ADVISER'S "PAY-TO-PLAY" RULE 206(4)-5

SUMMARY

On July 1, 2010 the U.S. Securities and Exchange Commission (SEC) adopted new Rule 206(4)-5 (the Rule) under the Investment Advisers Act (Advisers Act). This is the so-called "pay-to-play" rule. The Rule relates to certain political contributions from investment advisers and certain of their employees that seek to manage assets of state and local governments, restricting advisers from receiving compensation for advisory services for a period of two years for violations of the Rule. The Rule includes certain de minimus amounts for permissible political contributions without implicating the Rule's restrictions on receipt of compensation. The Rule also restricts some solicitation practices with respect to advisers.

TO WHOM DOES THE RULE APPLY?

The Rule applies to any investment adviser registered (or required to be registered) with the SEC, unregistered in reliance on the exemption available under section 203(b)(3) of the Advisers Act, or that is an exempt reporting adviser (as defined in Rule 204-4 of the Adviser's Act). Note, however, that the Dodd-Frank Act eliminates the exemption under section 203(b)(3). It applies to venture capital fund advisers, private fund advisers and foreign private advisers.

WHAT ARE THE RESTRICTIONS ON COMPENSATION FOR ADVISORY SERVICES?

Under the Rule, if an adviser or a covered associate makes a contribution to an official of a government entity who is directly or indirectly responsible for, or is in a position to influence, the award of the government entity's advisory business (or as has the authority to appoint such persons), then the adviser is prohibited from receiving compensation for providing advisory services to that government entity for two years after the contribution.

WHAT ARE CONTRIBUTIONS AND WHICH OF AN ADVISER'S EMPLOYEES ARE INCLUDED?

"Contribution" under the Rule is defined as any gift, subscription, loan, advance, or deposit of money, or anything of value made for: the purpose of influencing any election for federal, state, or local office, the payment of debt incurred in connection with any such election, or transition or inaugural expenses incurred by a successful candidate for state or local office.

An adviser's employees covered by the Rule are its "covered associates". The definition of a "covered associate" of an investment adviser includes any: general partner, managing member, executive officer or other individual with a similar status or function, any employee who solicits a government entity for the investment adviser (and any person who supervises, directly or indirectly, such an employee), and a PAC controlled by the investment adviser or by any of its covered associates.

Contributions by an adviser's employees who are not "covered associates" are not included, unless the adviser or any of its covered associates use the employee to indirectly make a contribution, or the employee solicits government business on the adviser's behalf.

The Rule provides for certain exceptions from the two-year prohibition for an adviser's receipt of compensation with respect to political contributions for certain covered associates. The prohibition does not apply to contributions made by a new covered associate who does not solicit clients on the adviser's behalf more than six-months prior to becoming a covered associate. Also, the two-year prohibition period applies for covered associates terminating employment with the adviser. Advisers typically require employees to report political contributions for these "look-back" periods, in order to identify contributions that may implicate the Rule's restrictions.

WHAT ARE THE RULE'S DE MINIMUS AMOUNTS?

The Rule provides for de minimis contributions, which will not implicate the Rule's two-year prohibition on an adviser receiving compensation for advisory services to a government entity. The de minimis exception allows a covered associate of an adviser to contribute: (i) up to $350 to an official per election if the covered associate is entitled to vote for the official at the time of the contribution, and (ii) up to $150 to an official per election if the covered associate is not entitled to vote for the official at the time of the contribution.

There are also certain returned contribution exceptions, which relieve the adviser from the two-year prohibition on contributions.

CAN THIRD-PARTIES BE USED TO SOLICIT POLITICAL CONTRIBUTIONS FOR AN ADVISER?

The Rule prohibits an adviser or a covered associate from directly or indirectly paying any person to solicit a government entity for the adviser unless the person is: (i) a registered adviser that has not made, nor has any of its covered associates made, a contribution to an official of a government entity, and has not coordinated or solicited any person or PAC to make, a contribution in the past two years in violation of the Rule; or (ii) a registered municipal advisor or a registered broker or dealer. In the case of a municipal advisor or a broker-dealer, the Rule provides that the solicitor must be subject to pay to play restrictions to be adopted by the Municipal Securities Rulemaking Board (MSRB) or Financial Industry Regulatory Authority (FINRA), which are substantially similar to, or more stringent than, the restrictions imposed by the Rule.

The SEC has delayed implementation of the third party solicitors ban to allow for orderly transition by advisers and solicitors, once the SEC's new municipal advisor registration rules are in place and pay-to-play rules are adopted by FINRA and MSRB.

MAY ADVISERS COORDINATE POLITICAL CONTRIBUTIONS?

The Rule also prohibits an adviser or a covered associate from coordinating or soliciting a person or PAC to: contribute to an official of a government entity to which the adviser provides or seeks to provide advisory services; or make a payment to a political party of a state or locality in which the adviser provides or seeks to provide advisory services to a government entity.

According to the SEC, this provision seeks to prevent advisers from circumventing the Rule's prohibitions by "bundling" a large number of small employee contributions to influence an election.

APPLICABILITY TO CERTAIN POOLED INVESTMENT VEHICLES.

Under the Rule, advisers to covered investment pools in which a government entity invests or is solicited to invest are treated as though they provided or were seeking to provide services directly to that government entity. The prohibited practices under the Rule apply also when advisers seek to obtain government entities as investors in covered investment pools managed by the adviser. Covered investment pools are: registered investment companies that are an investment option of a plan or program of a government entity; and any company that would be an investment company as defined in Section 3(a) of the Investment Company Act but for the exclusion from the definition of "investment company" under Section 3(c)(1), 3(c)(7), or 3(c)(11) of the Investment Company Act.

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