SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA–1812; File No. S7–19–99]

RIN 3235–AH72

Political Contributions by Certain Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The Commission is publishing for comment a new rule under the Investment Advisers Act of 1940 that would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or any of its partners, executive officers or solicitors make a contribution to certain elected officials or candidates. The Commission also is proposing rule amendments that would require a registered adviser that has government clients to maintain certain records of the political contributions made by the adviser or any of its partners, executive officers or solicitors. The new rule and rule amendments would address ''pay to play'' practices in the investment adviser industry.

DATES: Comments must be received on or before November 1, 1999.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549–0609. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–19–99; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W. Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Karen L. Goldstein, Attorney, <GoldsteinK@sec.gov>, or Jeffrey O. Himstreet, Attorney, <HimstreetJ@sec.gov>, at (202) 942–0716, Task Force on Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549–0506.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed rule 206(4)-5 (17 CFR 275.206(4)-5) and proposed amendments to rule 204–2 (17 CFR 275.204–2) under the Investment Advisers Act of 1940 (15 U.S.C. 80b) (''Advisers Act'' or ''Act'').

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Executive Summary

Public pension plan assets are held, administered and managed by elected officials for the benefit of citizens, retirees, and other beneficiaries. Elected officials who allow political contributions to play a role in the management of these assets violate the public trust by rewarding those who make political contributions. Moreover, they undermine the fairness of the process by which public contracts are awarded. Similarly, investment advisers that seek to influence the award of advisory contracts by public entities, by making or soliciting political contributions to those officials who are in a position to influence the awards, compromise their fiduciary obligations to the plans. These practices—known as ''pay to play''—distort the process by which investment advisers are selected and can harm plans, which may, consequently, receive inferior advisory services and/or pay higher fees. As a result, the millions of retirees and other beneficiaries who rely on these plans can be harmed.

We believe that advisers' participation in pay to play is inconsistent with the high standards of ethical conduct required of them under the Investment Advisers Act. We are therefore proposing a new rule designed to eliminate an adviser's ability to participate. Proposed rule 206(4)–5 would prohibit an adviser from providing advisory services for compensation to a government client for two years after the adviser, or any of its partners, executive officers or solicitors, make a contribution to state treasurers or comptrollers or other elected officials who can influence the selection of the adviser. The prohibition also would apply to contributions to candidates for these positions, but would not result from contributions of $250 or less to elected officials or candidates for whom the person making the contribution can vote.

Proposed rule 206(4)–5 also would prohibit an adviser from providing or seeking to provide advisory services for compensation to a government client while the adviser, or any of its partners, executive officers or solicitors, solicit contributions for an elected official or candidate. Finally, we are proposing rule amendments that would require an adviser registered with us that has government clients to make and keep certain records regarding the political contributions and solicitation activities of the adviser, its partners, executive officers and solicitors.

I. Background

Persons seeking to do business with the governments of some states and municipalities are increasingly being expected to make political contributions to elected officials or candidates.[1] In some cases, businesses that submit bids for public contracts make political contributions to elected officials, hoping to influence the selection process. In other cases, political contributions are solicited from businesses, or it is simply understood that only contributors will be considered for selection. Contributions do not typically guarantee an award of business to the contributor, but the failure to contribute will guarantee that another is selected. Hence the term ''pay to play.''

Pay to play practices can be viewed as imposing a hidden tax on persons seeking to do business with governments. They increase the cost of government services, which is likely to reflect the cost of the political contribution, and may diminish the quality of services, as officials may award contracts to less qualified advisory firms. Pay to play practices are unfair to businesses, particularly smaller businesses, that cannot afford the required contributions. Pay to play practices call into question the integrity

[1] *See generally* Alexander Heard, The Costs of Democracy 142–145 (1960); Peter M. Manikas, *Campaign Finance, Public Contracts and Equal Protection*, 59 Chi.-Kent L. Rev. 817 (1983). Pay to play practices have been found relating to a variety of government contracts outside of the financial markets. *See, e.g.*, O'Hare Truck Service, Inc. v. City of Northlake, 518 U.S. 712 (1996) (independent towing service contractor).

of public officials and the fairness of the government contracting process.

Pay to play practices have been a significant problem in the municipal securities market.[2] Securities firms seeking to underwrite municipal securities offerings have made political contributions and other payments to officials who are in a position to influence the award of underwriting contracts. After studying pay to play practices, the Commission staff concluded that they harm the municipal securities markets by increasing underwriting costs, undermining the integrity of municipal securities underwritings and damaging investor confidence.[3] We came to the same conclusion in 1994 when we approved Municipal Securities Rulemaking Board (''MSRB'') rule G–37 to end broker-dealer participation in pay to play practices.[4]

Rule G–37 prohibits broker-dealers from engaging in municipal securities business with a government issuer for two years after making a political contribution to an elected official of the issuer who can influence the selection of the broker-dealer.[5] The prohibition applies to contributions made by the firm or any of its ''municipal finance professionals,'' including certain executive officers.[6] A municipal finance professional, however, may make a contribution to a candidate of up to $250 per election without triggering the prohibition if he or she can vote for the candidate.[7] Rule G–37 also prohibits a broker-dealer from providing or seeking to provide underwriting services to a government, if the broker-dealer or any of its municipal finance professionals solicits or coordinates contributions for a candidate or elected official of the government.[8] The MSRB requires broker-dealers to file quarterly reports disclosing the political contributions made by the firm, its executive officers and municipal finance professionals,[9] and to keep accurate records of those contributions.[10]

Since the adoption of rule G–37, the Commission has become concerned about other pay to play practices that are not addressed by that rule; practices which involve public pension plans and other funds. We have received reports that the selection of investment advisers, which we regulate under the Advisers Act, may be influenced by political contributions,[11] and as a result, the quality of management services provided to funds may be affected.[12] We have become particularly concerned about the possibility that the adoption of rule G–37 has resulted in a shift of pay to play practices to this area as political contributions by broker-dealers are curtailed.[13] We therefore have examined the role of investment advisers in the management of public pension funds and other assets, the role of pay to play in their selection, and the implications of pay to play practices on the fiduciary obligations of investment advisers under the federal securities laws.

Investment advisers provide a wide variety of advisory services to state and local governments.[14] Advisers manage public monies that fund pension plans and a number of other important public programs, including transportation, children's programs, arts programs, environmental reclamation, and financial aid for education. In addition, advisers provide risk management,[15] asset allocation,[16] financial planning[17]

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[2] *See Murky Depths (Municipal Finance),* Economist, Nov. 4, 1995, at 83 (''America's municipal bond market is more rife with corruption than even its fiercest critics have claimed''); Terence P. Para, *The Big Sleaze in Muni Bonds,* Fortune, Aug. 7, 1995, at 113; Leah Nathans Spiro et al., *The Trouble with Munis,* Bus. Wk., Sept. 6, 1993, at 44. *See also* Lazard Freres & Co., Securities Exchange Act Release No. 39388 (Dec. 3, 1997) (enforcement action brought against municipal securities dealer for undisclosed contributions made by a former partner and officer through a consultant to obtain municipal securities underwriting business); *SEC* v. *Rudi,* Litigation Release No. 14421 (Feb. 23, 1995) (complaint alleged that financial advisor received ''kickbacks,'' the amount of which were to be reduced by campaign contributions).

[3] *See* Division of Market Regulation, U.S. Securities and Exchange Commission, Staff Report on the Municipal Securities Markets 9–11 (1993).

[4] *See* In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule, Securities Exchange Act Release No. 33868, at sections V.A.1 and 2 (Apr. 7, 1994) (59 FR 17621 (Apr. 13, 1994)) (''Rule G–37 Adopting Release'') (rule G–37 was adopted ''to establish industry-wide restrictions and requirements aimed at preventing fraudulent and manipulative practices''). In approving rule G–37, we also concluded that pay to play practices may harm the municipal markets by fostering a selection process that excludes those firms that do not make contributions, cause less qualified underwriters to be retained, and undermine equitable practices in the municipal securities industry. *Id.* at section V. In 1996, we approved MSRB rule G–38 to prevent persons from circumventing rule G–37 through the use of consultants. *See* Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Consultants, Securities Exchange Act Release No. 36727 (Jan. 17, 1996) (61 FR 1955 (Jan. 24, 1996)).

[5] MSRB rule G–37(b). The prohibition also applies to successful and unsuccessful candidates for an office that can influence the selection of the broker-dealer. MSRB rule G–37(g)(vi). Shortly after rule G–37 became effective, a municipal securities dealer challenged it as an infringement on the constitutional rights of municipal securities professionals. A federal appeals court upheld the constitutionality of rule G–37, finding that the rule served a compelling government interest in preventing fraudulent and manipulative acts. *Blount* v. *SEC,* 61 F.3d 938 (D.C. Cir. 1995), *cert. denied,* 517 U.S. 1119 (1996).

[6] MSRB rule G–37(b). A ''municipal finance professional'' generally is an associated person of a broker-dealer firm who is ''primarily engaged'' in municipal securities activities, solicits municipal securities business on behalf of a broker-dealer, or a person who supervises associated persons primarily engaged in municipal securities activities ''up through and including'' the chief executive officer of the firm (or person performing similar functions). MSRB rule G–37(g)(iv).

[7] MSRB rule G–37(b).

[8] MSRB rule G–37(c).

[9] MSRB rule G–37(e). Firms are required to make quarterly filings with the MSRB on Forms G–37 and G–38. *Id.* These filings are made available to the public through its website, at <http://www.msrb.org> (visited July 22, 1999).

[10] MSRB rule G–8(a)(xvi); Rule G–37 Adopting Release, *supra* note 4, at section III.B.2.

[11] Letter from Thomas Flanigan (former executive director of the California State Teachers' Retirement System) to Arthur Levitt, Chairman, SEC (June 7, 1997), available in File No. S7–19–99 (''(pay to play) potentially places the credibility of many investment operations, either through direct or indirect pressure, in jeopardy''). There also have been numerous press reports of investment advisers engaging in pay to play practices, some of which report an adverse impact on plans. *See infra* note 38.

[12] Anonymous Letter dated Feb. 5, 1999 to Arthur Levitt, Chairman, SEC, available in File No. S7–19–99 (marketer for institutional money manager is ''amazed at how many managers are awarded contracts by public funds due to the money they have donated when there were other more qualified managers available''). *See, e.g.,* Wyatt, Lindsay, *Paring the Politics from a Public Plan,* Pens. Mgmt., Nov. 1995, at 12 (Connecticut treasurer quoted as saying that pay to play ''adversely influenced our treasury''); David A. Vise, *D.C. Pension Plan Mishandled; Too Many Advisers, Poor Financial Results,* Wash. Post, Aug. 15, 1993, at A1.

[13] *See* Eric Bailey, *Firms with State Pacts Are Fertile Donors to Fong,* L.A. Times, May 25, 1998, at A1 ($400,000 decline in contributions from underwriting firms attributed to rule G–37); Bill Krueger, *Money Managers Giving to Boyles,* News & Observer, May 2, 1996, at A1 (noting that rule G–37 ''dried up'' a contribution source for a state treasurer, ''so now he is getting campaign contributions from a group (investment advisers) that is not subject to (rule G–37)''); Gerri Willis, *Filling Carl's War Chest: Comptroller Getting Thousands From State's Money Managers,* Crain's N.Y. Bus., Sept. 16, 1996, at 1 (securities executive observing that ''(b)ecause of the SEC's crackdown on the pay to play nature of the muni bond business, the game has shifted to asset management and brokerage'').

[14] *See* Werner Paul Zorn, *Public Employee Retirement Systems and Benefits, in* Local Government Finance, Concepts and Practices 376 (John E. Peterson and Dennis R. Strachota, eds., 1st ed. 1991) (discussing the services investment advisers provide for public funds).

[15] *See* Robert A. Fippinger, The Securities Law of Public Finance 669 (1997).

[16] *See, e.g.,* Public Employee Retirement Systems, *supra* note 14. *See also* Barry B. Burr, *The New $100 Billion Club, Pens. & Inv., May 4, 1998, at 1.*

[17] *See* Cal. Ed. Code § 22303.5 (1999) (requiring teachers' retirement system to offer retirement planning services to beneficiaries); CalSTRS Financial Education Program <http://www.calstrs.ca.gov/benefit/defined/mbrinfo/

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and cash management services;[18] structure bond offerings;[19] help state and local governments find and evaluate other advisers that manage public funds (''pension consultants'');[20] and provide other types of services.[21]

Most of the public funds managed by investment advisers fund state and municipal pension plans. These pension plans have over $2.3 trillion of assets and represent one-third of all U.S. pension assets.[22] They are among the largest and most active institutional investors in the United States.[23] The management of these funds significantly affects publicly held companies,[24] mutual funds[25] and the securities markets themselves.[26] But most significantly, their management affects the taxpayers,[27] and the millions of state and municipal retirees who rely on the funds for their pensions and other benefits.[28]

Elected officials of state and local governments are involved, directly or indirectly, in the selection of advisers to manage most public pension fund assets. In some jurisdictions, one or more elected officials have sole authority to select advisers.[29] In others, elected officials serve as members[30] or appoint some or all members[31] of a governing board that makes selections.[32] The selection process typically begins with the issuance of a request for proposals (''RFP''). The staff of the governing board of the fund receives the proposals and evaluates the applicants, often with the assistance of a pension consultant. Specific criteria such as past performance, experience, management approach, services and fees are established and used to narrow the list of applicants. Finalists are then interviewed, and the board selects one or more advisers.[33] The board may reject recommendations made by its staff and consultants and, in some instances, boards have selected advisers that were not among the ''finalists.''[34]

The absence of a fully objective bidding process makes it possible for considerations other than merit to intrude into the selection process.[35] The

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mctbl.html> (visited July 22, 1999). Other funds are also considering whether to offer financial planning services to their beneficiaries. *See, e.g.,* Steve Hemmerick, *CalPERS Officials Consider 'Comprehensive' Financial Planning for Participants,* Pens. & Inv., Feb. 8, 1998, at 3.

[18] *See* Government Finance Officers Association, an Introduction to External Money Management for Public Cash Managers 5 (1991).

[19] Not all persons who structure bond offerings for state and local governments are investment advisers subject to regulation under the Advisers Act. *See* The Knight Group (pub. avail. Nov. 13, 1991); East Texas Investment Company (pub. avail. Nov. 14, 1975). *But see* In re O'Brien Partners, Inc., Investment Advisers Act Release No. 1772 (Oct. 27, 1998) (financial advisor was subject to the Advisers Act for rendering advice to municipal securities issuers ''concerning their investment of bond proceeds in securities, including (non-government securities), and was compensated for that advice''). Recently, a group of these firms agreed to a self-imposed ban on making political contributions to obtain business. *See Financial Advisers Support SEC's 'Pay-to-Play'* Rules, WALL. ST. J., Mar. 2, 1999, at A8.

[20] In addition to assisting the fund in selecting investment advisers, pension consultants may also provide advice to state and local governments in designing investment objectives, determining available funding media, or recommending specific securities or investments for the fund. Pension consultants are generally investment advisers subject to the Advisers Act. *See* Applicability of Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release. No. 1092 (Oct. 8, 1987) (52 FR 38400, 38401 (Oct. 16, 1987)).

[21] For example, public funds may retain advisers to perform custodial services. *See, e.g.,* Public Employee Retirement Systems, *supra* note 14, at 376–77.

[22] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States, Flows and Outstandings, First Quarter 1999* (June 11, 1999) (at tables L.119 and L.120). Since 1994, total financial assets of public pension funds have grown by almost 45%. *Id.* at table L.120.

[23] According to a recent survey, seven of the ten largest pension funds were sponsored by state and municipal governments (one was the Federal Retirement Thrift Fund). *Top 200 Pension Funds/ Sponsors,* Pens. & Inv., Jan. 25, 1999, at 30.

[24] *See Corporate Governance: Funds Flex Their Muscles,* Pen. & Inv., at 109 (Oct. 19, 1998) (''Public funds discover they have the clout to influence corporate boards they believe are not acting in the shareholders' best interests.'').

[25] *See* Louis Trager, *Run on State Money Market Funds; Orange County Fallout: $1 Billion in Withdrawals,* San Francisco Examiner, Dec. 19, 1994, at B1 (reporting that, shortly after Orange County filed for bankruptcy, investors withdrew $1.03 billion (nearly 7% of the funds' assets) from money market funds that held securities issued by the county). *See also* Richard Marcis et al., *Mutual Fund Shareholder Response to Market Disruptions,* Investment Company Institute Perspective, at 10 (July 1995) (noting that the Orange County bankruptcy caused outflows in both tax-exempt bond funds and money market funds). Public funds are exempt from regulation as mutual funds under the Investment Company Act of 1940. Sections 2(b) and 3(c)(11) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(b) and 3(c)(11)).

[26] Federal Reserve reports indicate that, of the $2.3 trillion in non-federal government plans, $1.5 trillion are invested in corporate equities. Flow of Funds Accounts, *supra* note 22 (at table L.120).

[27] *See* Paul Zorn, 1997 Survey of State and Local Government Employee Retirement Systems 61 (1997) (''(t)he investment of plan assets is an issue of immense consequence to plan participants, taxpayers, and to the economy as a whole'' as a low rate of return will require additional funding from the sponsoring government, which ''can place an additional strain on the sponsoring government and may require tax increases'').

[28] The most current census data reports that public pension funds have 13.6 million beneficiaries. 1992 Census of Governments, U.S. Bureau of Census, VOL. 4, No. 6, *Employee-Retirement Systems of State and Local Governments,* at ii, 19 (1995) (available at <http:/ /www.census.gov/prod/2/gov/gc92–4/gc924–6.pdf> (visited July 22, 1999)).

[29] *See* ''What Are the Comptroller's Responsibilities?'' available at <http:// www.osc.state.ny.us/divisions/press_office/ response.htm> (visited July 22, 1999) (noting that the placement of state and local government retirement systems assets is under the sole custodianship of the New York State Comptroller). *See also* S.C. Code Ann. §§ 9–1–20, 1–11–10 (Law. Co-op. 1998) (five-member board consisting of five elected officials).

[30] *See, e.g.,* Cal. Gov't Code § 20090 (Deering 1999) (state controller, state treasurer); Md. Code Ann., State Pers. & Pens. § 21–104 (Supp. 1998) (state comptroller, treasurer, secretary of budget, superintendent of schools, and secretary of the state police); Miss. Code Ann. § 25–11–15(2) (1998) (state treasurer); N.C. Gen. Stat. § 135–6 (1999) (state treasurer and state superintendent of public instruction); R.I. Gen. Laws § 36–8–4 (Supp. 1998) (state treasurer); Utah Code Ann. § 49–1–202 (Supp. 1998) (state treasurer); W. VA. Code § 5–10D–1 (Supp. 1998) (governor, state treasurer, state auditor, secretary of the department of administration); Wyo. Stat. § 9–3–404 (Supp. 1998) (state treasurer).

[31] *See, e.g.,* Ariz. Rev. Stat. Ann. § 38–713 (1999) (governor appoints all nine members); CAL. Gov't Code20090 (Deering 1999) (governor appoints three of thirteen members); Hawaii Rev. Stat.§ 88–24 (Supp. 1998) (governor appoints three of eight members); IDAHO CODE § 59–1304 (Supp. 1998) (governor appoints all five members); Kan. Stat. Ann. § 74–4905 (Supp. 1997) (governor appoints four of nine members; speaker of the house and president of the senate each appoint one member); Me. Rev. Stat. Ann. tit. 5, § 17102 (Supp. 1997) (governor appoints four of eight members); Nev. Rev. Stat. § 286.120 (1997) (governor appoints all seven members); N.H. Rev. Stat. Ann. § 100–A:14(i) (1998) (governor and council appoint two of thirteen members); VA. Code Ann. § 51.1–124.20 (Michie 1998) (governor appoints five of nine members); W. Va. Code § 5–10D–1 (1998) (governor appoints ten of fourteen members); Wyo. Stat. § 9–3–404 (Supp. 1998) (governor appoints ten of eleven members (the state treasurer is the other member)).

[32] In some cases, state retirement systems have sought to insulate the selection process from the effects of political contributions by delegating the selection of investment advisers to the professional staff of the fund. *See, e.g.,* Missouri State Employees Retirement System, *External Manager Hiring and Termination Policy* (Nov. 13, 1998). *See* discussion *infra* at section II.A.1.

[33] *See* Stephen A. Berkowitz & Louis D. Finney, the Selection and Management of Investment Managers for Public Pension Plans 40–45 (1990) (discussing the RFP, selection criteria, performance measurement, interview process, and elements of a final contract); Public Cash Managers, *supra* note 18, at 12–13 (discussing elements of the RFP and selection process); M. Corrine Larson, an Introduction to Investment Advisers for State and Local Governments 6 (1996) (discussing the process for drafting the RFP, evaluating RFP responses, interviewing candidates, and selecting advisers); Girard Miller et al., Investing Public Funds5 (1998) (discussing selection criteria, and the use of consultants and an investment committee to aid in the selection process).

[34] *See, e.g.,* Josh Kosman, *Manager Access to Trustees Examined, Investment Mgmt. Wkly.,* Aug. 25, 1997, *available in* 1997 WL 15447410; Too Many Advisers, Poor Financial Results, *supra* note 12.

[35] In approving rule G–37, the MSRB observed, and we agreed, that in a competitive and objective bidding process, there is ''less possibility of collusion and political patronage,'' as bidders are able to publicly compete on price and their willingness to accept market risk. Rule G–37 Adopting Release, *supra* note 4, at section II.A. The prohibition contained in rule G–37 thus applies only to contracts that were awarded on a basis other

management of public pension funds is highly lucrative, and there is keen competition among advisers vying for selection.[36] The record suggests strongly that political contributions can play a significant role in the selection of investment advisers.[37] Allegations of pay to play have been reported in at least seventeen states.[38]

Pay to play practices are rarely explicit: participants do not typically let it be publicly known that contributions are made or accepted for the purpose of influencing the selection of an adviser. As one court noted, ''actors in this field are presumably shrewd enough to structure their relations rather indirectly.'' [39] Some elected officials who are responsible for public pension plans have actively solicited contributions from advisers that either provide or seek to provide advisory services to the state or local government.[40] Several have received large amounts of money from advisers and contractors to the pension funds.[41] Some have participated in the selection of investment advisers shortly before, or shortly after, receiving contributions from the adviser.[42]

Recently, the nation's largest public pension fund, the California Public Employees Retirement System (''CalPERS''), sought to end the participation of its trustees in pay to play practices. The CalPERS actions and subsequent litigation [43] provide unusual insights into how pay to play can work in the selection of investment advisers for public funds. According to court documents submitted by CalPERS, elected officials serving as CalPERS trustees solicited campaign contributions from investment advisers and other fund contractors.[44] Each raised a considerable amount of money from advisers that are providing, or are seeking to provide, advisory services to CalPERS.[45] Failure to contribute reduced the interest of the elected official in the adviser's role in managing the fund; [46] contributing a sufficient amount could lead to the official championing the selection of the adviser,[47] which could even result in the fund selecting the adviser over the recommendation of its professional staff and consultants.[48] In order to avoid the perception of a conflict, the elected officials voluntarily would abstain from a vote concerning an adviser that made contributions,[49] but the officials could participate in the discussions that preceded the vote.[50] CalPERS decided to bar contractors and prospective contractors from making political contributions as an effort to end pay to play, which it described as ''an insidious form of corruption'' that ''infects the entire decision-making process.'' [51]

Two states and some funds have come to similar conclusions regarding pay to play. Vermont and Connecticut both have recently enacted statutes prohibiting any person doing business with state funds from making contributions to the treasurer of either

than a ''competitive bid'' (*i.e.*, negotiated offerings). MSRB rule G–37(g)(vii). Contracts awarded on the basis of a competitive bid remain subject to the federal securities laws. *See* In re Stephens, Inc., Securities Act Release No. 7612 (Nov. 23, 1998) (enforcement action brought against consultant who authorized undisclosed payments to two public officials and an outside pension consultant to obtain municipal finance business that was subject to competitive bidding).

[36] A recent investment adviser search by CalPERS, for example, yielded 269 proposals submitted by 189 managers. *See* Steve Hemmerick, *58 Managers Make CalPERS' First Cut,* PENS. & INV., Aug. 18, 1997, at 6.

[37] In most cases, these political contributions are lawful. Thus, we do not suggest that the elected officials, by accepting these contributions, are acting unlawfully. Also, the Commission has not investigated and therefore cannot confirm the validity of the allegations described in the articles cited or referenced in the footnotes that follow. The *Blount* court held that allegations of pay to play were sufficient to support the rulemaking and that ''no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic.'' 61 F.3d at 945.

[38] The articles and other materials describing allegations of pay to play practices are available in File No. S7–19–99. *See, e.g.*, Janet Aschkenasy, *Pay-to-Play—Scrutiny of Unethical Practices at Public Funds Is Intensifying, But Will Self-Policing Efforts Succeed?*, PLAN SPONSOR, Feb. 1998, at 58–60; Charles Gasparino & Jonathan Axelrod, *Political Money May Sway Business of Public Pensions,* Wall St. J., Mar. 24, 1997, at C1; Matt O'Connor, *Santos Done in by Tape; 'Time to Belly Up' Remark Called Key to Guilty Verdict,* CHI. TRIB., May 4, 1999, at N1.

[39] *Blount,* 61 F.3d at 945.

[40] *See, e.g.*, Scrutiny of Unethical Practices Intensifying, *supra* note 38. Public fund officials also have provided us with first-hand reports of the solicitation activities of elected officials. *See* Letter from Maxie L. Patterson, Executive Director, Houston Firefighters' Relief and Retirement Fund, to Robert Plaze, Associate Director, SEC (Feb. 10, 1999), available in File No. S7–19–99.

[41] *See* Houston Firefighters' Fund Letter, *supra* note 40; Office of Vermont State Treasurer James H. Douglas, *If You Play, You Pay: New Campaign Finance Legislation Prohibits Contracts for Wall Street Firms Contributing to State Treasurer Races, a Provision Pushed by Douglas,* available at <http://www.state.vt.us/treasurer/press/pr970616.htm> (visited July 22, 1999); Scrutiny of Unethical Practices Intensifying, *supra* note 38.

[42] For example, a solicitor for an institutional adviser recently informed us that the solicitor received two invitations from the same elected official in the same week—one to make a presentation to the fund's selection committee, the other to attend a $1,000 fundraising dinner. Anonymous Letter, *supra* note 12. Representatives of the selection committee later requested that the solicitor inform them if a contribution was made ''so they could let the officials know it came from'' the parties making the presentation. Anonymous Letter, *supra* note 12.

[43] An elected official who is a CalPERS fiduciary sued to overturn the CalPERS ban on pay to play practices. A California court invalidated the CalPERS resolutions on procedural grounds. Kathleen Connell for Controller v. CalPERS, No. 98CS01749 (Cal. Sup. Ct. Sept. 18, 1998). *See also* Charles Gasparino, *California Controller's Committee Sues Calpers Over Campaign-Donation Rule,* WALL. ST. J., July 9, 1998, at B7. CalPERS subsequently proposed similar pay to play prohibitions by regulation. California Public Employees' Retirement System, Proposed Regulatory Action, Notice File No. 98–1016–10 (Oct. 30, 1998).

[44] *See* Memorandum of Points and Authorities in Opposition to Petition for Writ of Mandate, Kathleen Connell for Controller v. CalPERS, No. 98CS01749, at 20 (Cal. Sup. Ct. Sept. 4, 1998) (stating that ''there was actual evidence of *massive* contributions solicited by (the state controller) from CalPERS contractors and other prospective contractors'') (emphasis in original); *Oversight of Investment Procedures of the Public Employees' Retirement System and State Teachers' Retirement System, Before the Senate Committee on Public Employment and Retirement,* Calif. Leg. 20–21 (Aug. 25, 1997) (testimony of James E. Burton, Chief Executive Officer, CalPERS).

[45] The state controller, for example, raised over $180,000 from 1995 to 1998 from CalPERS contractors. CalPERS Brief, *supra* note 44 (declaration of Thomas W. Hiltachk). The state treasurer, who also is a CalPERS trustee, raised $150,000 from advisers and other CalPERS contractors in a recent U.S. Senate campaign. *See* Firms with State Pacts, *supra* note 13; Paul Jacobs, *Firms Lobby, Woo State Pension Officials, Win Pacts,* L.A. TIMES, Feb. 4, 1998, at A3.

[46] In connection with the litigation, CalPERS submitted a declaration in which an adviser stated that, after refusing to make a political contribution, the elected official's representative contacted the adviser less frequently about investment matters, and displayed a ''higher degree of skepticism'' about the adviser's recommendations. CalPERS Brief, *supra* note 44 (declaration of Leslie Brun, Hamilton Lane Advisors, Inc.). *See also* Paul Jacobs, *Donations to Pension Officials Scrutinized; Politics: Connell, Fong Say They Are not Influenced by Contributions from Firms Doing Business with State Systems,* L.A. Times, Aug. 21, 1997, at A1; Dan Smith, *Connell Accused of Shunning Non-Donor,* Sacramento Bee, Aug. 14, 1998, at A3.

[47] *See* Paul Jacobs, *Firms Lobby, Woo State Pension Officials, Win Pacts,* L.A. TIMES, Feb. 2, 1998, at A1. Elected officials may not only champion the selection of contributors, but also may advocate their retention. *See California Pension Fund Weathers Investment Controversy,* Nat'l Mortgage News, June 24, 1996, at 10.

[48] *See* Steve Hemmerick, *California Funds to Review Voting,* PENS. & INV., Sept. 15, 1997, at 36; Paul Jacobs, *Investment Raises Questions About State Pension Fund Finance,* L.A. TIMES, Sept. 16, 1997, at A1; *cf.* Manager Access to Trustees Examined, *supra* note 34.

[49] *See* Scrutiny of Unethical Practices Intensifying, *supra* note 38.

[50] *See* CalPERS Brief, *supra* note 44, at n. 16 (noting that one trustee who abstained from voting to award contracts to contributors ''has never'' sought recusal from ''participating in the discussions affecting the contributor''); Donations to Pension Officials, *supra* note 46.

[51] CalPERS Brief, *supra* note 44, at 8. CalPERS stated that pay to play negatively affects the decision-making process because ''it appears that decisions are made, not only by considering who gave a contribution, but also by considering who did *not* give a contribution.'' CalPERS Brief, *supra* note 44, at 8 (emphasis in original).

state.[52] The Connecticut Treasurer noted that, before the legislation was enacted, ''investment managers (were) being chosen more for their political connections and campaign contributions than for their performance.'' [53] Some funds have adopted codes of ethics prohibiting trustees from accepting contributions.[54] Some have delegated the selection of investment advisers to professional staff members, aiming to insulate the selection process from considerations of campaign contributions.[55] Not all efforts to address pay to play have been effective,[56] and most jurisdictions and pension plans have not acted effectively to stop pay to play practices.[57]

[52] *See* CONN. GEN. STAT. § 9–333o (1997); VT. STAT. ANN. tit. 32, § 109 (1997). Efforts to eliminate pay to play are not limited to the securities industry. Bar associations also are considering similar prohibitions to address pay to play practices in the legal profession. *See* American Bar Ass'n, Report and Recommendations of the Task Force on Lawyers' Political Contributions, Part I (July 1998); Special Committee on Government Ethics, Association of the Bar of the City of New York, Campaign Contributions by Lawyers Seeking Government Finance Work (Feb. 1997).

[53] *See* Christopher Burnham, *Reviving a Pension Plan,* AM. City & County, July 1998.

[54] *See, e.g.,* Oregon Investment Council, *Standard of Ethics,* at 1–2 (July 1998); State of New Hampshire, *An Order Enacting a Code of Ethics for Public Officials and Employees of the Executive Branch in the Performance of Their Official Duties,* Executive Order No. 98–1, at 2 (May 19, 1998); Fulton County Employees Retirement System Board, *Ethics Policy,* at 4–5 (Feb. 11, 1998). Other funds require disclosure of political contributions. *See, e.g.,* Cal. Gov. Code § 20152.5 (1999); Texas Permanent School Fund Operating Rules, Chapter 4, Conduct and Public Relations (Mar. 6, 1998).

[55] *See, e.g.,* Missouri Investment Adviser Selection Policy, *supra* note 32.

[56] Some public pension plans, for example, prohibit firms that contract with the plan from making contributions to plan trustees, but the prohibition does not apply to executives of the firm. Similarly, several statutory prohibitions apply only to contributions made to particular officeholders, but not to other elected officials who are plan trustees, appoint plan trustees, or otherwise can influence the selection of an investment adviser. Some codes of ethics can be difficult to enforce when plans are faced with evidence of pay to play. Also, some advisers have found a way to circumvent state and plan limitations and disclosure requirements by making political contributions indirectly, through the use of third parties such as consultants. *See infra* notes 92 to 93, and accompanying text (discussing the use of ''gatekeepers'').

[57] It is possible that many jurisdictions have found it difficult to address pay to play practices due to what the *Blount* court calls a ''collective action problem (that tends) to make the misallocation of resources persist.'' *Blount,* 61 F.3d at 945–46. Elected officials that accept contributions from state contractors may believe they have an advantage over their opponents that forswear the contributions, and firms that do not ''pay'' may fear they will lose government business to those that do. *See id. See generally* Mancur Olson, The Logic of Collective Action; Public Goods and the Theory of Groups 44 (17th ed. 1998) (group members that seek to maximize their individual personal welfare will not act to advance common objectives absent coercion or other incentive). *See also* Donations to Public Officials, *supra* note 46 (fund contractor quoted as saying, ''(i)f you don't contribute, you're subject to the concern that others might make contributions'').

II. Discussion

The Commission regulates investment advisers under the Investment Advisers Act of 1940. Section 206(1) of the Advisers Act prohibits an investment adviser from ''employ(ing) any device, scheme, or artifice to defraud any client or prospective client.'' [58] Section 206(2) prohibits advisers from engaging in any act, practice or course of business which operates as a fraud on a client or prospective client.[59] The Supreme Court has construed section 206 as establishing a federal fiduciary standard governing the conduct of advisers.[60]

An adviser that participates in pay to play practices undermines the merit-based selection process established by the public pension plan.[61] When an adviser makes political contributions to elected officials for the purpose of influencing the award of an advisory contract, the adviser contributes to the risk that the officials may ''award the contracts on the basis of benefit to their campaign chests rather than to the governmental entity.'' [62] If pay to play is a factor in the selection process, the public pension plan can be harmed in several ways. The most qualified adviser may not be selected, leading to inferior management, diminished returns or even losses.[63] The pension plan may pay higher fees because advisers must recoup the costs of contributions, or because contract negotiations may not occur on an arm's-length basis.[64] Moreover, the absence of arm's-length negotiations may enable advisers to obtain greater ancillary benefits, such as ''soft dollars,'' from the advisory relationship, which may be directed for the benefit of the adviser, at the expense of the pension plan, thereby using a fund asset for its own purposes.

[58] 15 U.S.C. 80b–6(1).

[59] 15 U.S.C. 80b–6(2).

[60] Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (citations omitted); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–192 (1963).

[61] *See supra* notes 29 to 34 and accompanying text.

[62] *Blount,* 61 F.3d at 944–45.

[63] Paring the Politics, *supra* note 12, at 12 (Connecticut treasurer quoted as saying that pay to play ''adversely influenced our treasury''); Too Many Advisers, Poor Financial Results, *supra* note 12 (municipal fund awarded contract to an adviser that ''had the worst performance numbers of all the candidates interviewed'').

[64] *See State Street Effort Fails in Its Lawsuit On Pennsylvania Pact,* Wall. St. J., May 28, 1998, at B17. Firm executives contributed ''perhaps several thousand dollars'' to the outgoing treasurer's campaign. *Id.*

Because pay to play has the potential to harm advisory clients, we believe that it is inconsistent with the high standards of ethical conduct required of fiduciaries under the Advisers Act. We have authority under section 206(4) of the Act to adopt rules ''reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.'' [65] Congress gave us this authority to prohibit ''specific evils'' that the broad anti-fraud provisions may be incapable of covering.[66] The provision thus permits the Commission to adopt prophylactic rules designed to prevent fraudulent conduct even if not all of the conduct prohibited is fraudulent.[67]

We are proposing new rule 206(4)–5 to prevent advisers from participating in pay to play practices and protect clients from the consequences of pay to play. The rule, and related rule amendments that we are also proposing today, are described below.

A. Rule 206(4)–5

Under proposed rule 206(4)–5, it would be a fraudulent, deceptive, or

[65] 15 U.S.C. 80b–6(4).

[66] S. Rep. No. 1760, 86th Cong., 2d Sess. 4, 8 (1960). The Commission has used this authority to adopt four rules addressing abusive advertising practices, custodial arrangements, the use of solicitors and required disclosures regarding the adviser's financial condition and disciplinary history. 17 CFR 275.206(4)–1; 275.206(4)–2; 275.206(4)–3; and 275.206(4)–4.

[67] The Supreme Court, in U.S. v. O'Hagan, 521 U.S. 642 (1997), interpreted nearly identical language in Section 14(e) of the Securities Exchange Act of 1934 (''Exchange Act'') (15 U.S.C. 78n(e)) as providing the Commission with authority to adopt rules that are ''definitional and prophylactic'' and that may prohibit acts that ''are not themselves fraudulent * * * if the prohibitions are reasonably designed to prevent acts and practices that are fraudulent.'' 521 U.S. 667, 673. The language of both section 206(4) and section 14(e) was taken from section 15(c)(2) of the Exchange Act (15 U.S.C. 78o(c)(2)). *See SEC Legislation, Hearing on S. 1180, S. 1181 and S. 1182, Before the Senate Committee on Banking and Currency, Subcommittee on Securities,* 86th Cong., 2d Sess. 137 (1959) (testimony of Philip A. Loomis, Director, Division of Trading and Exchanges, SEC) (''(The language of Section 206(4)) is almost the identical wording of Section 15(c)(2) of the Securities Exchange Act in regard to brokers and dealers.'') and S. Rep. No. 1760, 86th Cong., 2d Sess. 8 (June 28, 1960) (''(The language of section 206(4)) is almost the identical wording of Section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers.''). *See also* H.R. Rep. No. 1655, 91st Cong., 2d Sess. at 4 (Dec. 7, 10, 1970) (the amendment to section 14(e) ''is identical to that contained in existing section 15(c)(2) of the Exchange Act''). Congress, in amending section 15(c)(2) to expand the Commission's authority to prohibit fraud by municipal securities dealers, described the Commission's rulemaking authority under section 15(c)(2)(D) as including ''the promulgation of prophylactic rules.'' S. Rep. No. 75, 94th Cong., 1st Sess. 228 (Apr. 14, 1975).

manipulative act for an investment adviser to provide advisory services for compensation to a government entity within two years after the adviser, any of its partners, executive officers or solicitors made a contribution to an elected official who could influence the selection of the adviser. The rule would also make it unlawful for an adviser to solicit contributions for an official of a government client while providing or seeking to provide the government client advisory services. Proposed rule 206(4)–5 would not be a ban on political contributions, but rather a ban, or ''time-out,'' on conducting advisory business with a government client for two years after a contribution is made.

Investment advisers subject to the proposed rule would include all investment advisers that are not prohibited from registering with the Commission.[68] As a result, the rule would apply to Commission-registered advisers and those exempt from registration under section 203 of the Advisers Act, such as those advisers that had fewer than fifteen clients during the last twelve months.[69]

The rule generally would not apply to smaller advisers that are registered with state securities authorities.[70] We believe that the great majority of advisers to public funds are registered with the Commission. We, therefore, are not proposing to cover state-registered advisers under the proposed rule. We request comment on our assumption, and on whether we should extend the scope of the proposed rule to include state-registered advisers.

The Commission modeled proposed rule 206(4)–5 after MSRB rule G–37, which we believe has successfully addressed pay to play in the municipal bond market. This approach should minimize the compliance burdens on firms that would be subject to both rules by allowing them to adopt common compliance procedures. We have modified the proposed rule, however, to reflect the different statutory framework under which the rule would be adopted and the differences between municipal underwriting and asset management. The differences between proposed rule 206(4)–5 and rule G–37 are highlighted below. Comment is requested on whether we should use rule G–37 as a model for proposed rule 206(4)–5. Are there additional differences in the selection of municipal underwriters and investment advisers that should be reflected in the rule?

The Commission considered proposing a different approach to address pay to play, which would require an adviser to disclose information concerning its political contributions. Disclosure, however, may not be effective to protect public pension plan clients. Disclosure to a pension plan's trustees would be ineffective because, in some cases, the trustees would have received the contributions. Disclosure to plan beneficiaries also would be ineffective because they are generally unable to act on the information by moving their pension assets to a different plan or reversing adviser hiring decisions.[71] Moreover, disclosure requirements have not worked in the past at stopping pay to play practices and can be circumvented.[72] We request comment on this approach.

1. ''Pay to Play'' Restrictions

Proposed rule 206(4)–5 would prohibit investment advisers from providing advice for compensation to a ''government entity'' [73] within two years after a contribution to an official of the government entity has been made by (i) the adviser, (ii) any of its partners, executive officers or solicitors, or (iii) any political action committee (''PAC'') controlled by the adviser or by any of the adviser's partners, executive officers or solicitors.[74] Each element of the proposed rule and one exception from the prohibition are discussed below.

Investment advisers making contributions covered by the proposed rule would not be prohibited from providing advisory services to a government client, but only from *receiving compensation* from the client for providing advisory services. This approach is intended to avoid requiring an adviser to abandon a government client after the adviser or any of its partners, executive officers or solicitors make a political contribution covered by the rule. An adviser subject to the prohibition would likely be obligated to provide (uncompensated) advisory services until the government client finds a successor.[75] Alternatively, the rule could establish a time period after the expiration of which the adviser could no longer provide advisory services. We request comment on which approach would cause the least disruption to the government client.

The prohibitions in the rule would be triggered by a contribution to an *official of a government entity*. Government entities under the proposed rule include all state and local governments, their agencies and instrumentalities, and all government pension plans and other collective government funds.[76] An official would include an incumbent, candidate or successful candidate for elective office of a government entity if the office (or an appointee of the office) is directly or indirectly responsible for, or can influence the outcome of, the selection of an investment adviser.[77] Generally, executive or legislative officers who hold a position with influence over the selection of an investment adviser are government officials under the proposed rule.[78] These definitions are substantively the same as those in MSRB rule G–37.[79]

[68] Proposed rule 206(4)–5(a).

[69] Section 203(b) of the Advisers Act (15 U.S.C. 80b–3(b)). The Commission is including unregistered advisers within the scope of the rule principally to make the rule applicable to advisers to private investment companies. *See* discussion *infra* section II.A.4.

[70] Amendments to the Advisers Act in 1996 placed regulatory responsibility for these advisers in the hands of state regulators. *See* section 203A of the Advisers Act (15 U.S.C. 80b–3a) enacted as part of Title III of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

[71] For these reasons, the Commission is not proposing a reporting requirement for advisers required to keep records of their political contributions under the proposed amendments to the recordkeeping rules. *See* discussion of recordkeeping amendments *infra* at Section II.B. MSRB rule G–37, however, does establish a reporting and disclosure system for broker-dealers subject to that rule. MSRB rule G–37(e)(ii).

[72] *See* discussion of ''gatekeepers'' *supra* section II.A.2.

[73] ''Government entity'' is defined by the proposed rule as any State or political subdivision of a State, including any agency, authority, or instrumentality, plan or pool of assets controlled by the State or political subdivision or any agency, authority or instrumentality thereof; and officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity. Proposed rule 206(4)–5(e)(3). In this Release, we use the term government entity interchangeably with ''government client'' and ''public pension plan.''

[74] Proposed rule 206(4)–5(a)(1).

[75] An investment adviser that violates the rule may be required, under its fiduciary duties, to continue providing advisory services to the public fund, for a reasonable period of time, until the fund obtains a new adviser. *See* Temporary Exemption for Certain Investment Advisers, Investment Advisers Act Release No. 1736 (July 22, 1998) (63 FR 40231, 40232 (July 28, 1998)) (describing an investment adviser's fiduciary duties to an investment company in the case of an unforeseeable assignment of the advisory contract).

[76] Proposed rule 206(4)–5(e)(3).

[77] Proposed rule 206(4)–5(e)(4).

[78] The scope of authority of the particular office of an official, not the individual, would determine whether the official may have influence over the awarding of an investment advisory contract. In some cases, authority to select and terminate an investment adviser is completely delegated to the staff of a public fund, in which case a government official may not be able to influence the selection. *See supra* note 32. Under the proposed rule, contributions to the official would not trigger the prohibitions of the rule.

[79] MSRB rule G–37(g)(ii) and (g)(vi).

The proposed rule covers *contributions* made by an investment adviser, its partners, executive officers and solicitors; and any PAC controlled by the adviser or any of its partners, executive officers or solicitors. The proposed rule uses the same definition of contribution as MSRB rule G–37.[80] A contribution would generally be anything of value made to an official to influence a federal, state or local election, including any payments for debts incurred in an election, and transition or inaugural expenses incurred by a successful candidate for state or local office.[81]

Contributions made to influence the selection process are typically made not by the firm, but by officers and employees of the firm who have a direct economic stake in the business relationship with the government client. This is why the MSRB also applied the prohibitions of rule G–37 to contributions made by ''municipal finance professionals'' employed by a broker-dealer. There is no group, however, within the typical investment advisory firm that corresponds to municipal finance professionals. In our examination of pay to play practices involving investment advisers, we found that political contributions intended to influence the selection of the advisory firm were typically made by executives of the adviser or persons who solicit government clients on behalf of the adviser. Therefore, we are proposing to limit application of the rule to contributions made by the adviser or its partners, executive officers or solicitors.

Under the proposed rule, the term *executive officer* includes the adviser's president, vice-presidents in charge of a business unit or division of the adviser, and other officers or persons who perform a policy-making function for the adviser.[82] A *solicitor* is any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser.[83] Employees who play a role in obtaining government clients are thus covered by the proposed rule as are third-party solicitors an investment adviser engages to obtain clients. Contributions by other employees of the adviser or other persons (such as spouses, control persons and affiliates) would not otherwise trigger the rule's prohibitions unless the adviser or any of its partners, executives or solicitors used the person to indirectly make a contribution. This could occur, for example, if a firm paid a non-executive employee a bonus with the expectation or understanding that the employee would make a political contribution that, if made by the firm, would trigger the rule's prohibition.[84]

The Commission has drafted the proposed rule so that its prohibitions are triggered by political contributions by persons we have found are typically involved in pay to play practices and who, in the context of an advisory firm, are likely to have an economic incentive to make contributions to influence the advisory firm's selection. We are mindful of the burdens the proposed rule would place on advisory firms and on the ability of persons associated with an adviser to participate in civic affairs. We thus have narrowly tailored the rule to achieve our goal of ending adviser participation in pay to play practices. We request comment on the scope of the rule in its application to persons associated with an adviser. Are there less restrictive alternatives that would accomplish our goals?

Proposed rule 206(4)–5 contains a *de minimis* provision that would permit a partner, executive officer or solicitor to make contributions of $250 or less to an elected official or candidate without triggering the rule's prohibitions if the person making the contribution is entitled to vote for the official or candidate.[85] The Commission assumes that contributions of less than $250 are typically made without the intent or ability to influence the selection process for investment advisers and thus do not involve the conflicts of interest the rule is intended to prevent. Comment is requested on the scope of the exception. The $250 amount is the same as the *de minimis* amount excepted from MSRB rule G–37.[86] Should the amount be increased or decreased? Should we provide a *de minimis* exemption for contributions of a lesser amount, *e.g.* $100, to officials for whom an individual is not entitled to vote?

Under the proposed rule, a contribution made by a partner, executive officer or solicitor of an adviser would also be attributed to any other adviser that employs or engages the person who made the contribution within two years after the date the contribution was made.[87] As a result, an investment adviser would be required to ''look-back'' in time to determine whether it would be subject to any business restrictions under the proposed rule when employing or engaging a partner, executive officer or solicitor. This provision, which is similar to one in MSRB rule G–37,[88] would prevent advisers from circumventing the rule by channeling contributions through departing employees, or by influencing the selection process by hiring persons who have made political contributions. Comment is requested on the look-back requirement. Would a shorter period be sufficient to prevent circumvention of the rule?

2. Solicitation Restrictions

Another way an adviser can attempt to influence the selection process is by soliciting contributions for an elected official. Therefore, like MSRB rule G–37,[89] the proposed rule would prohibit an adviser from providing or seeking to provide advisory services for compensation while the adviser, or any of its partners, executive officers or solicitors, solicit any person or PAC to make, or coordinate, any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory

[80] MSRB rule G–37(g). Like rule G–37, the proposed rule would encompass, for federal offices, only those contributions to an official of a government entity who is seeking election to a federal office. Proposed rule 206(4)–5(e)(3).

[81] Proposed rule 206(4)–5(e)(1). Contributions to political parties would not trigger the proposed rule's prohibitions, unless the contribution is earmarked or known to be provided to an official. Contributions to state and local political parties are, however, subject to the proposed rule's recordkeeping requirements. *See infra* section II.B.

[82] Proposed rule 206(4)–5(e)(2). The definition of ''executive officer'' is the same as that used in Advisers Act rule 205–3. 17 CFR 275.205–3.

[83] Proposed rule 206(4)–5(e)(6). The definition of ''solicitor'' is the same as that used in Advisers Act rule 206(4)–3. 17 CFR 275.206(4)–3.

[84] *See* discussion of indirect contributions *infra* section II.A.3.

[85] Proposed rule 206(4)–5(b). Under the proposed rule, a partner, executive officer or solicitor of an investment adviser could, without triggering the prohibitions of the rule, contribute up to $250 in both the primary election campaign and the general election campaign (up to $500) of each official for whom the person making the contribution would be entitled to vote. For purposes of this rule, a person would be ''entitled to vote'' for an official if the person's principal residence is in the locality in which the official seeks election.

[86] MSRB rule G–37(b).

[87] Proposed rule 206(4)–5(a)(1)(ii). Persons who are employees as well as ''independent contractors'' would be covered by the proposed rule. In no case would the prohibition imposed by the proposed rule be longer than two years from the date the executive officer makes a covered contribution. If, for example, an executive officer becomes employed by an investment adviser one year and six months after making a contribution, the new employer would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. The executive officer's employer at the time of the contribution would be subject to the proposed rule's prohibition for the entire two-year period regardless of whether the executive officer remains employed by the adviser. However, if an executive officer is not an employee of an adviser, the adviser would not be responsible for any recordkeeping requirements with respect to that executive officer. *See supra* section II.B.

[88] MSRB rule G–37(g)(iv).

[89] MSRB rule G–37(c).

services.[90] This provision would also prohibit advisers from seeking to influence the selection process by, for example, ''bundling'' [91] contributions from its employees or by making contributions through a third party, such as a ''gatekeeper.''

In a gatekeeper arrangement, political contributions are arranged by an intermediary, typically a pension consultant, which distributes or directs contributions to elected officials or candidates. The gatekeeper ensures that advisers not making a requisite amount of contributions are not included among the final candidates for advisory contracts. In addition, the gatekeeper may arrange ''swaps'' of contributions between elected officials in order to shield the contributions from public disclosure or to circumvent plan restrictions on contributions to trustees.[92] Under the proposed rule, the gatekeeper in these arrangements would be soliciting political contributions and, if the gatekeeper is an investment adviser, would violate the proposed rule.[93]

3. Direct and Indirect Contributions or Solicitations

The proposed rule would also prohibit acts ''done indirectly, which, if done directly would be considered a fraudulent, deceptive or manipulative act under the rule.'' [94] Thus, an adviser could not circumvent the rule by directing or funding contributions through third parties, including, for example, consultants, attorneys, family members or persons controlling the adviser who have an economic interest in the adviser being awarded an advisory contract. This provision would also cover contributions made, directed or funded, with the expectation that, as a result of the contribution, another contribution would be made by a third party for the benefit of the adviser. Contributions made through gatekeepers (described above) thus would be considered made ''indirectly'' for purposes of the proposed rule.

4. Private Investment Companies

In some cases, advisers to ''private investment companies,'' [95] such as hedge funds and venture capital pools, have reportedly made contributions to elected officials who have influenced the decision of a government entity to invest in the adviser's company.[96] The proposed rule would treat an investment by a government entity in a private investment company the same as if the government entity entered into an advisory contract directly with the adviser.[97] As a result, a contribution by an adviser, any of its partners, executive officers or solicitors to an official of a government entity who can influence the decision to invest in the private fund, would trigger the prohibitions of the proposed rule. If the government entity was an investor in the fund at the time of the contribution, the adviser would be required to cause the private investment company to redeem the investment of the government entity, or, alternatively, return to the government entity amounts it received as compensation for managing the assets of the private investment company attributable to the government entity's investment. The Commission requests comment on whether additional types of government investments should be covered by the proposed rule. In particular, should the rule apply to off-shore funds, which do not fall within the definition of private investment company, and therefore are not subject to the proposed rule?[98]

5. Exemptions

Under the proposed rule the Commission could, upon application, exempt advisers from the rule's prohibitions that are triggered by inadvertent contributions or when imposition of the prohibitions is inconsistent with the rule's intended purpose. In determining whether to grant an exemption, we would consider whether (i) the exemption is in the public interest and consistent with the purposes of the rule, (ii) the adviser, before the contribution is made, had developed procedures to ensure compliance with the rule and had no actual knowledge of the contributions, and (iii) the adviser, after the contribution was made, took appropriate preventative and remedial measures, including all available steps to obtain a return of the contribution.[99]

These factors are similar to those considered by the NASD and the appropriate bank regulators in determining whether to grant an exemption under MSRB rule G–37(i). Under the proposed rule, however, exemptive authority will be exercised by the Commission.[100] In applying the criteria, we expect to take into account, among other things, the varying facts and circumstances presented by each application. We would apply these exemptive provisions with sufficient flexibility to avoid consequences disproportionate to the violation while accomplishing the remedial purpose of the rule.[101] We request comment on the proposed exemptive criteria. Are there additional criteria the Commission should consider when determining whether to grant an exemption.

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[90] Proposed rule 206(4)–5(a)(2)(i). An investment adviser would be seeking to provide advisory services to a government entity when it responds to an RFP, communicates with a government entity regarding that entity's formal selection process for investment advisers, or engages in some other solicitation of investment advisory business with the government entity. A violation of paragraph (a)(2)(i) of the proposed rule would not trigger a two-year ban on the provision of investment advisory services for compensation, but would be a violation of the rule.

[91] An employee or person acting on an adviser's behalf ''bundles'' contributions by coordinating small contributions from several employees of the adviser to create one large contribution.

[92] For example, Adviser A advises Plan X, while Adviser B advises Plan Y. The ''gatekeeper'' may direct a political contribution from Adviser A to the elected official, who is a trustee to Plan Y, and from Adviser B to the elected official, who is a trustee to Plan X, agreeing to place both advisers on each plan's approved list. Persons reviewing records of the political contributions would have no way of determining that the contributions were swapped and that they created conflicts of interest on the part of the advisers as well as the elected officials.

[93] Regardless of whether the gatekeeper is an investment adviser, a person participating in such a scheme would, if the rule is adopted, likely be aiding and abetting an adviser's violation of the rule. *See* section 209(d) of the Act (15 U.S.C. 80b–9(d)) (authorizing Commission enforcement action for aiding and abetting a violation of the Advisers Act or any Advisers Act rule).

[94] Proposed rule 206(4)–5(a)(2)(ii). *See also* section 208(d) of the Advisers Act (15 U.S.C. 80b–8(d)).

[95] The proposed rule defines a private investment company as an investment company exempt from Commission registration under section 3(c)(1) or (3)(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)(1) and 3(c)(7)). Proposed rule 206(4)–5(e)(5).

[96] The articles describing allegations that advisers to private investment companies engage in pay to play practices are available in File No. S7–19–99.

[97] Proposed rule 206(4)–5(c). The proposed rule would thus ''look through'' the private investment company and treat its security holders as clients of the adviser. *Cf.* rule 205–3(b) (17 CFR 275.205–3(b)) (equity owners of private investment companies treated as clients for purposes of performance fee exemptive rule).

[98] Off-shore funds are generally not required to register with the Commission under section 8(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–8(a)).

[99] Proposed rule 206(4)–5(d).

[100] The MSRB has provided four ''Questions and Answers'' regarding application of MSRB rule G–37–(i). Question 4, *Additional Rule G–37 Q&As,* June 15, 1995, MSRB Rule Book at 196 (1999), *Questions and Answers Regarding Rule G–37(i),* June 29, 1998, MSRB Rule Book at 199 (1999). Denials of an exemption pursuant to MSRB Rule G–37(i) are not subject to appeal to the Commission. *See* In re Morgan Stanley & Co., Securities Exchange Act Release No. 39459 (Dec. 17, 1997).

[101] Under the proposed rule, an adviser applying for an exemption, could place advisory fees earned between the date of the contribution triggering the prohibition and the date on which we determine whether to grant an exemption in an escrow account. The escrow account would be payable to the adviser if the Commission grants the exemption. If the Commission does not grant the exemption, the fees contained in the account must be returned to the public fund.

B. Recordkeeping

We are also proposing amendments to rule 204–2 to require an investment adviser that is registered with us and has government clients to make and keep certain records of contributions made by the adviser, its partners, executive officers and solicitors.[102] These records would be confidential,[103] and only reviewed by our staff in the course of an adviser examination. We believe they would be necessary to allow us to enforce compliance with rule 206(4)–5, if adopted.

The proposed amendments would require an adviser to make and keep a list of its partners, executive officers and solicitors, the states in which the adviser has, or is seeking, government clients, the identity of those clients, and the contributions made by the firm and its partners, executive officers and solicitors to government officials and candidates.[104] These requirements would be similar to the MSRB recordkeeping rule for broker-dealers.[105]

These new recordkeeping requirements should not be burdensome. As discussed above, a single contribution could, under the rule, lead to a two-year suspension of advisory activities for a government client. We would expect, therefore, that advisers would adopt sufficient internal procedures to prevent the rule's prohibitions from being triggered. The records that we propose registered advisers make and keep would be those an adviser undertaking a serious compliance effort would ordinarily make, and thus we assume the amendments would involve no substantial additional burdens. Comment is requested on our assumptions and on whether our assessment of the burdens is correct. We request that commenters opposing the new recordkeeping requirements suggest alternative means we could use to enforce the new rule.

C. Transition Period

The prohibition and recordkeeping requirements under the proposed rule would arise from contributions made on or after the effective date of the rule, if adopted. As a result, firms would need to begin monitoring contributions made by their partners, executive officers and solicitors on that date. The Commission requests comment on whether firms would require additional time to develop procedures to comply with the proposed rule and, if so, how long of a transitional period following the rule's adoption would be necessary?

D. General Request for Comment

Any interested persons wishing to submit written comments on the proposed rule and rule amendment that are the subject of this release, or to suggest additional changes or submit comments on other matters that might have an effect on the proposals described above, are requested to do so. Commenters suggesting alternative approaches are encouraged to submit proposed rule text.

III. Cost/Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules, and understand that compliance with proposed rule 206(4)–5 and the proposed amendments to rule 204–2 may impose costs on some advisers. The proposed rule and rule amendments would apply only to investment advisers that provide advisory services to government clients and which make political contributions. In addition, the proposed rule and rule amendments would only affect the political contributions made by the adviser, and its partners, executive officers and solicitors. The majority of advisers and advisory employees thus would be unaffected by the proposed rule and rule amendments.

A. Benefits

Proposed rule 206(4)–5 would likely yield several important benefits to investment advisers and state and local governments, both direct and indirect. The proposed rule would reduce or eliminate the costs of political contributions incurred by investment advisers through pay to play practices. While not readily quantifiable, the record above indicates that advisers, and their partners, executive officers and solicitors, have made substantial contributions to elected officials from whom the advisers are seeking business.[106] We believe these contributions would decrease substantially if the proposed rule were adopted. This could result in lower advisory fees being paid by the state or local government for advisory services, as advisers would not have to recoup the cost of contributions through fees the advisers charge the government client.

The proposed rule should also yield several indirect benefits, including benefits to state and local governments and taxpayers. If state and local governments select an adviser on the basis of campaign contributions, the most qualified adviser may not be selected. As discussed above, awarding advisory contracts to advisers that make political contributions may lead to inferior management, and diminished or negative returns.[107] Similarly, an adviser that is selected on bases other than merit may obtain soft dollars and other ancillary benefits at the expense of the government client. Finally, the proposed rule would level the playing field for advisers to state and local governments. Campaign contributions create artificial barriers to competition for firms that cannot or will not make political contributions. Eradicating pay to play arrangements enables advisory firms, particularly smaller advisory firms, to compete on the basis of merit, rather than their ability to make contributions.

B. Costs

The proposed rule and rule amendments would impose some costs on advisers that provide advisory services to government clients. The proposed rule would require an adviser with government clients, and an adviser which solicits business from government clients, to incur costs to monitor contributions made by the adviser, and its partners, executive officers and solicitors, and to establish procedures to comply with the proposed rule and rule amendments. The initial and ongoing compliance costs imposed by the proposed rule would vary significantly among firms, depending on a number of factors. These include the number of partners, executive officers and solicitors of the adviser, the degree to which compliance procedures are automated, and whether the adviser is affiliated with a broker-dealer firm that is subject to rule G–37. A smaller adviser, for example, would likely have a small number of partners, executive officers and solicitors, and thus expend less resources to comply with the proposed rule and rule amendments than a larger adviser.

As a comparison, Commission staff has been advised that the burden imposed by rule G–37 on smaller broker-dealer firms is negligible. Although a large adviser is likely to spend more resources to comply with

[102] 17 CFR 275.204–2.

[103] Section 210(b) of the Advisers Act (15 U.S.C. 80b–10(b)) prohibits the Commission staff from disclosing to anyone outside the Commission any information obtained as a result of an examination or investigation without Commission approval.

[104] Proposed rule 204–2(l).

[105] MSRB rule G–8(a)(xvi). Like rule G–37, the proposed rule requires an investment adviser to keep, in addition to records of political contributions, records of any other ''payments'' made to officials. A payment is defined as any gift, subscription, loan, advance, or deposit of money or anything of value.

[106] *See supra* note 38.

[107] *See supra* note 63 and accompanying text.

the rule than a smaller adviser, an adviser with a broker-dealer affiliate that is required to comply with MSRB rule G–37 could likely use some or all of the compliance procedures established by the affiliate. As a result, many advisers with broker-dealer affiliates may spend few resources to comply with the proposed rule and rule amendments.

Based on compliance with other recordkeeping rules, Commission staff anticipates that most advisory firms would develop compliance procedures to monitor the political contributions made by the adviser and its partners, executive officers and solicitors. We estimate that the costs imposed by the proposed rule would be higher initially, as firms establish and implement procedures to comply with the rule and rule amendments. If we adopt the proposed rule and rule amendments, firms with government clients would likely develop and implement compliance procedures within 60 to 90 days after adoption. It is anticipated that compliance expenses would then decline to a relatively constant amount in future years.

The Commission has limited data on the costs that the proposed rule and rule amendments would impose on investment advisers with government clients. We estimate that as many as 1,500 investment advisers registered with the Commission may be affected by the proposed rule and rule amendments.[108] Based on registration information filed with the Commission, we estimate that approximately 450 advisers have fewer than five partners, executive officers, or solicitors that would be subject to the proposed rule (''smaller firms''); approximately 825 advisers have between five and 15 partners, executive officers or solicitors (''medium firms''); and approximately 225 advisers have more than 15 partners, executive officers, or solicitors that would be subject to the prohibitions of the proposed rule (''larger firms'').

Advisers that are exempt from registration with the Commission would be subject to the proposed rule (but not the rule amendments). The Commission has limited data regarding the number of investment advisers that are exempt from registration under section 203(b) of the Advisers Act. Reports indicate that the number of exempt advisers may exceed 3,000.[109] While not readily quantifiable, the estimated number of exempt advisers likely includes advisers to off-shore funds that would not be subject to the proposed rule. The Commission also has limited information regarding the number of partners, executive officers and solicitors of exempt advisers. For purposes of this analysis, it is anticipated that the number of persons of each exempt advisory firm that would be subject to the proposed rule are comparable to the ranges for registered investment advisers, described above.

Although the time needed to comply with the proposed rule would vary significantly from adviser to adviser, the Commission estimates that firms with government clients would spend between 2.5 hours and 250 hours to establish adequate procedures to comply with the proposed rule. These estimates are derived in part from conversations with industry professionals regarding broker-dealer compliance with rule G–37. Commission staff estimates that ongoing compliance with the proposed rule would require between 10 and 1,000 hours, annually. Initial compliance procedures would likely be designed and administered by compliance professionals and clerical staff. We estimate that the hourly wage rate for compliance professionals is $114, including benefits, and for clerical staff, $15 per hour, including benefits. To establish and implement adequate compliance procedures, the Commission staff estimates that the proposed rule would impose initial compliance costs of approximately $285[110] per smaller firm, approximately $13,387.50[111] per medium firm, and approximately $22,312.50[112] per larger firm. It is estimated that the proposed rule would impose annual, ongoing compliance expenses of approximately $892.50[113] per smaller firm, $53,550[114] per medium firm, and $89,250[115] per larger firm.

The prohibitions of the proposed rule may also impose other, less quantifiable costs on advisers and political officials. An adviser that becomes subject to the prohibitions of the proposed rule would no longer be eligible to receive advisory fees from its government client. The adviser, however, would likely be obligated under its fiduciary duties to continue providing advisory services to the government client for a period of time without compensation. An adviser that provides uncompensated advisory services to a government client may incur opportunity costs if the adviser is unable to pursue other government clients. Advisers to government clients, as well as the partners, executive officers and solicitors of the adviser, also may be less likely to make political contributions to political officials, possibly imposing costs on the officials if they are unable to secure alternate funding.

We anticipate that the proposed rule amendments would impose few, if any, additional costs. As discussed above, advisers generally would establish internal compliance procedures to comply with the proposed rule. Advisers would create and maintain various records, as required by their own compliance procedures. The proposed rule amendments are intended to cover those records an adviser typically would maintain in complying with the proposed rule. Advisers that are exempt from Commission registration under section 203(b) of the Advisers Act would be subject to the proposed rule, but not the proposed recordkeeping amendments. We have requested comment on the scope of the proposed rule and rule amendments.

C. Requests for Comment

The Commission requests comment on the effects of the proposed rule and rule amendments on individual investment advisers and on the advisory profession as a whole. We request data to quantify the costs and value of the benefits associated with the proposed rule. Specifically, comment is requested on the costs of establishing compliance procedures to comply with the proposed rule, both on an initial and ongoing basis. Comment also is requested on the costs of using compliance procedures of an affiliated broker-dealer that the broker-dealer established as a result of rule G–37. In addition, we request data

[108] This number was used for purposes of the Paperwork Reduction Act analysis, *infra* section IV.

[109] Hal Lux, *Hedge Fund? Who Me?*, Institutional Investor, Aug. 1998, at 33; Bethany McLean, *Everybody's Going Hedge Funds*, Fortune, June 8, 1998, at 180.

[110] The per firm cost estimate is based on our estimate that development of initial compliance procedures for smaller firms would take 2.5 hours of professional time (at $114 per hour).

[111] The per firm cost estimate is based on our estimate that development of initial compliance procedures for medium firms would take 112.50 hours of professional time (at $114 per hour) and 37.5 hours of clerical time (at $15 per hour).

[112] The per firm cost estimate is based on our estimate that development of initial compliance procedures for larger firms would take 187.50 hours of professional time (at $114 per hour) and 62.5 hours of clerical time (at $15 per hour).

[113] The per firm cost estimate is based on our estimate that ongoing compliance procedures for smaller firms would take 7.5 hours of professional time (at $114 per hour) and 2.5 hours of clerical time (at $15 per hour), per year.

[114] The per firm cost estimate is based on our estimate that ongoing compliance procedures for medium firms would take 450 hours of professional time (at $114 per hour) and 150 hours of clerical time (at $15 per hour), per year.

[115] The per firm cost estimate is based on our estimate that ongoing compliance procedures for larger firms would take 750 hours of professional time (at $114 per hour) and 250 hours of clerical time (at $15 per hour), per year.

regarding our assumptions about advisers exempt from registration under section 203(b) of the Act, such as the number of advisers that would be subject to the proposed rule, and the number of partners, executive officers and solicitors of these exempt advisers. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with this proposal.

IV. Paperwork Reduction Act

The proposed rule amendments contain a ''collection of information'' requirement within the meaning of the Paperwork Reduction Act of 1995,[116] and the Commission has submitted the amendments to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is ''Rule 204–2'' under the Advisers Act. Rule 204–2 contains a currently approved collection of information number under OMB control number 3235–0278. An agency may not sponsor, conduct, or require response to an information collection unless a currently valid OMB number is displayed.

Section 204 of the Advisers Act provides that investment advisers required to register with the Commission must make and keep certain records for prescribed periods, and make and disseminate certain reports. Rule 204–2 sets forth the requirements for maintaining and preserving specified books and records. This collection of information is mandatory. The Commission staff uses this collection of information in its examination and oversight program, and the information generally is kept confidential.[117] The current collection of information for rule 204–2 is based on average of 235.47 burden hours each year, per Commission-registered adviser, for a total of 1,483,461 burden hours. The current total burden is based on 6,300 potential respondents.

The proposed amendments to rule 204–2 would require registered investment advisers that provide advisory services to government clients to maintain certain records of contributions made by the adviser or any of its partners, executive officers, or solicitors. These records would be required to be maintained in the manner, and for the period of time, as other books and records under rule 204–2(a). This collection of information would be found at 17 CFR 275.204–2. Advisers that are exempt from Commission registration under section 203(b) of the Advisers Act would not be subject to the recordkeeping requirements.

Commission records indicate that there currently are approximately 8,200 potential respondents to the collection of information imposed by rule 204–2. As a result of the increase in the number of advisers registered with the Commission, the total burden is being increased by 447,393 hours (1,900 new advisers × 235.47 hours). We estimate that there may be as many as 1,500 advisers that provide advisory services to government clients and would thus be affected by the proposed rule amendments. Under the proposed amendments, each respondent would be required to retain the records on an ongoing basis. The proposed amendments to rule 204–2 are estimated to increase the burden by approximately two hours, to 237.47, per Commission-registered adviser with government clients. The weighted average burden per Commission-registered adviser is 235.83. The annual aggregate burden for all respondents to the recordkeeping requirements under rule 204–2 thus would be 1,933,854 hours.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information; (iii) enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and also should send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549–0609 with reference to File No. S7–19–99. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–19–99, and be submitted to the Securities and Exchange Commission, Office of Filings and Information Services. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication. A comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

V. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding proposed rule 206(4)–5 and proposed amendments to rule 204–2, both under the Advisers Act. The following summarizes the IRFA.

As set forth in greater detail in the IRFA, the proposed rule would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or any of its partners, executive officers or solicitors made a contribution to certain elected officials or candidates. The prohibition would not result from contributions of up to $250 (per election) made by a partner, executive officer or solicitor of the adviser to an elected official or candidate for whom the person making the contribution can vote. The rule amendments would require a registered adviser that has government clients and makes political contributions to maintain certain records of their political contributions. The IRFA states that the new rule and rule amendments are designed to prevent advisers from engaging in pay to play practices, and to protect advisory clients (and their beneficiaries) from the consequences of pay to play.

The IRFA contains the statutory authority for the proposed rule and rule amendments. The IRFA also discusses the effect of the proposed rule and rule amendments on small entities. For purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if (i) it manages assets of less than $25 million reported on its most recent Schedule I to Form ADV (17 CFR 279.1), (ii) it does not have total assets of $5 million or more on the last day of the most recent fiscal year, and (iii) it is not in a control relationship with another investment adviser that is not a small entity.[118]

The Commission estimates that of the investment advisers subject to the proposed rule and rule amendments, approximately 1,000 are small entities. The Commission has no information regarding the number of small-entity advisers that provide advisory services

[116] 44 U.S.C. 3501.

[117] *See* section 210(b) of the Advisers Act (15 U.S.C. 80b–10(b)).

[118] Rule 0–7 (17 CFR 275.0–7).

to government clients. Advisers to state and local governments, however, are unlikely to be small entities. The proposed rule and rule amendments, therefore, would likely affect few or no small entities.

The IRFA states that the proposed rule and rule amendments would impose no new reporting requirements. The proposed rule and rule amendments, however, would create certain new compliance and recordkeeping requirements. The proposed rule imposes a new compliance requirement by prohibiting an adviser from providing advisory services for compensation to government clients for two years after the adviser or any of its partners, executive officers or solicitors makes a contribution to certain elected officials or candidates. The proposed rule amendments would impose new recordkeeping requirements by requiring an adviser to state and local governments that makes political contributions to maintain certain records of its contributions and its advisory clients. An investment adviser that either does not make political contributions or does not provide advisory services to a state or local government would be unaffected by the proposed rule and rule amendments. Moreover, as discussed above, few or no small entities are likely to be affected by the proposed rule and rule amendments. There are no rules that duplicate, overlap, or conflict with, the proposed rule and rule amendments.

The IRFA discusses the various alternatives considered by the Commission in connection with the proposed rule amendments that might minimize the effect on small entities, including (a) the establishment of differing compliance or reporting requirements or timetables that take into account resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule and rule amendments for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the proposed rule and rule amendments, or any part thereof, for small entities.

As discussed in more detail in the IRFA, we believe it would be both unfeasible and unnecessary to exempt small entities from the proposed rule and rule amendments. After taking into account the resources available to small entities and the potential burden that could be placed on small-entity investment advisers, the Commission is proposing to require small entities to be subject to the proposed rule and rule amendments. As discussed in more detail in the IRFA, we have taken steps to minimize the effects on small-entity investment advisers. We have determined that it does not appear feasible to establish different reporting or compliance requirements or to further clarify, consolidate, or simplify the reporting or compliance requirements.

The IRFA includes information concerning the solicitation of comments with respect to the IRFA generally, and in particular, the number of small entities that would be affected by the proposed rule and rule amendments. A copy of the IRFA may be obtained by contacting Jeffrey O. Himstreet, Attorney, Securities and Exchange Commission, 450 5th Street, N.W., Washington, DC 20549–0506.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is also requesting information regarding the potential impact of the proposed rule and rule amendment on the economy on an annual basis. Commenters should provide empirical data to support their views.

VI. Statutory Authority

The Commission is proposing new rule 206(4)–5 of the Act pursuant to the authority set forth in sections 206(4) and 211(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–6(4), 80b–11(a)).

The Commission is proposing amendments to rule 204–2 of the Act pursuant to the authority set forth in sections 204 and 206(4) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–4 and 80b–6(4)).

List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule and Rule Amendments

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4), 80b–6a, 80b–11, unless otherwise noted.

* * * * *

2. Section 275.206(4)–5 is added to read as follows:

§ 275.206(4)–5 Political contributions by certain investment advisers.

(a) *Prohibitions.* As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b–6(4)), it shall be unlawful:

(1) For any investment adviser not prohibited from registering with the Commission under section 203A(a) of the Act (15 U.S.C. 80b–3a(a)) to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by:

(i) The investment adviser;

(ii) Any partner, executive officer or solicitor of the investment adviser (including a person who becomes a partner, executive officer or solicitor within two-years after the contribution is made); or

(iii) Any political action committee controlled by the investment adviser or by any partner, executive officer or solicitor of the investment adviser; and

(2) For any investment adviser not prohibited from registering with the Commission under section 203A(a) of the Act (15 U.S.C. 80b–3a(a)), or any of its partners, executive officers or solicitors:

(i) To solicit any person or political action committee to make, or coordinate, any contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or

(ii) To do anything indirectly which, if done directly, would result in a violation of this section.

(b) *Exception.* Paragraph (a)(1) of this section does not apply to contributions made by a partner, executive officer or solicitor to officials for whom the partner, executive officer or solicitor was entitled to vote at the time of the contributions and which in the aggregate do not exceed $250 to any one official, per election.

(c) *Special rule for private investment companies.* For purposes of this section, an investment adviser to a private investment company in which a government entity invests provides investment advisory services to the government entity.

(d) *Exemptions.* The Commission, upon application, may conditionally or unconditionally exempt an investment adviser from the prohibition under paragraph (a)(1) of this section. In determining whether to grant an exemption, the Commission will consider, among other factors, whether:

(1) The exemption is consistent with the purposes of this section;

(2) The investment adviser, before the contribution(s) resulting in the prohibition was made:

(i) Developed and instituted procedures reasonably designed to ensure compliance with this section;

(ii) Had no actual knowledge of the contribution(s); and

(3) The investment adviser:

(i) Has taken all available steps to obtain a return of the contribution(s); and

(ii) Has taken other remedial or preventive measures as may be appropriate under the circumstances.

(e) *Definitions.* For purposes of this section:

(1) *Contribution* means any gift, subscription, loan, advance, or deposit of money or anything of value made for:

(i) The purpose of influencing any election for federal, state or local office;

(ii) Payment of debt incurred in connection with any such election; or

(iii) Transition or inaugural expenses of the successful candidate for State or local office.

(2) *Executive officer* means the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the investment adviser.

(3) *Government entity* means any State or political subdivision of a State, including

(i) Any agency, authority, or instrumentality of the State or political subdivision;

(ii) Plan or pools of assets controlled by the State or political subdivision or any agency, authority or instrumentality thereof; and

(iii) Officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

(4) *Official* means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate:

(i) For an elective office of a government entity, if the office is directly or indirectly responsible for, or can influence the outcome of, the use of an investment adviser by a government entity; or

(ii) For any elective office of a government entity, if the office has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the use of an investment adviser.

(5) A *Private investment company* is a company that would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(a)) but for the exceptions to that definition in sections 3(c)(1) and 3(c)(7) of the Investment Company Act (15 U.S.C. 80a–3(c)(1)).

(6) A *Solicitor* is any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser.

(f) *Effective date.* The prohibition on providing investment advisory services as described in this section arises only from contributions made on or after (the effective date of this section).

3. Section 275.204–2 is amended by revising paragraphs (e)(1) and (h)(1) and adding paragraph (l) to read as follows:

§ 275.204–2 Books and records to be maintained by investment advisers.

* * * * *

(e)(1) The following books and records must be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser:

(i) Books and records required to be made under the provisions of paragraphs (a) to (c)(1) (except for books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this section); and

(ii) Books and records required to be made under the provisions of paragraph (1) of this section.

* * * * *

(h)(1) Any book or other record made, kept, maintained and preserved in compliance with §§ 240.17a–3 and 240.17a–4 of this chapter under the Securities Exchange Act of 1934, or with rules adopted by the Municipal Securities Rulemaking Board, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this rule, shall be deemed to be made, kept, maintained and preserved in compliance with this rule.

* * * * *

(l)(1) Every investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b–3) that provides investment advisory services to a government entity, must make and keep the following records:

(i) The names, titles and business and residence addresses of all partners, executive officers or solicitors of the investment adviser;

(ii) The States in which the investment adviser or any of its partners, executive officers, or solicitors is providing or seeking to provide investment advisory services to a government entity;

(iii) All government entities to which the investment adviser has provided investment advisory services in the past five years, but not prior to (insert effective date of rule); and

(iv) All direct or indirect contributions or payments made by the investment adviser or any of its partners, executive officers, or solicitors or a political action committee controlled by the investment adviser or any of its partners, executive officers, or solicitors to an official, a political party of a State or political subdivision thereof, or a political action committee.

(2) Records of the contributions and payments must be listed in chronological order and indicate:

(i) The name and title of each contributor;

(ii) The name and title (including any city/county/state or other political subdivision) of each recipient of a contribution or payment; and

(iii) The amount and date of each contribution or payment.

(3) For purposes of this section:

(i) The terms *contribution*, *government entity*, *official*, *executive officer* and *solicitor* have the same meanings as set forth in § 275.206(4)–5.

(ii) The term *payment* means any gift, subscription, loan, advance, or deposit of money or anything of value.

Dated: August 4, 1999.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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