

SECURITIES UPDATE



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SEC ENACTS RULES TO END "PAY TO PLAY" PRACTICES OF INVESTMENT ADVISERS

On June 30, 2010, the U.S. Securities and Exchange Commission ("SEC") adopted new Rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Rule") designed to prevent so-called "pay for play" practices by investment advisers. "Pay to play" refers to the making of campaign contributions or similar payments to elected officials to influence the award of contracts to manage public pension plan assets or government investment accounts. The Rule is designed to eliminate the pay to play practice so that the selection of investment advisers to manage public plans is based solely on the plans' best interests. The Rule targets not only direct solicitation by investment advisers but also indirect ways advisers may attempt to engage in pay for play activities.

The Rule prohibits a registered investment adviser¹ from providing advisory services for compensation (either directly or through a pooled investment vehicle like a hedge fund) for the two years following the making of a political contribution by the adviser or its "covered associate" to an elected official who is in a position to influence the selection of the adviser.² The SEC likens this restriction to a "time-out"

during which an adviser may not accept compensation for providing advisory services. Contributions to candidates are treated the same as contributions to incumbents if the position is one that can influence the selection of advisers. To address new hires of an adviser, the Rule prohibits an investment adviser from providing advisory services for compensation if a newly-hired covered associate made a contribution to a government official within the previous six months, despite not being a covered associate when the contribution was made.³ Investment advisers who have government clients (or who provide advisory services to a covered investment pool which has government entity investors) will be required to keep records of the political contributions of itself and its covered employees.

The Rule also prohibits advisory firms from soliciting or coordinating campaign contributions from another person or political action committee (a practice commonly known as "bundling") for an elected official in a position to influence the selection of the adviser. Solicitation and coordination of payments to political parties in the state or locality where the adviser seeks business is similarly prohibited. The

¹ The Rule also applies to investment advisers who are required to be registered or are unregistered in reliance on the exemption available under Section 203(b)(3) of the Investment Advisers Act of 1940 (for advisers with less than fifteen clients who generally do not hold themselves out to the public as investment advisers).

² "Covered associates" are general partners, managing members, executive officers or employees who solicit government entities and their direct or indirect supervisors, and political action committees controlled by the investment adviser or a covered associate.

³ However, a full two year look-back period is applied to new covered associates who actually solicit clients.

SEC designed this portion of the Rule to prevent the "bundling" of many small employee contributions to influence an official in the position to select the adviser.

Investment advisers are also prohibited from paying third parties, such as solicitors or placement agents, to solicit government clients on behalf of the investment adviser, unless the third party is an SEC-registered investment adviser or broker-dealer subject to similar pay to play restrictions. The SEC's originally proposed rule completely banned fund managers from using placement agents to market their offerings to public pension funds. While such a complete ban was ultimately abandoned, SEC Chairwoman Shapiro warned that the SEC would re-consider a complete ban if third party placement agents continued to facilitate pay for play practices.

Anticipating the development of disguised or complicated pay for play arrangements, the Rule prohibits indirect pay for play activities by prohibiting the channeling of contributions through third parties (such as family members, consultants, or affiliated companies) if the indirect conduct would violate the Rule if the adviser or covered associate made the contribution directly.

The Rule contains certain exceptions. A de minimis exception allows contributions of up to \$350 per election per candidate if the

contributor is entitled to vote for the candidate and up to \$150 per election per candidate if the contributor is not entitled to vote for the candidate. The Rule also provides advisers with a limited ability to cure inadvertent contributions to officials where the contributor was not entitled to vote for the candidate. Also, the SEC will grant an order exempting an investment adviser from the two year compensation ban in certain limited situations.

The Rule becomes effective on September 13, 2010. Investment advisers subject to the Rule must be in compliance with the Rule by March 14, 2011. Compliance with the third-party solicitation restrictions will be required by September 13, 2011.

If you have any additional questions regarding this Update or have any other Securities Law needs, please contact any member of the Securities Law Group.

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