CLEARY GOTTLIEB

Alert Memo

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SEC Curbs "Pay to Play" Practices by Investment Advisers

The Securities and Exchange Commission ("SEC") voted unanimously on June 30, 2010 to approve new rules effectively banning the influence of so-called "pay to play" practices by investment advisers, significantly curtailing their ability to make political contributions to elected officials who have a decision-making role over public pension fund assets. The new rule follows a number of recent scandals, including one involving the New York State Common Retirement Fund, in which investment advisers allegedly made campaign contributions to certain politicians with the intention of influencing their selection of state pension fund asset managers.

The new Rule 206(4)-5 now directly prohibits an investment adviser from receiving any compensation for advisory services provided to a government entity, including any public pension plan, for two years after the advisory firm or certain of its executives or employees makes a political contribution to a government official or related political action committee ("PAC"). The rule encompasses donations made to any incumbent or candidate for elective office with responsibility for or influence over the selection of an investment adviser. There is, however, a *de minimis* exception for contributions up to $350 per candidate per election, if the donor is eligible to vote for the candidate, or up to $150, if the donor is ineligible. Furthermore, investment advisers are prohibited from "bundling" political contributions, that is, soliciting or coordinating contributions from others on behalf of an elected official or PAC.

Lastly, the new rule prohibits an investment adviser from hiring a third-party placement agent, such as a consultant, solicitor, or other intermediary, to attempt to obtain government business on its behalf, unless the third party is itself an SEC-registered investment adviser or broker-dealer subject to similar "pay to play" regulations. In this regard, FINRA has advised that it expects to promulgate rules for broker-dealers that will be "as rigorous and as expansive" as the SEC's restrictions. Notably, the SEC stopped short of a complete ban on the use of third-party placement agents; however, Chairman Schapiro made clear that the SEC will continue to monitor for any improper influence by them and that an outright ban could be considered in the future.

Rule 206(4)-5 will become effective on September 13, 2010, and compliance is generally required within six (6) months after the effective date (or one year with respect to the third-party placement agent provisions). This should allow investment advisers sufficient time to adopt and implement the necessary compliance policies and procedures.

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

Although stringent, the SEC rule provides welcome guidance to an area where investment advisers currently face different, and sometimes murky, obligations imposed by various state laws. It remains to be seen, though, how federal courts will apply this new rule and address any potential legal challenges based on recent First Amendment or federalism jurisprudence.

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