SEC ADOPTS "PAY TO PLAY" RULES

In response to the growing number of enforcement actions by the U. S. Securities and Exchange Commission (the "SEC") and the various states with regards to "pay-to-play" practices by investment advisers, on June 30, 2010 the SEC voted unanimously to adopt rules[1] under the Investment Advisers Act of 1940, as amended (the "Advisers Act") designed to curtail the influence of such "pay-to-play" practices. The new rules are designed to prohibit investment advisers from seeking to influence the award of advisory contracts by public entities by making or soliciting political contributions to or for officials who are in a position to influence the awards. In addition, the rule bans the use of third party solicitors unless they are registered advisers or broker dealers.

The new rules are effective on September 13, 2010. Compliance with most of the new rules will be required by March 14, 2011; however, compliance with the new rules by investment advisers to registered investment companies that are covered investment pools and the new rules related to the use of third-party solicitors will not be required until September 13, 2011 at the earliest. The delays in implementing the new rules provide investment advisers with a transition period to give them time to identify their covered associates and current government entity clients and to modify their compliance programs to address new compliance obligations under the rules.

The following outline is intended to provide a brief overview of the impact of these new rules.

Ban on Certain Third Party Solicitors

Beginning no earlier than **one year** from the effective date of the new Rule (September 13, 2010), an investment adviser is prohibited from making (or agreeing to make) any payment to a third-party to solicit business from a government entity unless that third-party is a regulated person (a registered broker-dealer or SEC-registered investment adviser which has complied with pay-to-play rules on contributions to government officials).

- The Rule applies to both to SEC-registered investment advisers **and** unregistered advisers relying on the "fewer than 15 clients" exemption (which includes many managers of hedge funds, private equity funds, real estate and similar funds).[2] Subsection (c) of the Rule specifically states that an investment adviser to a "covered investment pool" in which a government entity invests or is solicited to invest is treated as though the adviser were providing or seeking to provide advisory services directly to the government entity.

- The prohibition applies to the adviser entity itself and to "Covered Associates" (as defined below).

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[1] The SEC has adopted new Rule 206(4)-5 and amendments to existing Rules 204-2 (the "Books and Records" rule) and 206(4)-3 (the "Cash Solicitation Rule") under the Advisers Act.

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Bill"), if signed by the President as expected, would amend the Act to remove the "fewer than 15 clients" or "private adviser" exemption. Instead, the Dodd-Frank Bill creates new exemptions from federal registration, including for advisers solely to private funds if the advisers have less than $ 150 million in assets. Advisers should expect the SEC to amend the Rule to cover those advisers taking advantage of this new exemption (or any of the others contained in the Dodd-Frank Bill, such as exemptions for venture funds and family offices).

- "Solicitation" is defined very broadly in the Rule itself and in the SEC's specific statements in the Release and includes an introduction, referral or any other communication whose purpose is to find or refer a client or investor.

- A "government entity" includes any governmental agency, instrumentality, subdivision, any officer or agent of those (acting in their official capacity); a pool of assets sponsored or established by any of them, such as a defined benefit plan; and any participant-directed "plan or program" of a government entity, such as a 529 Plan, 403(b) or 457 Plan.

- Cash Solicitation Rule (Rule 206(4)-3) is amended to reflect that government business is governed by new Rule 206(4)-5

Required Registration of Solicitors

A finder, solicitor or other placement agent introducing government business to a registered or unregistered investment adviser must itself be a registered broker-dealer or investment adviser (or if an individual, be employed or associated with such a registered entity) which is in compliance with the pay-to-play rules to get any payment (whether transaction- or non-transaction based compensation) relating to those assets.

- SEC's Paul Anka No-Action Letter (SEC July 2001) and its progeny are no longer valid with respect to government business.

- Finders receiving payments from advisers for these kinds of leads, and not currently registered or supervised by a broker-dealer or adviser, should explore strategic options for either starting or associating with a regulated entity for this business, or becoming employed by an existing regulated entity.

- Finders may want to consider working specifically for and being paid specifically by the government entities if such entities are legally permitted to make those payments.

Compliance Procedures Related To Solicitors

Any investment adviser compensating regulated persons for soliciting government entities must adopt policies and procedures reasonably designed to prevent a violation of the new Rule, and such policies should include an ongoing review of those solicitors' political contributions and other conduct that would disqualify them from receiving payment.

- Although advisers not registered with the SEC are technically not subject to Rule 206(4)-7 (known as the "Compliance Rule"), they will need to adopt and maintain similar policies to facilitate their own compliance with the new Rule's provisions regarding payments to solicitors.

Required Time Out Period Following Political Contributions

Rule 206(4)-5 under the Advisers Act makes it unlawful for an investment adviser to receive compensation for providing advisory services to a government entity for a two-year period after the investment adviser or any of its "Covered Associates" makes a political contribution to a public official of a government entity or candidate for such office who is or will be in a position to influence the award of advisory business. Important to note here are the following:

- Rule 206(4)-5 not only applies to federally registered investment advisers, but also to unregistered investment advisers relying on the private adviser exemption from registration contained in Section 203(b)(3) of the Advisers Act. That means this new rule will also apply to unregistered advisers to hedge funds and private equity funds.

- "Covered Associates" is defined in the rule as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any of its covered associates. Certain exemptions from this definition exist. For example, certain types of owners, such as shareholders of a corporation, limited partners and non-managing members of a limited liability company are not covered associates so long as such persons are not executive officers or solicitors of the firm. When drafting compliance policies and procedures to comply with this rule, investment advisory firms should be careful to not be overly inclusive and thus accidently include employees not required to be covered by the rules.

- Investment advisers to a "covered investment pool" in which a government entity invests or is solicited to invest will be treated as if the adviser is providing investment advisory services directly to the to the government entity. A "covered investment pool" is an investment company as defined in Section 3(a) of the Investment Company Act of 1940, and any company exempted from Section 3(a) by Section 3(c)(1), Section 3(c)(7) or Section 3(c)(11) of that Act. This provision will not impact a regular mutual fund that is offered to the general public and that has as a shareholder a government entity. This provision does effect the investment of public funds in a hedge fund or other type of pooled investment vehicle (e.g., private equity funds venture capital funds and collective investment trusts). Further, the selection of a pooled investment vehicle sponsored or advised by an investment adviser (*including* registered mutual funds) as a funding vehicle or investment option in a government-sponsored plan, such as 403(b), 457, and 529 plans will trigger the time out provisions.

- The rule's two-year time out is triggered by a contribution to an "official" of a "government entity." The two-year time out is triggered by contributions, not only to elected officials or candidates for offices that have legal authority to hire the investment adviser, but also to elected officials or candidates for offices that can influence the hiring of the investment adviser (such as persons with appointment authority). Government entities include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b), 457, and 529 plans

- A "contribution" is defined to include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing an election for a federal, state or local office, including any payments for debts incurred in such an election. The definition also includes transition or inaugural expenses incurred by a successful candidate for state or local office. A covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the investment adviser is not otherwise paying the employee's salary (e.g., an unpaid leave of absence).

- When hiring a new employee, or promoting an employee into a position that could be considered a covered associate, it is important that the investment adviser "look back" in time to that employee's contributions. Generally, if a contribution was made less than six months from the time the person becomes a covered associate, the rule prohibits the adviser from receiving

compensation for providing advisory services from the hiring or promotion date until the two-year period has run, although for certain employees who provide solicitation services to an investment adviser, this "look back" period is two-years.

- Similarly, a covered associate's employer at the time of a contribution would be subject to the rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate or remains employed by the adviser. Thus, dismissing a covered associate would not relieve the adviser from the two-year time out.

- Investment advisers and their covered associates will be prohibited from soliciting or coordinating campaign contributions from others – a practice referred to as "bundling" – for an elected official who is in a position to influence the selection of the adviser. The new rules will also prohibit solicitation and coordination of payments to political parties in the state or locality where the investment adviser is seeking business.

- Rule 206(4)-5 provides a "catch-all" provision that precludes an investment adviser and its covered associates from doing anything indirectly that they would be prohibited from doing directly. Specifically, an adviser and its covered associates could not funnel payments through third parties (including, for example, consultants, attorneys, family members, friends or companies affiliated with the adviser) as a means to circumvent the rule.

Please note that there are certain misconceptions about the effect of new Rule 206(4)-5 under the Advisers Act. For example:

- Rule 206(4)-5 ***<u>does</u>*** ***<u>not</u>*** ban political contributions and does not limit the amount of any political contribution. Instead, the rule imposes a ban – a "time out" – on receiving compensation for conducting advisory business with a government client for two years after certain contributions are made. An investment adviser could continue to perform such services for no compensation. In fact, the SEC has stated in the release that under certain circumstances, an investment adviser may have a fiduciary obligation to continue to provide such services, for no compensation, for a period of time to allow a government entity to orderly transition its account to another advisory firm.

- Rule 206(4)-5's limitations do not apply to all contributions. The rule provides certain *de minimis* exceptions from the time out provision for contributions by covered associates of up to $350 to any one official per election if the contributor is entitled to vote for the official and of up to $150 to any one official per election if the contributor is not entitled to vote for the official.

- Rule 206(4)-5 also allows an adviser to "cure" certain contributions of $350 or less to an official for whom the contributor is not entitled to vote under certain circumstances. The investment adviser must have discovered the contribution within four months of it having been made, and returned such contribution to the donor within sixty days of its discovery. An investment advisory firm with fifty or more employees may rely on this exception up to three times in any one calendar year; a firm with fewer than fifty employees may rely on this exception twice in any calendar year. However, an investment advisory firm may not rely on this exception more than once with respect to contributions by the same covered associate, regardless of the time period.

- Contributions to a political action committee (not controlled by the investment adviser or by any of its covered associates) or to local political parties do not necessarily trigger the two-year time out. It is a facts and circumstances situation. If the political action committee or political party is soliciting funds for the purpose of supporting a limited number of government officials, then,

depending upon the facts and circumstances, contributions to the political action committee or payments to the political party may be considered a contribution to a particular official and trigger the two-year time out. In other cases, however, such contributions may fund general party political activities or the campaigns of other candidates and not trigger a two-year time out period. In reviewing the facts and circumstances, an investment advisory firm should be careful to consider the rule's "catch-all" provision that precludes doing anything indirectly that they would be prohibited from doing directly.

New Recordkeeping Requirements

In connection with the adoption of Rule 206(4)-5, the SEC also adopted amendments to Rule 204-2, which sets out recordkeeping requirements for all investment advisers registered with the SEC. Under the amendments, federally registered investment advisers that have government entity clients or provide investment advisory services to a covered investment pool in which a government entity invests must maintain records of contributions made by the adviser and covered associates to government officials and payments to state or local political parties and political action committees. The investment adviser must also maintain a list of its covered associates and of government entities to which the adviser has provided advisory services in the past five years. An investment adviser to a covered investment pool must maintain a list of government entity investors if the investments are made as part of a plan or program of a government entity. An investment adviser must keep a list of names and business addresses of each regulated person that it pays or agrees to pay for soliciting government entities for investment advisory services, whether or not it currently has any government clients. Note that:

- The compliance date for keeping records of covered associates and government clients is six months after the Rule's effective date; advisers have until one year after the effective date to begin keeping records of regulated persons soliciting government clients on their behalf.

- Advisers that solicit government clients on behalf of other advisers are also subject to the amended recordkeeping requirements.

- Advisers that are exempt from SEC registration under the "fewer than 15 clients" rule, such as hedge fund or private equity fund managers, are not subject to the recordkeeping requirements. However, such advisers should consider keeping similar records in light of applicable anti-fraud rules such as Rule 206(4)-8.