MorrisonCohen LLP

CLIENT UPDATE

SEC UNANIMOUSLY APPROVES "PAY TO PLAY" RULE

July 13, 2010 – The Securities and Exchange Commission (the "SEC") unanimously approved new rules to curtail the corrupting influence of "pay to play" practices by investment advisers.

The rule includes prohibitions intended to capture not only direct political contributions by investment advisers, but also other ways that advisers may engage in pay to play arrangements. Based largely on the SEC's proposed rule in August 2009 http://www.morrisoncohen.com/downloads/proposed%20pay%20to%20play%20rule.pdf (the "Proposed Rule"), new Rule 206-4(5) under the Investment Advisers Act of 1940 (the "New Rule") has three key elements:

- It institutes a two-year "time out" from providing advisory services for compensation if an investment adviser or certain of its "covered associates" directly or indirectly makes a political contribution to an elected official who is in a position to influence the selection of the adviser;
- It prohibits "bundling" and other efforts by investment advisers to solicit political contributions to an elected official who is in a position to influence the selection of the adviser;
- It prohibits the use of placement agents and other third-party solicitors that are not either registered with the SEC as an investment adviser or with the Financial Industry Regulatory Authority ("FINRA") as a broker-dealer registered and therefore subject to similar pay to pay restrictions.

The New Rule becomes effective 60 days after its publication in the Federal Register. Compliance with the New Rule's provisions will generally be required within six months of the effective date, although compliance with the provision regarding placement agents will be delayed for one year after the effective date. Below is a summary of the key provisions:

1. TWO-YEAR "TIME-OUT"

The New Rule follows closely the Proposed Rule, in that it imposes a two-year "time out" ban on an investment adviser from receiving compensation for providing advisory services if such adviser or any of its "covered associates" directly or indirectly makes a political contribution to an elected official in a position to influence the selection of the adviser. The New Rule defines "covered associates" to included any general partner, managing partner, or "executive officer", or other individuals with similar status or function, any employee who solicits government business or supervises someone who does, and any political action committee ("PAC") controlled by the investment adviser or one of its covered associates. The New Rule provides that whether a person is an executive officer depends on his or her function, not title.

Investment advisers will have to monitor prospective employees to ensure they are not "hiring a ban" since the proposed rule includes a "look-back" component that would attribute contributions made by a covered associate to investment advisers that employ that person within two years after the date of the contribution. The "look back" period is only six months for employees who are hired or promoted to positions that are "covered associates" and who do not solicit clients as part of their duties. The New Rule provides an exception for de minimis contributions ($350 or less per election per candidate if the contributor is entitled to vote for the applicable official or candidate; and $150 or less per election per candidate if the contributor is not entitled to vote for the candidate or official, and permits investment advisers to request for an exemption from the "time out" provision. The SEC emphasized that a key factor in determining whether to grant such exemption will be whether the firm has adopted and implemented an adequate pay-to-play compliance program. Therefore, it will be advisable for all investment advisers, whether or not registered under the Investment Advisers Act, to adopt detailed and comprehensive compliance policies relating to political contributions from each of its employees and covered associates that conform to the increased restrictions imposed by the New Rule.

2. PROHIBITION AGAINST "BUNDLING" SOLICITATIONS.

The New Rule prohibits investment advisers and their "covered associates" from soliciting or coordinating campaign contributions from others – also known as "bundling" – for any elected official in a position to influence the selection of the adviser. It also prohibits solicitation and coordination of payments to political parties in the state or locality where the adviser is seeking business.

3. RESTRICTIONS ON THE USE OF PLACEMENT AGENTS.

Unlike the Proposed Rule, the New Rule prohibits investment advisers from paying third parties to solicit a government client on behalf of the investment adviser, unless such third party is an investment adviser registered with the SEC or is a broker-dealer registered with FINRA. Reacting to a substantial number of comments received by the SEC against a complete ban on use of placement agents, the SEC adopted the modified ban implemented by the New Rule. The SEC created a one-year transition period to enable FINRA to propose comparable compliance rules for broker dealers. The SEC cautioned that abuse of the limited restriction might result in the imposition of a total prohibition on the use of third party placement agents.

If you have any questions relating to the proposed rule, please feel free to contact your primary contact at Morrison Cohen LLP.

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