advisers Act and the First Amendment. Although the SEC has broad authority to take steps to prevent "fraudulent, deceptive, or manipulative" practices in the provision of investment advisory services under the Advisers Act,[86] such authority is constrained by the

[85] SIFMA also recommends that the look-back provision set out in § 206(4)-5(a)(1) of the Proposed Rule be limited to avoid application to individuals hired by advisers to covered investment pools. To the extent that an investment pool has government entity investments and is thus covered by the Proposed Rule, it is problematic that the hiring of an individual who had made contributions within the past two years would trigger the application of the Two-Year Ban. The potential to improperly influence the government entity's investment decision is absent as that decision has already been made. Such coverage therefore appears to be an unintended consequence that should be reevaluated and revised.

[86] 15 U.S.C. § 80b-6.

requirement that any rule so adopted must be "reasonably designed" to prevent such practices.[87] As noted above, the purpose of the Proposed Rule is to prevent pay-to-play practices from affecting the award of investment advisory contracts for government entities government entities investment decisions. There are certainly circumstances in which applying the Proposed Rule's restrictions to advisers to covered investment pools would be "reasonably designed" to serve such a goal, such as when an adviser to a private investment pool actively engages a public pension fund to secure investment by that fund. But the Proposed Rule's effect on covered investment pools reaches beyond such circumstances and restricts the activity of advisers to private funds who neither interact with, nor seek advisory business from, government officials; for example, the Restrictions apply to the adviser of any private fund that solicits a government investment, even if the adviser was unaware that the solicitation occurred. Restrictions on the conduct of those advisers — where there is no meaningful nexus between the activities of the investment adviser and government entities who may invest in the covered investment pool — have no reasonable relationship to the Proposed Rule's goals, and therefore such restrictions cannot be justified by the SEC's authority to adopt prophylactic measures to prevent "fraudulent, deceptive, or manipulative" practices in the advisory services market. In short, applying the Covered Investment Pool Restrictions to advisers to private investment pools who have no contact with government entities may exceed the SEC's authority under Section 206(4) of the Advisers Act.[88]

The broad sweep of the Covered Investment Pool Restrictions — and the failure to distinguish between advisers to private investment pools who have significant government contacts and those that do not — also implicates constitutional concerns under the First Amendment. Because political contributions are a form of political speech, laws restricting campaign contributions "'implicate fundamental First Amendment interests,'"[89] and are permissible only when the limits are "'closely drawn'" to match a "'sufficiently important interest.'"[90] As practical matter, contribution limits qualify as "closely drawn" only if they are proportional to the government's interest, and limit speech no more than is necessary to advance that interest.[91] Although preventing corruption and the appearance of corruption are sufficiently compelling government interests to justify contribution limits,[92] the Covered Investment Pool

87 *United States v. O'Hagan*, 521 U.S. 642, 667, 673 (1997).

88 It is also not clear that the SEC has a sufficient factual basis to regulate advisers to private funds with minimal to no contacts with government actors under its Section 206(4) authority, regardless of whether it has the requisite legal basis to do so. Under the Administrative Procedures Act (**"APA"**), there must be a "logical and rational" connection between the facts found and the regulation adopted by the agency. *Allentown Mack Sales and Servs., Inc. v. NLRB*, 522 U.S. 359, 374 (1998). None of the evidence marshaled by the SEC regarding the present pay-to-play problems at the state and local level involve political contributions of parties or individuals who are solely serving as investment advisers to private funds, and who have no interaction with any government officials or government entity; thus, it is not apparent that the SEC has the authority to regulate such parties pursuant to the Covered Investment Pool Restrictions.

89 *Randall v. Sorrell*, 548 U.S. 230, 241 (2006) (plurality opinion) (quoting *Buckley v. Valeo*, 424 U.S. 1, 15, 23 (1976) (per curiam)).

90 *Id.* at 247 (quoting *Buckley*, 424 U.S. at 25).

91 *Id.*

92 *See Nixon v. Shrink Missouri Gov't PAC*, 528 U.S. 377, 386 (2000).

Restrictions on advisers' political contributions go well beyond what is necessary to serve those interests, particularly in circumstances in which the investment adviser has no meaningful role in the distribution of the covered investment pool. Restricting the ability of advisers (and employees of advisers) who have no contacts with government officials to make political contributions cannot be easily justified on anti-corruption rationale; accordingly, the extension of the Covered Investment Pool Restrictions may abridge such parties' First Amendment rights.

Extending the Proposed Rule to advisers to covered investment pools does not, in and of itself, give rise to legal and constitutional concerns. But extending the Proposed Rule beyond advisers to private funds who have significant interaction with government entities is legally and constitutionally suspect. We therefore respectfully suggest that SEC narrow the scope of the Covered Investment Restrictions to ameliorate such concerns.

V. ADDITIONAL ISSUES CREATED BY THE PROPOSED RULE

A. Books and Records

The books and records requirements under the Proposed Rule are under-inclusive in terms of coverage, overbroad in scope, and difficult to implement. As an initial matter, the books and records requirements apply to only some of the advisers covered by the Proposed Rule — although the Proposed Rule applies to a substantial number of entities who are exempt from registration under the Advisers Act, the Proposed Rule's additional books and records requirements only modify the rules that apply to registered investment advisers. Second, recordkeeping under the Proposed Rule is complicated by the fact that the Proposed Rule defines the term "solicit" to mean *any* attempt to obtain or retain investment advisory services business.[93] As proposed, advisers would be required to keep records of every solicitation — oral or written — and therefore would need to design systems capable of tracking every single communication that could be construed as an attempt to solicit advisory business. In addition to the impracticability of implementing such a system, we are unaware of any similar requirement under Rule G-37 or under the record keeping requirements of the Advisers Act or Exchange Act that requires an adviser or broker-dealer to maintain records of every oral solicitation of municipal or other securities business.[94] And such a requirement is not needed to satisfy the Proposed Rule's stated goals of preventing pay-to-play activity; as a practical matter, it is the actual award of government business, not the solicitation of government entities, which is relevant to pay-to-play.

Third, the proposed record keeping requirements extend to all direct or indirect contributions from covered associates to all PACs, separate and distinct from contributions to covered officials and political parties. Tracking all contributions to PACs dramatically increases the administrative burden of compliance, despite the fact that unaffiliated PACs lack a nexus to officials who are involved in the selection of investment advisers. In contrast, under Rules G-8 and G-37, the record keeping obligations only require records of contributions to covered issuer officials and political party payments. Based on the absence of a connection to government entities, we suggest that the Proposed Rule's record keeping requirements be scaled back to the

---

93 Proposed Rule § 275.206(4)-5(f)(10). Note that the MSRB interpretations of "solicitation" are significantly narrower. *See*, *e.g.*, note 28, *supra*.

94 *See* Advisers Act, 15 U.S.C. §§ 80b-1–80b-21; Exchange Act, 15 U.S.C. § 78a *et seq.*; and MSRB Rule G-8.

scope of Rule G-8, which has been sufficient to enable effective examination, enforcement, and implementation of Rule G-37.

Finally, the recordkeeping concerns are sufficiently complex that the implementation period for the Rule should be expanded. The systems required to implement the Rule would involve the design of systems that interact and pull data from a firm's account tracking systems as well as the human resources systems.[95] Member firms already subject to Rule G-37 advise that the human resources systems must be utilized to design a system capable of tracking a covered associate's home address and to develop information regarding where an employee is eligible to vote. Such systems are complex to design to work effectively as well as to meet required confidentiality regarding employees' personal information. Even more difficult is the need to create systems that utilize firms' account tracking system as required to identify government accounts that may be covered by the Rule. Firms account tracking systems are extremely large and complex as they are designed to track thousands if not millions of accounts, transactions, holdings, and pricing of securities held in those accounts, fees and commissions charged to customers, compensation paid to brokers and to create confirmation and account statements sent to customers. The development of systems that can feed from the human resources and accounts systems will be complex and time consuming to develop because such systems are complicated and therefore changes must be carefully designed and tested to ensure no inadvertent impact occurs to these critical processes. Large member firms have advised that it takes months to implement even modest changes to their firm's new account systems, and the changes required by the Proposed Rule will be significantly more than modest. Accordingly, the SEC should reconsider the limited implementation period proposed and rather work with the industry to establish reporting and recordkeeping requirements that the industry is capable of creating and implementing in the time allotted.

B. Concerns Regarding the Proposed Rule's Cost/Benefit Analysis

While SIFMA believes that addressing practices that potentially undermine the merit-based selection of investment advisers is an important and laudable effort, the SEC appears to have underestimated the compliance costs the Proposed Rule will impose on covered parties.

In describing the expected costs of implementing the Proposed Rule, the SEC identified a number of factors that are expected to impact the costs imposed by the Proposed Rule, which include: (1) the number of covered associates of an adviser; (2) the degree to which compliance procedures are automated; (3) the extent to which an adviser has a pre-existing policy under its code of ethics or compliance program; and (4) whether the adviser is affiliated with a municipal dealer that is already subject to Rules G-37 and G-38.[96] The SEC also believes that the

---

[95] The systems required to track covered associates potentially must be more extensive than the Rule G-37 systems as the municipal finance professional tracking systems essentially track a single department and its supervisory chain, whereas the systems required to track covered associates under the Proposed Rule must track personnel involved in government business in many different departments of a firm, including at least retail investment advisory business, asset management business, and placement agent business. Even firms that have such Rule G-37 systems may not be able to accommodate such tracking without further work and as such systems may be limited to a single unit or broker dealer within a financial services company and may or may not accommodate the addition of employees from other affiliated broker dealers.

[96] NPRM, 74 Fed. Reg. at 39,861. With regard to the last factor, the SEC expressed the view that "a large adviser could likely use some or all of the compliance procedures established by its broker-dealer affiliate to facilitate

compliance costs associated with the Proposed Rule will be higher initially as firms develop their compliance procedures, declining to a fairly constant amount in future years, with costs being correlated to the size of a covered adviser. The SEC estimated that the approximate compliance costs for establishing and implementing a compliance system under the Proposed Rule for larger firms (*i.e.*, those with more than 15 covered associates) would be $52,313, $26,156 for medium size firms (5-15 associates); and $2,064 for small firms (5 or fewer covered associates), with annual compliance expenses of $209,250, $104,625, and $2,580 respectively.[97] The SEC also assumed that outside legal fees relating to the Proposed Rule would be roughly $12,000 for larger firms, $4,000 for medium-size firms, and $1,200 for small firms.

Although the SEC notes that these estimates are "significantly increased" from the costs associated with its 1999 proposal on which the Proposed is based, these estimates significantly understate the costs of compliance with the Proposed Rule as currently drafted.[98] First, as noted above, existing Rule G-37 and G-38 compliance systems are not easily extensible to the Proposed Rule, and therefore, the efficiencies anticipated by the SEC are not likely to exist. As discussed in significant detail above, the scope of the Proposed Rule's coverage of individuals and entities whose activity must be tracked dramatically increases the time and resources an adviser must devote to meet its obligations under the Rule. Second, because the SEC has not provided that the Proposed Rule will preempt similar state and municipal laws and rules, the requirements of the Proposed Rule will in many cases be duplicative, and potentially inconsistent with these state regimes, adding further layers of regulatory requirements and obligations to advisers already subject to state and municipal pay-to-play restrictions. Third, for those advisory firms and covered investment pools that currently lack in-house marketing units, the costs associated with staffing and creating an internal marketing team are significant and will require a large amount of initial and ongoing resources. The NPRM does not address this important effect of the Proposed Rule, further underestimating the financial impact it will have on covered entities.

We strongly encourage the SEC to work with the municipal dealer industry to more accurately assess the various costs associated with Rules G-37 and G-38 compliance. This would at a minimum provide a baseline from which the SEC could better assess the costs associated with a pay-to-play regime applicable to certain investment advisers.

VI. SUMMARY OF RECOMMENDATIONS

The goal of this comment letter is to highlight the aspects and impacts of the Proposed Rule that SIFMA believes will be contrary to the SEC's objectives in addressing the issue of pay-to-play in the investment adviser industry. SIFMA believes that a collaborative approach between the SEC and the regulated parties is capable of producing a regime that is effective in

---

its compliance with proposed rule 206(4)-5[and] [a]s a result, many advisers with broker-dealer affiliates may spend less resources to comply with the proposed rule and rule amendments."

97 *Id.* at 39,861-63 and accompanying notes. The annual expenses are based on the expectation that it would take 750 hours of compliance officer time (at $258 per hour) and 250 hours of clerical time (at $63 per hour) for large firms; 375 hours of compliance officer time and 125 hours of clerical time for medium-size firms (at same hourly rates); and 10 hours of compliance manager time for small firms. *Id.* at n.227–29.

98 *Id.* at n.226.

preventing the distortions pay-to-play causes on the selection of investment advisers to government entities, including the placement of private fund interests, while minimizing potential unintended and unnecessary negative consequences. For ease of reference, we summarize our specific recommendations for revisions to the Proposed Rule below, and look forward to the opportunity to work further with the SEC to adopt a practical, functioning regulatory structure.

The Proposed Placement Agent Ban

SIFMA respectfully requests that in lieu of a ban on paying third-party intermediaries to place fund interests, the SEC clearly reassert its longstanding position and guidance with respect to the Exchange Act's general prohibition of the use of unregistered finders. We believe that requiring the use of registered placement agents provides a better avenue for regulating placement agent pay-to-play activity that is consistent with the SEC's objectives, reduces the ever increasing regulatory confusion, and results in a more manageable compliance burden. Broker-dealer employees who engage in placement activity with government entities could be easily identified and sequestered by the broker-dealer's compliance department, which could apply appropriate policies to avoid pay-to-play to this group of associated persons. This approach also would have the added protection of enabling the SEC and FINRA to examine these placement agents' activities, similar to the current reviews conducted under Rule G-37 and Rule G-38.

The Two-Year Ban

With regard to the Two-Year Ban, we would suggest that the SEC replace the proposed prohibition based-regime with a disclosure regime. Such a regime would include periodic disclosure of: (1) all political contributions made by the adviser or its covered associates to any covered official during that reporting period; and (2) any government entity to which the adviser provides investment advisory services and where the adviser or its covered associates made a contribution to the entity's covered officials. Disclosure of this activity would provide the SEC and government entities with sufficient information to determine whether advisers were attempting to distort the decision to select investment advisers.

We further suggest that the Proposed Rule be narrowed to better address the SEC's objectives. More specifically, we would propose that (1) the terms "investment advisory services" and "executive officers" be defined to cover only those individuals with a nexus to the provision of investment advisory services to government entities; and (2) the type of contributions that trigger the Two-Year Ban should be narrowed to only cover activity that may actually impact government entities' decision-making.

In the event that the SEC chooses to retain the proposed Two-Year Ban, we further would suggest that the SEC consider revising the look-back period along the lines of what is currently applicable under MSRB Rule G-37, creating a staggered look-back provision based on an employee's proximity to government advisory business, with a more limited six-month period for individuals who are only covered by the Proposed Rule because of their supervisory responsibilities. In the alternative, we propose walling off individuals who made triggering contributions from interacting with government officials for a reasonable period of time. We have also raised the possibility of exempting contributions to presidential and vice-presidential candidates up to the Federal Election Commission statutory maximum and contributions to federal PACs and committees from the Two-Year Ban, and allowing an employee who newly qualifies as a covered associate to request a refund from a covered official within a certain number of months of becoming a covered associate. Finally, we believe that the amount of *de minimis* contributions under the Two-Year Ban should be increased, as well as indexed for inflation.

Third-Party Solicitor Ban

For unaffiliated third parties who solicit advisory services from government entities, SIFMA suggests that the SEC should expand its regulation of payments to such parties to require that investment advisers make payment to such third-party solicitors contingent on their disclosure of political contributions to covered officials. The Cash Solicitation Rule currently regulates the circumstances of payments to third-party solicitors, and a reasonably simple amendment to that rule would provide the best means to address this issue.

Covered Investment Pool Restrictions

We recommend revising the scope of the restrictions on covered investment pools to exclude investment advisers to investment companies and private funds in which the private fund is not a virtual alter ego of the investment adviser. We also recommend that for those advisers to investment pools covered by the Proposed Rule, the restrictions be revised to apply the proposed disclosure-based regime to the covered advisers’ political contributions to covered officials, rather than prohibiting such contributions.

Implementation Period

Finally, because of the significant requirements of time and resources to create the systems required under either a disclosure- or prohibition-based regime, SIFMA also respectfully requests that the SEC establish a longer period for implementing the requirements of the Proposed Rule.

*　　　*　　　*

We appreciate the opportunity to provide comment on the SEC's rule proposal. Please do not hesitate to contact me at (202) 962-7373, or Barbara Stettner and Charles Borden of O'Melveny & Myers LLP at (202) 383-5283, if you have any questions or comments.

Sincerely,

Ira D. Hammerman
Senior Managing Director
and General Counsel

cc: The Hon. Mary Schapiro, Chairman
The Hon. Kathleen L. Casey
The Hon. Luis A. Aguilar
The Hon. Troy A. Paredes
The Hon. Elisse B. Walter
James Brigagliano, Co-Acting Director, Division of Trading and Markets
Daniel M. Gallagher, Co-Acting Director, Division of Trading and Markets
Andrew J. Donohue, Director, Division Of Investment Management
David M. Becker, General Counsel