Investment Management Regulatory Update

SEC Rules and Regulations

SEC Votes to Adopt New Proxy Access Rules

On August 25, 2010, the SEC voted to adopt a new set of proxy access rules. The rules provide for two significant changes: (1) a new Rule 14a-11(the "**Rule**") under the Securities Exchange Act of 1934 (the "**Exchange Act**") that would permit shareholders owning a specified percentage of a company's shares for a specified holding period to nominate up to 25% of the company's board of directors and solicit proxies in favor of those nominees; and (2) a repeal of the existing Exchange Act Rule 14a-8(i)(8) under the Exchange Act, which would mean that companies generally would no longer be able to exclude shareholder proposals dealing with the director nomination process. Highlighted below are key elements of the new proxy access rules, including those pertaining to registered investment companies ("**RICs**").

For a discussion of the new rules and their impact, please see the Davis Polk Client Memorandum ***Summary of Proxy Access Rules*** and General Counsel update ***Proxy Access Year One: What to Expect and What to Do Now***. For a brief background summary of the rules as initially proposed, please see the ***July 1, 2009 Investment Management Regulatory Update***.

Applicability

- *Applicability.* Rule 14a-11 will apply to all companies subject to the proxy rules (including RICs), other than companies subject to the Exchange Act solely because they have a class of registered debt and foreign private issuers. Companies may not opt out of Rule 14a-11 (even through a shareholder vote) and will be subject to the rule even if they are facing a concurrent proxy contest or nomination under state law.
- *Effective Date.* The new rules are set to be effective 60 days after they are published in the Federal Register, except with respect to smaller reporting companies (defined generally to be

companies with a public float of less than $75 million) that will not have to comply until three years after the effective date.

Eligibility

- *Uniform 3% ownership threshold of voting securities.* As adopted, Rule 14a-11 requires that a nominating shareholder or group hold, as of the date of the shareholder notice on new Schedule 14N (described below), at least 3% of the voting power of the company's securities entitled to vote on the election of directors.
    - The Rule implements a uniform 3% threshold for all companies, including RICs (regardless of the RIC's net asset value).
    - Only those shares over which the nominating shareholder or group has both voting and investment power may be counted. Securities loaned to a third party can only be included in instances where the shareholder or group has not only retained the right to recall the loaned securities but will also actually recall such securities upon being notified that any of its nominees will be included in the company's proxy materials. Borrowed shares and shares that have been sold in a short sale may not be included.
- *3-year holding period and disclosure of intent to hold securities through the election.* The Rule requires nominating shareholders to have held their voting securities for at least three years from the filing of the Schedule 14N disclosing an intent to nominate. The Rule also requires that such shareholder or group hold its securities through the date of the election and disclose in the Schedule 14N whether it intends to continue its ownership of shares after the election.
- *Certification of no "change in control" purpose.* A nominating shareholder must provide a certification in its Schedule 14N that explicitly states it is not holding securities with the purpose, or with the effect, of changing the control of the company or to gain a number of seats on the board in excess of the maximum number of nominees the company would be required to include under the Rule. A nominating shareholder or any member of a nominating shareholder group must not be a participant in another nomination or proxy contest with respect to the same election.
- *No agreement with the company.* To protect against a company using an internal arrangement with a shareholder to block other shareholder nominees, a nominating shareholder or group will not be eligible to use the Rule if an agreement exists with the company regarding the nomination before such nomination is made. Nominating shareholders or groups must confirm this by certifying to such representations in their Schedule 14N filing.
- *No limit to use of the Rule.* A nominating shareholder or group's ability to use the Rule will not be limited by previous uses of the Rule, regardless of the outcome.

Nominations

- *Nomination must conform with applicable state and federal laws and regulations*. Under the Rule, a nominee will not be eligible to be included in a company's proxy materials if the nominee's candidacy would violate federal law, state law or applicable exchange requirements and such violation cannot be cured during the relevant time period.
- *Independence standards.* In order to be eligible under the Rule, the nominee must meet the objective criteria for "independence" as defined in the relevant securities exchange rules, or in the case of a RIC, the nominee must not be an "interested person" as defined in Section 2(a)(19) of the Investment Company Act of 1940 (the "**Investment Company Act**"). However, the Rule does not require the nominee to satisfy any subjective or otherwise stricter independence criteria established by individual companies.

Number and Priority of Nominees

- *25% threshold.* The Rule requires a company to include at least one shareholder nominee or the number of nominees that represents 25% of the company's board of directors, whichever is greater.
  - *Staggered boards.* In cases where a company has a staggered board, any director who was previously nominated and elected under the Rule whose term extends past the current election would continue to count against the 25% cap.
  - *Agreements with the company.* If after a Schedule 14N is filed, the company later decides to include a shareholder nominee as a company nominee on its proxy materials, the company can count such nominee toward the 25% limit (as long as the company did not have an agreement or enter into negotiations with the nominating group regarding the candidate before filing its notice on Schedule 14N).
  - *Incumbent shareholder-nominated directors.* If a company decides to nominate an incumbent director who was previously elected as a shareholder nominee, such incumbent director would not count towards the cap.
- *Priority of nominees.* In situations where more than one shareholder or shareholder group would be eligible to have its nominees included in the company's proxy materials, the Rule gives priority to the nominee or nominees of the shareholder or group with the highest qualifying voting power percentage. If a shareholder nominates more candidates than it is allowed under the Rule, the shareholder can decide which candidates to include (up to the allowed number). If a nominee withdraws or is disqualified before the company has printed its proxy materials, the company must substitute a remaining eligible nominee of that shareholder or, if none are available, of the next highest vote-holding shareholder. If a nominee withdraws or is disqualified after the company has printed its proxy materials, the company is no longer required to include a replacement nominee.

Schedule 14N Requirements

- *Notice.* The nominating shareholder or group must file on EDGAR and send to the company on the same day a Schedule 14N containing the required disclosures, representations, and certifications under the Rule within the time periods prescribed. The Rule requires a nominating shareholder or group to provide notice in the Schedule 14N of its intent to nominate no earlier than 150 calendar days and no later than 120 calendar days before the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting. If the company did not hold an annual meeting during the prior year, or if the date of the meeting changed by more than 30 calendar days, the company is required to disclose the date by which a nominating shareholder must submit its Schedule 14N under a new Item 5.08 to Form 8-K, which date must be a reasonable time before the company's release of its proxy materials.
- *Disclosure.* In addition to the required representations and certifications mentioned above, the nominating shareholder or group must also provide certain disclosures in the Schedule 14N including, but not limited to: (i) contact information, (ii) percentage of securities held and voting power derived therefrom, (iii) whether the nominee meets any director qualifications that may be set forth in the company's governing documents, (iv) any statement that the shareholder or group would want included in the company's proxy materials (capped at 500 words) and (v) any disclosure about the nature and extent of the relationships, if any, between the shareholder or group, the nominee and the company.

Procedure for Companies Receiving Nominations

- *Procedure for companies that want to include the nominee*

   - If the company determines that it will *include* the nominee, the company is required to notify the nominating shareholder or group (or their authorized representative) of its decision no later than 30 calendar days before it files its definitive proxy materials with the SEC.
- *Procedure for companies that want to exclude the nominee*
   - *Reasons a company may exclude the nominee under the Rule:*
      - the Rule is not applicable to the company;
      - the nominating shareholder or group or nominee failed to satisfy the eligibility requirements set forth in the Rule; or
      - including the nominee would result in the company exceeding the maximum number of nominees it is required to include under the Rule.
   - A company is not permitted to exclude a nominee or statement on the basis that, in the company's view, shareholder-submitted materials are false or misleading, though a company *is* able to provide additional disclosure on why it believes the nominating shareholder's disclosure is incorrect.
   - If the company determines that it may *exclude* a shareholder nominee, it is required to notify the nominating shareholder or group no later than 14 calendar days after the window period for submission of nominations closes. In turn, the shareholder or shareholder group's must cure the deficiency within 14 calendar days after receipt of the company's notice to exclude the candidate. If the shareholder is not able to cure the deficiency within 14 calendar days, the company can exclude the nominee by filing a notice with the SEC, with a copy to the nominating shareholder or group, no later than 80 calendar days before the company files its definitive proxy statement with the SEC. Notably, the shareholder may not change the composition of the nominating shareholder group or the identity of the nominee to correct a deficiency.

Chart Showing Timeline for Required Actions for Exclusion

Action Required	Time period
Nominating shareholder or group must provide notice on Schedule 14N to the company and file the Schedule 14N with the SEC.	No earlier than 150 and no later than 120 calendar days before the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting.
Company must notify the nominating shareholder or group of any determination to exclude a nominee.	No later than 14 calendar days after the close of the window period for shareholder of nominations.
Nominating shareholder or group must respond to company's notice of deficiency and cure any defects.	No later than 14 days calendar days after the shareholder or group's receipt of the company's notice.
Company must provide notice of intent to exclude the nominee and the basis for its determination to the SEC (with a copy to the nominating shareholder) and, if desirable, seek a no-action letter regarding its determination.	No later than 80 calendar days before the company files its definitive proxy statement with the SEC.
Nominating shareholder or group may submit a response to the company's notice to the SEC.	No later than 14 calendar days after the shareholder or group's receipt of the company's notice to the SEC.
At the request of the company, the SEC may provide an informal statement of its views to the company and the shareholder or group.	As soon as practicable.

Company must provide notice to the shareholder or group stating whether it will include or exclude the nominee.	Promptly following receipt of the SEC's informal statement of its views.

False and Misleading Statements

- A new Rule 14a-9(c) prohibits nominating shareholders or groups from causing any false or misleading statements to be included in a company's proxy materials, including the Schedule 14N and other soliciting communications. The company is not liable for any information contained in the company's proxy materials that was provided by a nominating shareholder and none of the information provided by such shareholder would be incorporated by reference into any of the SEC filings unless the company specifically incorporates it, in which case it would be treated as company disclosure for purposes of anti-fraud rules.

Proxy Mechanics and Voting

- *Identification of shareholder nominee candidates on form of proxy.* A company that is required to include a shareholder nominee on its form of proxy can identify the shareholder nominees as such and recommend whether shareholders should vote for, against or withhold votes on those nominees.
- *Company cannot group its own recommendations.* If a company is required to include a shareholder nominee, new Rule 14a-4(b)(2)(iv) provides that the company may not give shareholders the option of voting for or withholding authority to vote for the company nominees as a group; instead, the company must require that shareholders vote for each nominee separately.

Proxy solicitation exemptions

- *Proxy solicitations to form a nominating group.* Rule 14a-2(b)(7) provides a solicitation exemption that allows shareholders to communicate with other shareholders to form a nominating shareholder group. If shareholders make use of this exemption, they are also required to include with the Schedule 14N a cover page explaining the circumstances under which the exemption is available at a time no later than when the solicitation commences. Oral communications are allowed at any time after the shareholder files a "notice of commencement" on Schedule 14N.
    - *Written communication.* Any written communications pursuant to this exemption is limited to (i) a statement of the shareholder's intent to form a nominating group under the Rule, (ii) identification of and a brief statement regarding the potential nominees, (iii) the percentage of voting power that each shareholder holds (or the aggregate holdings of each shareholder group) and (iv) the means by which shareholders may contact the soliciting party. All written communications must be filed with the SEC by the nominating shareholder or group.
- *Proxy solicitations to support a shareholder nominee.* If a nominating shareholder or shareholder group wishes to solicit other shareholders in favor of its nominees (either orally or in writing), Rule 14a-2(b)(8) provides an exemption from the proxy rule limitations on solicitations, provided that (i) the soliciting party does not seek the power to act as proxy for a shareholder and does not furnish a form of proxy to another shareholder, (ii) written communications include the identity of the nominating shareholder or group and a description of its holdings along with a legend containing specified information and (iii) all soliciting materials sent to shareholders or published pursuant to this exemption are filed with the SEC on Schedule 14N no later than the date the material is first published or sent to shareholders.

Amendment to the "Election Exclusion" in Rule 14a-8

- *Changes to the rule for companies seeking to exclude.* Before the amendment, Rule 14a-8(i)(8) allowed a company to exclude from its proxy statement any shareholder proposal that related to the director nomination or election process. This provision also permitted the exclusion of proposals that would result in an immediate election contest or establish a process for shareholders to conduct an election contest in the future. The new rules amend Rule 14a-8(i)(8) by removing the ability of companies generally to exclude such proposals.
- *Permitted exclusions.* Amended Rule 14a-8 now only permits companies to exclude shareholder proposals if such proposal:
  - would disqualify a nominee who is standing for election;
  - would remove a director from office before his or her term expired;
  - questions the competence, business judgment or character of one or more nominees or directors;
  - seeks to include a specific individual in the company's proxy materials for election to the board of directors (except pursuant to the nominating process described above); or
  - otherwise could affect the outcome of the upcoming election of directors.
- *Additional rights.* Pursuant to the amended rule, shareholders proposing amendments to the company's governing documents can only *increase* the means by which shareholders can nominate directors (*e.g.*, shareholders can propose amendments to lower ownership thresholds, holding periods or other qualifications described above).
- *Disclosure for Shareholder Nominations Made Through a Different Nomination Process.* In situations where director nominations are submitted outside of the Rule (e.g., pursuant to a more lenient nominating process established by the company or a prior shareholder proposal), nominating shareholders must generally provide notice to the company and file certain disclosures in their Schedule 14N by the date specified in the advance notice provisions, or where no such provisions are in place, no later than 120 calendar days before the date the company mailed its proxy materials for the prior year's annual meeting.
  - ► See a copy of the SEC adopting release containing a full text of the final rules
  - ► See a copy of SEC Commissioner Mary Schapiro's statement on the adoption of the new proxy access rules

Industry Update

Technical Corrections and Revisions to New York Law Governing Powers of Attorney Effective September 12, 2010

On August 13, 2010, Governor David A. Paterson signed into law corrective amendments to Title 15 of Article 5 of the New York General Obligations Law (the "**Corrective Amendments**") governing powers of attorney ("**POAs**") executed by individuals in New York. The Corrective Amendments clarify various ambiguities in the law, including by specifying that the requirements imposed in the 2009 version of the statute (such as specific disclosure and execution requirements), do not apply to "[POAs] given primarily for a business or commercial purpose". See the August 17, 2010 Client Newsflash, ***New York State Amends 2009 Power of Attorney Statute to Clarify that Disclosure and Execution Requirements Do Not Apply to Most Corporate Transactions***, for an overview of the Corrective Amendments. See the

September 3, 2009 Investment Management Regulatory Update for a summary of the 2009 amendments to the statute.

POA provisions are standard in many fund operating, subscription, transfer and related documents. In the case of private funds, subscription and transfer agreements often include a POA authorizing the general partner to sign the fund's operating documents on behalf of its limited partners. The fund's operating documents also typically include a POA authorizing the fund's general partner to take certain actions and execute certain documents and amendments on behalf of its limited partners. For example, many private equity funds permit the use of "alternative investment vehicles" when structuring investments, and general partners may be empowered to execute the operative documents of such vehicles through a POA contained in the fund's partnership agreement. In registered investment companies, members of the company's senior management or board of directors may, for example, execute a POA designating one or more of its members to sign and file a registration statement.

Among the various types of POAs specifically excluded by the Corrective Amendments from the reach of the statute are powers given by individuals who are or are seeking to become officers, shareholders, employees, partners, members, or managers of entities in their capacities as such (which, together with other categories listed in Section 5-1501C of the New York General Obligations Law, would generally include POAs given in fund subscription and transfer agreements), as well as powers contained in partnership agreements, LLC operating agreements, declarations of trust or condominium offering plans and bylaws (which would include POAs contained in fund partnership agreements and LLC operating agreements).

POAs executed by individuals that continue to be subject to the statute (*e.g.,* POAs commonly executed by individuals for general financial or estate planning purposes) must continue to comply with the specific execution and disclosure requirements of Section 5-1501B.

The revised provisions became effective *September 12, 2010* (30 days from the date of enactment) and apply retroactively to September 1, 2009 (except that powers validly executed under prior law will remain valid).

- See a copy of the Corrective Amendments signed by Governor Paterson

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SEC Issues No-Action Letter Temporarily Relieving Money Market Funds from NRSRO Designation Obligations

On August 19, 2010, the SEC's Division of Investment Management (the "**Division**") issued a no-action letter to the Investment Company Institute regarding compliance with Rule 2a-7 under the Investment Company Act of 1940, which was amended earlier this year to require that, among other things, by December 31, 2010 money market fund boards of directors (i) designate at least four nationally recognized statistical rating organizations ("**NRSROs**"), whose ratings the fund would use to determine the eligibility of portfolio securities under the amended rule and (ii) disclose the designated NRSROs in the fund's statements of additional information. The SEC's amendments to money market fund rules in February 2010 were detailed previously in the ***March 9, 2010 Investment Management Regulatory Update***.

The letter addresses an issue raised by members of the mutual fund industry with respect to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). Section 939A requires the SEC to review its regulations that reference credit ratings and modify the regulations by replacing each such reference with an alternative standard of creditworthiness the SEC deems appropriate. In the no-action letter, the SEC staff explained that one of the purposes of the NRSRO designation requirement was to give the money market fund board the responsibility to decide which NRSROs it would use to determine whether a security is an eligible security for Rule 2a-7 purposes. However, the SEC staff indicated that the requirements of Section 939A could render irrelevant any such determinations made by money market fund boards over the next few months in order to meet the rule's December 31, 2010 compliance date, because the SEC may be required to amend Rule 2a-7 in light of Section 939A. For a more comprehensive summary of the Dodd-Frank Act, including the provisions concerning credit rating agencies, please see the Davis Polk Client Memorandum, ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010***.

The letter provides that the Division would not recommend SEC enforcement action if a money market fund board does not designate NRSROs before the SEC has completed its review of Rule 2a-7 as required by the Dodd-Frank Act and made any necessary modifications to the rule. In the meantime, money market funds that rely on the no-action letter must continue to comply with the obligations for determining and monitoring eligible securities under Rule 2a-7 as in effect before May 5, 2010 (other than the limitation on a fund's ability to acquire unrated asset backed securities, which was rescinded by the 2010 rulemaking).

- See a copy of the SEC no-action letter:

SEC Announces the Expiration of Temporary Rule 206(3)-3T

In an open letter to the Securities Industry and Financial Markets Association ("**SIFMA**"), the SEC's Division of Investment Management announced that it anticipates that temporary Rule 206(3)-3T (the "**Rule**") promulgated under the Investment Advisers Act of 1940 (the "**Advisers Act**") will expire on December 31, 2010. As previously reported in the ***January 7, 2010 Investment Management Regulatory Update***, the SEC extended the expiration date of the Rule by one year on December 23, 2009.

Section 206(3) of the Advisers Act prohibits a registered investment adviser from knowingly selling a security to, or purchasing a security from, a client's account on a principal basis without, for each such transaction, providing written disclosure to such client and obtaining the client's consent. As more fully described in the ***October 2007 Investment Management Regulatory Update***, the Rule was adopted in September 2007 to provide relief from these trading restrictions for certain transactions with nondiscretionary advisory accounts.

The Rule generally allows a registered investment adviser that is also registered with the SEC as a broker-dealer to trade on a principal basis on behalf of certain nondiscretionary advisory accounts if, among other things: (i) the adviser discloses conflicts of interest associated with principal transactions and the manner in which such adviser addresses those conflicts, (ii) the client executes a blanket consent prospectively authorizing principal transactions, (iii) before the execution of a principal transaction, the adviser informs the client of the capacity in which it may act with respect to the transaction and obtains the client's consent (either written or orally), (iv) the adviser sends the client written confirmation of the principal transaction and (v) at least annually, the adviser provides the client reports of principal transactions executed in reliance on the Rule.

In its letter to SIFMA, the SEC recognized that few firms have been relying on the Rule, but noted that it would consider applications for exemptive orders from firms affected by the expiration of the Rule "that could provide a similar means to comply with Section 206(3) of the [Advisers] Act."

- See a copy of the SEC's letter to SIFMA

ABA Task Force Completes Report on Fund Use of Leverage and Derivatives; SEC Hopes to Take Action by Year's End

At an August 9, 2010 meeting of the federal securities regulation committee, SEC Division of Investment Management Director Andrew J. Donohue expressed his hope that the SEC would act soon on recommendations from the American Bar Association ("**ABA**") regarding the use of leverage and derivatives by mutual funds. In the wake of significant losses in mutual funds in 2008 and early 2009, Donohue spoke to the ABA in the spring of 2009 describing his concerns about investment companies' use of derivatives, as reported in the ***May 8, 2009 Investment Management Regulatory Update***. In particular, he expressed concern whether mutual funds' disclosure regarding their use of derivatives adequately enables investors to understand the risks associated with funds' investments in derivatives. He challenged the group to address those concerns. For recent developments regarding the SEC's views on derivatives-related disclosure by investment companies, please see the ***April 6, 2010, May 10, 2010*** and ***August 16, 2010 Investment Management Regulatory Updates***.

In response to Donohue's request, the ABA assembled a task force that produced a report addressing the issues in July 2010. In summary, the task force recommended that the SEC:

- take a principles-based approach to the regulation of derivatives;
- require funds to measure diversification for purposes of Section 5(b) of the Investment Company Act of 1940 (the "**Investment Company Act**") by looking, when applicable, at the reference assets underlying the particular derivatives;
- regulate counterparty risk under Section 12(d)(3) of the Investment Company Act, including counterparties not in a traditional securities-related business;
- use a principles-based approach to place limits on fund use of leverage, including requiring that funds adopt policies and procedures and maintain "Risk-Adjusted Segregated Amounts" based on the risk profiles of derivative instruments;
- suggest that funds measure concentration based on reference assets;
- clarify that, pursuant to Rule 35d-1 under the Investment Company Act, a fund's reference assets should be used to determine whether the fund invests in a manner consistent with its name;
- require funds to improve disclosure of how derivatives affect actual investment results;
- emphasize the responsibility of a fund's board of directors to oversee the fund's use of derivatives and leverage; and
- conduct additional roundtable discussions and other informational opportunities for SEC staff to learn more about how mutual funds use leverage and derivatives.

While Donohue declined to say specifically what action the SEC would take, he stated that the regulation of mutual funds' use of leverage and derivatives remains "a high priority" for his division. He noted that he hopes to take action before the end of the year, but that it was "more likely than not" that the SEC would seek public comment before doing so.

► See a copy of the ABA task force report

Securities Regulators Update Report on Best Practices for Firms Serving Senior Investors

On August 12, 2010, the SEC staff (the "**Staff**"), the Financial Industry Regulatory Authority ("**FINRA**"), and the North American Securities Administrators Association ("**NASAA**") jointly released a 2010 Addendum (the "**Addendum**") to their 2008 report, "Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors," which provides examples of best practices used by financial services firms in providing services to senior investors.

According to studies referenced in the Addendum, total retirement assets decreased by $4.5 trillion, or 25%, from 2007 to the first quarter of 2009. As a result of this environment, the Staff, FINRA and NASAA found it especially important to ensure protections are put into place to protect senior investors.

The Addendum highlights the following six general areas which financial services firms should focus on when providing services to senior investors:

- Communicating effectively with senior investors;
- Training and educating firm employees on senior-specific issues;
- Establishing an internal process for escalating issues and taking next steps;
- Obtaining information at account opening;
- Ensuring appropriateness of investments; and
- Conducting senior-focused supervision, surveillance and compliance reviews.

A few of these areas are discussed in more detail below:

Training firm employees on senior-specific issues: In order to make sure securities professionals are more focused on senior investor issues, the Addendum recommends enhancing training methods. The Addendum highlights the following training methods that firms use: (a) continuing education courses which identify senior-specific considerations, (b) providing real-life examples to securities professionals of SEC, FINRA and state actions taken with respect to senior financial abuse and (c) providing a training brochure for securities professionals to help them identify issues related specifically to senior-investors.

Establishing an internal process for escalating issues and taking next steps: Some policies that financial services firms have implemented include (a) identifying a contact person within the firm's compliance department that will provide guidance on senior-specific issues, (b) escalating any suspected elder abuse to an appropriate supervisor and (c) declining a transaction or the opening of an account if there is a suspicion of financial abuse or diminished capacity.

Ensuring the appropriateness of investments: Securities professionals must assess the appropriateness of an investment for each client. The age and life stage of an investor are important factors to be considered. In order to ensure this issue is properly addressed, the Addendum recommends that: (a) a firm's new product committee identify potential risks to senior investors when creating new products and services and (b) securities professionals maintain ongoing contact with clients to determine whether there have been any significant changes in life circumstances which would require a reevaluation of the client's investment objectives or needs.

Highlighting the importance of this issue, Carlo di Florio, Director of the SEC's Office of Compliance Inspections and Examinations, said: "Securities regulators are focused on ensuring a fair market for seniors where sales practices are responsible, the facts are clear, and products are suitable. This report helps firms understand increasing regulatory expectations and effective industry practices that better protect senior investors."

- ► See a copy of the 2010 Addendum
- ► See a copy of the 2008 Report

Litigation

Second Circuit Upholds the Constitutionality of Connecticut's "Pay-to-Play" Law As It Relates to Contractors and their Families

On July 13, 2010, the U.S. Court of Appeals for the Second Circuit (the "**Second Circuit**") in *Green Party of Conn. v. Garfield*, 2010 U.S. App. LEXIS 14248 (2d Cir. 2010), upheld Connecticut's "pay-to-play" law against a constitutional challenge insofar as it prohibits state contractors, and, notably, their spouses and dependent children, from making campaign contributions to candidates for state office. The court did, however, strike down a similar provision which prohibits contributions by lobbyists, as well as a provision that prohibits both contractors and lobbyists from soliciting contributions on behalf of candidates for state office. The Connecticut "pay-to-play" law contains similar prohibitions that specifically concern investment advisers, though those provisions were not directly at issue in the court's ruling. The Second Circuit's ruling may serve as a bellwether to how courts will assess the constitutionality of similar laws under First Amendment challenge, including the new prohibitions on "pay-to-play" practices by investment advisers recently adopted by the SEC in Rule 206(4)-5 under the Investment Advisers Act of 1940. For other recent developments regarding both state and federal "pay-to-play" laws, including Rule 206(4)-5, see the ***January 7, 2010, March 9, 2010, April 6, 2010, May 10, 2010, June 10, 2010*** and ***July 14, 2010 Investment Management Regulatory Updates***.

According to the court's opinion, Connecticut's Campaign Finance Reform Act ("**CFRA**") prohibits "state contractors and certain lobbyists from (1) making campaign contributions to candidates for state office and (2) soliciting campaign contributions on behalf of candidates for state office." The contractor contribution and solicitation bans, which are outright bans as opposed to limits, apply not only to contractors but also to (i) prospective contractors, (ii) principals of contractors or prospective contractors and (iii) spouses or dependent children of any such persons. A "principal" includes any member of the entity's board of directors, an individual who owns five-percent or more of the entity, certain specified officers of the entity and political committees established or controlled by the entity or an individual that controls the entity.

The plaintiffs, which included two Connecticut political parties as well as state lobbyists and contractors, challenged these aforementioned provisions of the CFRA on First Amendment grounds, among other constitutional challenges. The district court in *Green Party of Conn. v. Garfield*, 590 F. Supp. 2d 288 (D. Conn. 2008), granted summary judgment to the defendants, which included the executive director and general counsel of the State Elections Enforcement Commission and the Attorney General of Connecticut. The plaintiffs subsequently appealed the judgment to the Second Circuit.

The court stated that the standard of review for First Amendment challenges to laws restricting campaign contributions is whether the statute is "closely drawn to match a sufficiently important [government] interest" for each group of individuals covered by the statute. The court distinguished the recent Supreme Court decision in *Citizens United v. Fed. Election Comm'n*, 130 S. Ct. 876 (2010) as applying only to campaign expenditures and not to campaign contributions, as is the subject matter here.

The Second Circuit upheld the ban on contributions from contractors concluding that it meets the "closely drawn" standard because it addresses the "actuality" and "appearance" of corruption involving state contractors. In making this determination, the court detailed the recent state political scandals that led to the CFRA being passed.

While many states have similar laws prohibiting contributions by contractors, the court also upheld the extension of the ban to spouses and dependent children concluding that it is also "closely drawn". The court explained that Connecticut was justified in its concern that the statute may be circumvented by siphoning improper contributions through spouses or children.

The court then turned to the ban on lobbyists and concluded that it is not “closely drawn” because “[l]obbyists have not been directly linked to the pay-to-play scandals, which primarily involved *state contractors* offering bribes in exchange for preferential treatment” and therefore, an outright ban on lobbyists does not address the appearance of corruption, and, as such, the outright ban is not “closely drawn” in violation the First Amendment.

Finally, the court invalidated the ban on solicitation by state contractors and lobbyists as being overbroad. The court explained that because a solicitation of contributions involves political speech, the statute’s ban is subject to strict scrutiny and, thus, must be narrowly tailored to further a compelling state interest.

The term “solicit” is defined by statute to include, among other things, “requesting that a contribution be made,” “participating in any fund-raising activities for a candidate” and “bundling contributions” for a candidate. Bundling occurs when contractors or lobbyists organize large numbers of coordinated contributions to a state official, such as by means of a large fundraising event. The threat posed by bundling is that the organizer may be promised assistance in securing a state contract in exchange for organizing the event.

The court stated that the solicitation ban was intended to “combat corruption and the appearance of corruption caused by bundling” but instead prohibits a wide range of activity unrelated to bundling. For instance, under the CFRA, a state contractor would be prohibited from “advising his mother about whether she should contribute to a particular gubernatorial candidate.” A less restrictive ban, the court indicated, would target only large-scale fundraising efforts of a certain size.

In addition, to meet the narrowly tailored standard, the court noted that the ban on bundling should be directed at individuals over which the lobbyist or contractor may have influence such as the lobbyist’s clients or the contractor’s employees or subcontractors, rather than apply to *all* solicitation efforts by lobbyists and contractors. As a result of the foregoing, the court found that the solicitation ban is not narrowly tailored and, therefore, violates the First Amendment.

As mentioned above, one of the most notable aspect of the court’s ruling seems to be the court’s upholding of the ban on contributions as applied not only to contractors and their principals but to their families as well. Although the SEC declined to include families within the coverage of the restrictions under the new Rule 206(4)-5, the rule does contain an anti-evasion provision which, according to its adopting release, would prohibit political contributions to candidates from being funneled through family members in order to circumvent the rule.

We will continue to monitor developments in this area.

- See a copy of the court’s opinion

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