

SEC Scrubs Rules of References to Credit Ratings

BY ED ZAHAREWICZ

The SEC has adopted amendments to certain rules to remove references to credit ratings issued by nationally recognized statistical rating organizations. The amendments, which go into effect on November 12, 2009, are designed to address concerns that references to NRSRO ratings in SEC rules may have contributed to an undue reliance on those ratings by market participants. With regard to investment companies, the amendments affect changes to Rules 5b-3 and 10f-3 under the Investment Company Act. The SEC, however, deferred action and reopened the comment period on other proposed amendments to remove NRSRO ratings from existing rules, including Rule 2a-7 which governs money market funds.

Under Rule 5b-3, a “refund security” is a debt security the principal and interest of which are to be paid by U.S. government securities that have been escrowed and pledged for the payment of the debt security. Rule 5b-3 permits a mutual fund to treat the acquisition of a refunded security as an acquisition of the escrowed securities for diversification purposes, if certain conditions are met. As amended, the rule will no longer allow such treatment for a refunded security that has received a debt rating in the highest category from an NRSRO unless the an independent accountant has certified to the escrow agent that the escrowed securities will satisfy all scheduled payments on the refunded security.

Rule 10f-3 provides an exemption from the provisions of Section 10(f) of the Investment Company Act for purchases of certain securities, including eligible municipal securities, if certain conditions are met. Section 10(f) prohibits a registered fund from knowingly purchasing securities in an underwriting in which an affiliate is participating. The amended rule revises the definition of “eligible municipal security,” which the current rule defines with references to NRSRO ratings, to mean securities that “are sufficiently liquid that they can be sold at or near their carrying value within a reasonable time” and are subject to either “no greater than moderate credit risk” or, for certain “less seasoned” securities, “a minimal or low amount of credit risk.”

SEC Proposes Restrictions on Adviser Pay-to-Play Practices

BY KAREN BENSON

The SEC has proposed rulemaking aimed at addressing “pay-to-play” practices by investment advisers soliciting advisory business from government entities, including public pension plans. According to the SEC, pay-to-play practices distort the process by which advisers are selected, can harm clients who may receive inferior advisory services and pay higher fees, and are inconsistent with the high standards of ethical conduct required of advisers under the Investment Advisers Act.

Modeled on rules adopted by the Municipal Securities Rulemaking Board to address pay-to-play practices in the municipal securities market, proposed Rule 206(4)-5 under the Advisers Act would make it unlawful for an adviser or certain of its executives or employees to engage in the following activities:

- Providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates (with an exception for certain de minimis contributions by an executive or employee).
- Coordinating, or asking another person or political action committee to make: (i) a contribution to an elected official (or candidate for the official’s position) who can influence the selection of the adviser, or (ii) a payment to a political party of the state or locality where the adviser is seeking to provide advisory services to the government.
- Paying a third party, such as a solicitor or placement agent, to solicit a government client on behalf of the adviser.
- Engaging in pay-to-play conduct indirectly, such as by directing or funding contributions through third parties such as spouses, lawyers or companies affiliated with the adviser, if that conduct would violate the rule if the adviser did it directly.

If adopted, the proposed rule would apply to investment advisers registered or required to be registered with the SEC as well as unregistered advisers relying on the de minimis exemption under Section 203(b)(3) of the Advisers Act. The proposed rule would cover not only situations where an adviser directly manages or advises a government entity’s assets, but also situations where an adviser manages or advises a private fund or mutual fund in which the government entity invests its assets.

The SEC has also proposed rule amendments that would require advisers to maintain certain records of political contributions made by them or certain of their executives or employees.