Staff Responses to Questions about the Pay to Play Rule

Updated as of August 18, 2017

The staff of the Division of Investment Management (the "Division") has prepared the following responses to questions about rule 206(4)-5 (the "pay to play rule") under the Investment Advisers Act of 1940. We may update this posting from time to time with responses to additional questions or to make other modifications, such as if the rule is amended. These responses represent the views of the staff of the Division. They do not constitute a rule, regulation, or statement of the Securities and Exchange Commission, and the Commission has neither approved nor disapproved this information. The adopting release for the pay to play rule, dated July 1, 2010 (the "Adopting Release") can be found at: http://www.sec.gov/rules/final/2010/ia-3043.pdf.

I. Compliance Dates

Question I.1. Compliance Date for Recordkeeping Obligations.

Q: When must an adviser subject to the pay to play rule begin to comply with the related requirement in Advisers Act rule 204-2 to make and keep a record of all government entities to which it provides or has provided advisory services (or which are, or were, investors in any covered investment pool to which the adviser provides or has provided investment advisory services)?

A: An adviser subject to the pay to play rule that is also subject to Advisers Act rule 204-2 must begin to keep such a record on March 14, 2011 (see section III.C. of the Adopting Release). However, an adviser to a registered investment company that is a covered investment pool need not begin to keep such a record of government entities that are, or were, investors in such covered investment pool until September 13, 2011 (see section III.D of the Adopting Release). (Posted March 22, 2011).

We note that the staff of the Division issued a letter on September 12, 2011 regarding an adviser to a registered investment company's compliance with these requirements in Advisers Act rule 204-2. A copy of this letter is available at: http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204.htm.

Question I.2. Coverage Period for Recordkeeping Requirements.

Q: Advisers Act rule 204-2 provides that an adviser subject to the pay to play rule must make and keep a record of all government entities to which it provides or has provided advisory services (or which are, or were, investors in any covered investment pool to which the adviser provides or has provided advisory services) for the past five years, but "not prior to September 13, 2010" (see rule 204-2(a)(18)(i)(B)). Does this mean that an adviser's records must extend back to September 13, 2010?

A: No. An adviser must begin to create and maintain a list of current government clients (if it has any) on March 14, 2011, except clients that are registered investment companies with respect to which it must begin to create and maintain such list on September 13, 2011. (Posted March 22, 2011).

Question I.3. Compliance Date for Regulated Person Recordkeeping

Q: The Commission recently extended the compliance deadline for the pay to play rule's ban on third-party solicitation from June 13, 2012 to nine months after the compliance date of a final rule adopted by the Commission by which municipal advisor firms must register under the Securities Exchange Act of

1934 (see Investment Advisers Act Release No. 3418). May an adviser also delay compliance with the related recordkeeping requirements?

A: The Division would not recommend enforcement action to the Commission if an adviser does not comply with the requirement of Advisers Act rule 204-2(a)(18)(i)(D) to "make and keep a list of the name and business address of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf" until it is required to comply with the rule's third-party solicitation provisions (Modified July 27, 2012).

Question I.4. Compliance Date for the Ban on Third-Party Solicitation

Q: In a June 2012 release (Investment Advisers Act Rel. No. 3418), the Commission extended the compliance date for the ban on third-party solicitation in the Advisers Act pay-to-play rule (rule 206(4)-5) until nine months after the compliance date of a final rule adopted by the Commission by which municipal advisors must register under the Securities Exchange Act of 1934. On June 25, 2015, notice was provided of the third-party solicitation ban compliance date, as set in the June 2012 release, as July 31, 2015. (See Investment Advisers Act Release No. 4129.) Neither FINRA nor the MSRB have yet adopted pay to play rules. Will the staff recommend enforcement action with respect to the third-party solicitation ban in rule 206(4)-5?

A: Rule 206(4)-5 prohibits an investment adviser subject to the rule, and its covered associates, from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser, unless such third party is a "regulated person," defined as (i) an SEC-registered investment adviser, (ii) a registered broker or dealer subject to pay-to-play rules adopted by a registered national securities association, or (iii) a registered municipal advisor that is subject to pay-to-play rules adopted by the MSRB. The Commission must find, by order, that the rules applicable to broker-dealers and municipal advisors (i) impose substantially equivalent or more stringent restrictions than rule 206(4)-5 imposes on investment advisers, and (ii) are consistent with the objectives of rule 206(4)-5.

Until the later of (i) the effective date of such a FINRA pay to play rule or (ii) the effective date of such an MSRB pay to play rule, the Division would not recommend enforcement action to the Commission against an investment adviser or its covered associates under rule 206(4)-5(a)(2)(i) for the payment to any person to solicit a government entity for investment advisory services. (Posted June 25, 2015).

Question I.5. Compliance Date for the Ban on Third-Party Solicitation for Capital Acquisition Brokers

Q: Among other things, rule 206(4)-5 seeks to prevent investment advisers from engaging in pay to play practices that involve an adviser’s payments to third parties to solicit government business. Thus, rule 206(4)-5 prohibits an investment adviser subject to the rule, and its covered associates, from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser. The rule permits payments to a third party that is a “regulated person,” which is defined, in part, to include a registered broker or dealer that is itself subject to pay to play rules adopted by a registered national securities association.

The compliance date of the third-party solicitation ban in rule 206(4)-5 was July 31, 2015 (see Investment Advisers Act Release No. 4129), but because FINRA and the MSRB had not yet adopted pay to play rules at that time, the Division indicated that it would not recommend enforcement action to the Commission against an investment adviser or its covered associates under rule 206(4)-5(a)(2)(i) for

payment to any person to solicit a government entity for investment advisory services until the effective date of such rules (see Question I.4. above). On August 25, 2016, the Commission approved FINRA rules 2030 and 4580, which establish a regime to regulate the activities of member firms that engage in distribution or solicitation activities with government entities on behalf of investment advisers (the "FINRA pay to play rules"). (See Exchange Act Release No. 78683.) The FINRA pay to play rules become effective, and the relief previously provided by the Division expires on its own terms, on August 20, 2017. (See FINRA Regulatory Notice 16-40.)

On August 18, 2016, the Commission approved a set of FINRA rules that apply only to firms that meet the definition of "capital acquisition broker" ("CAB") and that elect to be governed under this rule set (collectively, the "CAB rules"). (See Exchange Act Release No. 78617.) CABs are registered broker-dealers that engage in a limited range of activities, including distribution and solicitation activities with government entities on behalf of investment advisers. The CAB rules subject CABs to certain FINRA rules, but do not expressly provide that the FINRA pay to play rules apply to CABs. On August 18, 2017, FINRA filed with the Commission a proposed rule change to adopt CAB rules 203 and 458, which would apply the established FINRA pay to play rules to CABs. (See Exchange Act Release No. 81438.) But, until the effective date of any rules subjecting CABs to the FINRA pay to play rules, CABs will not be included within the definition of "regulated person," and thus an investment adviser and its covered associates will be prohibited from providing payments to any person that is a CAB to solicit a government entity for investment advisory services.

Will the staff recommend enforcement action to the Commission against an investment adviser or its covered associates under rule 206(4)-5(a)(2)(i) for the payment to any person that is a CAB to solicit a government entity for investment advisory services?

A: Until the effective date of any rules subjecting CABs to the FINRA pay to play rules, the Division would not recommend enforcement action to the Commission against an investment adviser or its covered associates under rule 206(4)-5(a)(2)(i) for payment to any person that is a CAB to solicit a government entity for investment advisory services on behalf of the investment adviser or its covered associates. (Posted August 18, 2017)

II. Definition of "Covered Associate"

Question II.1. Parent Company.

Q: Footnote 179 in the Adopting Release states that, depending on facts and circumstances, there may be instances in which a person who formally resides at an adviser's parent company, but who supervises an adviser's covered associate, could also thereby be considered a covered associate. Would the parent company itself be considered a covered associate?

A: No. Rule 206(4)-5(f)(2) provides that only natural persons (and political action committees ("PACs") controlled by those natural persons or by the investment adviser) can be covered associates. (Posted March 22, 2011).

Question II.2. Managing Members' PACs.

Q: If a company is the managing member of an investment adviser, would its PAC be a covered associate?

A: No. The definition of covered associate only includes managing members who are individuals (i.e., natural persons) (see rule 206(4)-5(f)(2)). Therefore, unless the adviser or any of its covered associates has the ability to direct or cause the direction of the governance or the operations of the managing member's PAC, that PAC would not be a covered associate. (Posted March 22, 2011).

Question II.3. Affiliates.

Q: Can an adviser choose to treat its affiliated company or that affiliate's personnel as covered associates of the adviser in order to enable them to solicit on behalf of the adviser?

A: No. Covered associates include only an investment adviser's general partner, managing member or executive officer, or other individual with a similar status or function; any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and any PAC controlled by the investment adviser or by another covered associate.

As of the compliance date of the pay to play rule's prohibition against paying a third party for solicitations, if an affiliated company receives payment from the adviser to solicit government entities on the adviser's behalf, the affiliated company must be a regulated person under the pay to play rule (see rule 206(4)-5(a)(2)(i)). Likewise, as of that date, if the affiliated company's personnel receive such payment directly, they must be employed by a regulated person and covered by the pay to play restrictions to which the regulated person is subject.

We note that, depending on facts and circumstances, there may be instances in which a person who formally resides at an adviser's affiliated company, but who supervises an adviser's covered associate, could also thereby be considered a covered associate, such that his or her contributions could trigger the rule's two-year time out provision for the adviser (see footnote 179 in the Adopting Release, Question II.1. above, and II.9. and II.10. below). Additionally, rule 206(4)-5 and section 208(d) of the Advisers Act prohibit doing anything indirectly that would be prohibited if done directly (see rule 206(4)-5(d)). (Modified July 27, 2012)

Question II.4. Adviser-Affiliated PACs.

Q: On December 12, 2010, the MSRB issued guidance about PACs affiliated with dealers and municipal finance professionals (see Guidance on Dealer-Affiliated Political Action Committees Under Rule G-37, available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx?tab=2). Does the Commission take a similar view?

A: MSRB guidance does not provide authoritative interpretations of the Commission's pay to play rule. However, where the MSRB's rule G-37 interpretations directly address an issue that the Commission has not addressed, such as this guidance on dealer-affiliated PACs, the interpretations may be useful to consider (see also Question V.2. below). (Posted March 22, 2011).

Question II.5. Chain of Contributions through PACs.

Q: If an adviser or a covered associate of an adviser contributes to a trade association PAC that then contributes to a candidate, would the trade association PAC be a covered associate?

A: Under the rule, a PAC is a covered associate only if the adviser or any of its covered associates has the ability to direct or cause the direction of the governance or the operations of that PAC (see section II.B.2(a)(4) of the Adopting Release). However, a chain of contributions through PACs made for the purpose of avoiding the pay to play rule, would violate the rule's, and section 208(d) of the Advisers

Act's, general prohibitions against doing anything indirectly which would be prohibited if done directly (see rule 206(4)-5(d)). (Posted March 22, 2011).

Question II.6. Covered Associates' Family Members.

Q: Are contributions by an advisory employee's family members covered under the rule?

A: Generally not. However, rule 206(4)-5 and section 208(d) of the Advisers Act prohibit doing anything indirectly which would be prohibited if done directly (see rule 206(4)-5(d)). (Posted March 22, 2011).

Question II.7. Independent Contractors.

Q: If certain personnel of an investment adviser are considered "independent contractors," rather than "employees," for state law or tax law purposes, will they still be regarded as covered associates if they solicit or supervise those who solicit government entities on behalf of the adviser?

A: The term "employee" is not defined in the Advisers Act. The staff interprets the term "employee" to include "independent contractors" acting on behalf of an investment adviser (see Interpretive Release No. IA-1000, at II.C.3). (Posted March 22, 2011).

Question II.8. Employees of a Dual Registrant.

Q: If a firm is registered as both an investment adviser and as a broker-dealer, would all of its employees who solicit government entities for investment advisory services be covered associates?

A: Yes. (Posted March 22, 2011).

Question II.9. Employee Solicitor's Supervisors.

Q: In certain circumstances, an adviser's employee solicitor may be supervised by a person who is employed by the adviser's affiliated company, not by the adviser. In such circumstances, would the supervisor be considered a covered associate?

A: Yes. The definition of covered associate contains no requirement that the supervisor be an employee of the advisory firm. (See also Questions II.1. and II.3. above and footnote 179 in the Adopting Release). (Posted November 8, 2011).

Question II.10. Affiliate Solicitors and the Compliance Date of Third-Party Solicitor Ban.

Q: Until the compliance date of the prohibition against paying a third party for solicitations in rule 206(4)-5(a)(2)(i), must an adviser treat its affiliate's employees as covered associates if they solicit clients on the adviser's behalf?

A: No. (See Investment Advisers Act Release No. 3221, at n.354 and accompanying text. See also Questions II.1., II.3., and II.9 above). (Modified July 27, 2012).

III. Definition of "Government Entity" and "Official"

Question III.1. Foreign Governments.

Q: Does the definition of government entity include foreign governments?

A: No. (Posted March 22, 2011).

Question III.2. Participant-Elected Members of a Board.

Q: Can a participant-elected member of a public pension board be considered an official of a government entity?

A: Yes. The pay to play rule does not differentiate between popularly elected officials and participant-elected officials. The board member would be an official if he or she was, at the time of a contribution, an incumbent, candidate or successful candidate for the office, if the office: (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by the government entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by the government entity (see rule 206(4)-5(f)(6)). (Posted March 22, 2011).

IV. Third-Party Solicitors

Question IV.1. Trailing Compensation for Solicitation.

Q: Under many solicitation agreements, an adviser continues to compensate a solicitor for soliciting a client for as long as the client remains a client of the adviser. If an adviser obtained a government entity client with the assistance of a solicitor (that does not qualify as a regulated person) prior to the pay to play rule's compliance date applicable to the adviser, would trailing payments after that date be prohibited?

A: If the solicitor does not solicit the government entity client after the compliance date, then the trailing payments would not be prohibited. However, solicitation is broadly defined under the rule to include (among other things) communications to retain a client for the adviser (see rule 206(4)-5(f)(10)(i)). Further, a compensation arrangement structured to avoid the pay to play rule's restrictions would violate the pay to play rule's and section 208(d) of the Advisers Act's general prohibitions against doing anything indirectly which would be prohibited if done directly (see rule 206(4)-5(d)). (Posted March 22, 2011).

Question IV.2. Shared Employee of an Adviser and Affiliated Broker-Dealer.

Q: If an adviser's covered associate is also employed by an affiliated broker-dealer firm to solicit government entities on the adviser's behalf, would the broker-dealer firm have to be a regulated person?

A: If the adviser provides or agrees to provide, directly or indirectly, payment to the broker-dealer firm in connection with such solicitation, then the broker-dealer firm would have to be a regulated person (see rule 206(4)-5(a)(2)(i)). Regardless, the shared employee would also be a covered associate of the investment adviser (see rule 206(4)-5(f)(2)). (Posted March 22, 2011).

Question IV.3. Single Exception for a Returned Contribution per Employee Does Not Travel with the Employee.

Q: The exception for returned contributions may be used only once per advisory employee (see rule 206(4)-5(b)(3)(iii)). If that employee becomes employed by another firm, would the new firm be prohibited from relying on the exception with respect to another contribution of that employee?

A: No. (Posted March 22, 2011).

V. Miscellaneous

Question V.1. Affect on State and Local Laws.

Q: Does the pay to play rule pre-empt state and local laws regarding campaign contributions and pay to play activities?

A: No. (Posted March 22, 2011).

Question V.2. Reliance on MSRB Interpretations.

Q: Can the MSRB's rule G-37 interpretations be relied on to interpret the pay to play rule?

A: No. MSRB guidance does not provide authoritative interpretations of the Commission's pay to play rule. However, where the MSRB's rule G-37 interpretations directly address an issue that the Commission has not addressed, such interpretations might be useful to consider. (Posted March 22, 2011).

Question V.3. Contributions to Others.

Q: If an adviser subject to the pay to play rule, or one of the adviser's covered associates, makes a contribution to a political party, PAC or other committee or organization, but not to an official, could the adviser still be subject to a two-year time out under rule 206(4)-5(a)(1)?

A: A contribution to a political party, PAC or other committee or organization would not trigger a two-year time out under rule 206(4)-5(a)(1), unless it is a means to do indirectly what the rule prohibits if done directly (for example, the contribution is earmarked or known to be provided for the benefit of a particular political official) (see footnote 154 of the Adopting Release).

We note, however, that the pay to play rule prohibits advisers and their covered associates from coordinating or soliciting any person (including a non-natural person) or PAC to make any payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity (see rule 206(4)-5(a)(2)(ii)). (Posted March 22, 2011).