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Fiduciary Governance

June 25, 2020

Risk&Reward
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Surviving Election Season: Refresher on Pay-to-Play Rules for Investment Advisers

Election season is already in full swing. As a result, investment advisers may wish to increase their attention to applicable pay-to-play compliance obligations, as further described herein.

I. Background on the Rule

In connection with political contributions, registered investment advisers, certain exempt reporting advisers and foreign private advisers (collectively referred to as herein as "advisers"),[1] as well as their "covered associates"[2] (which is broadly defined), are subject to Rule 206(4)-5 of the Advisers Act, otherwise known as the "pay-to-play" rule. The purpose of the rule is to curtail "pay-to-play" practices by advisers seeking to manage the assets of state and local governments (*e.g.*, public pension funds and investments by public universities) in return for political contributions. The SEC does not have to show any intent or quid pro quo to allege a violation of this anti-fraud rule. Penalties imposed by the

SEC in connection with violations of the rule are severe even for foot-faults. Such penalties generally include disgorgement of any advisory fees received from such governmental entities, as well as the imposition by the SEC of civil monetary penalties (which are regularly in the hundreds of thousands of dollars).[3]

II. Prohibitions

A. Ban on Fees Following Contributions

As a general matter, the rule prohibits advisers and their covered associates from making political "contributions"[4] to any "official"[5] of a "government entity"[6] who was, at the time of the contribution, an incumbent, candidate or successful candidate for an elective office of a government entity if that office could influence the hiring of an investment adviser for such entity or have authority to appoint a person who could have such influence. If such a political contribution is made, the adviser is prohibited from receiving any compensation from advisory services to that government entity for two years thereafter - otherwise known as the "time-out" period. The adviser can still provide uncompensated advisory services to such entity during the time-out period, or provide uncompensated advisory services until the entity locates a replacement adviser. Note that an adviser to a "covered investment pool"[7] in which a government entity invests or is solicited to invest shall be treated as though that adviser was providing or seeking to provide investment advisory services directly to the entity.

B. Ban on Using Third Parties to Solicit Government Business

The rule further prohibits an adviser from providing payment[8] to (or agreeing to pay), directly or indirectly, any person to solicit[9] a government entity for advisory services on behalf of the adviser. However, such solicitation is not prohibited if the person is a (1) "regulated person"[10] (such as a registered investment adviser, broker-dealer or municipal adviser) or an (2) executive officer, general partner, managing member, similar person or employee of the adviser. The rule also prohibits an adviser from coordinating or soliciting a person or PAC to: (1) contribute to an official of a government entity to which the adviser provides or seeks to provide advisory services or (2) 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.

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C. Catchall Ban

As a sort of catchall provision, the rule prohibits any acts done indirectly which, if done directly, would violate the rule. For example, the SEC staff has indicated that while a covered associate's contribution to a PAC generally would not trigger the two-year time-out, if the contribution is earmarked or known to be provided for the benefit of a particular political official, it would implicate the catchall provision because the covered associate would be doing indirectly what it could not do directly.[11]

III. Exceptions and Exemptions from the Rule

A. Exception for Certain New Covered Associates

Whereas the rule requires a two-year look-back for all covered associates who solicit clients, it only requires a six-month look-back for "new" covered associates who do not solicit clients. The "look-back" period will follow covered associates that change advisers, such that a prohibited contribution by a covered associate will result in a "time out" for the covered associate's new firm for the remainder of the two-year or six-month period, depending on whether the covered associate solicits clients for the new firm. To prevent advisers from channeling contributions through departing covered persons, if a covered person makes a prohibited contribution and then leaves the employ of that adviser, the former adviser will also still be subject to the two-year time-out period, despite the departure of the covered associate who made the contribution.

B. De Minimis Exception

The primary exception to the pay-to-play rule is the *de minimis* exception. The de minimis exception allows an adviser's covered associate that is a natural person to contribute: (1) up to $350 to an official per election (with primary and general elections counting separately) if the covered associate is *entitled* to vote for the official at the time of the contribution; and (2) up to $150 to an official per election (with primary and general elections counting separately) if the covered associate is not entitled to vote for the official at the time of the contribution. Most firms implement pre-clearance requirements in connection with covered person political contributions in order to ensure compliance with this exception. Any contribution above such *de minimis* amounts, no matter how small, can trigger a violation of the rule.

C. Returned Contribution Exception

If a covered associate makes a contribution that triggers the two-year time-out period solely because he or she was not entitled to vote for the official at the time of the contribution, the adviser can undo the contribution under very narrow circumstances. To be eligible for the returned contribution exception, the contribution had to be less than $350, the adviser must have discovered the contribution within four months of the date of such contribution, and the adviser must cause the contributor to re-collect the contribution within 60 days after the adviser discovers the contribution. However, an adviser can only rely on the returned contribution exception on limited occasions (for advisers with fewer than 50 employees, twice in a 12-month period; for advisers with more than 50 employees, three times in a 12-month period), and an adviser can never use the returned contribution exception for the same covered associate twice. Again, this exception is only applicable if the violation is discovered and remedied on a timely basis.

D. Request for Exemptive Relief

In extremely narrow circumstances, the rule also allows an adviser to apply for an order exempting it from the two-year timeout requirement in the event of an inadvertent violation that falls outside of the exceptions set forth above. The SEC will grant orders only when, according to the SEC, the imposition of the time-out provision is unnecessary to achieve the rule's intended purpose.[12] Advisers applying for an order must do so through an application process that exposes the firm and the covered associate to public scrutiny.

IV. Recordkeeping Requirements

As part of their recordkeeping requirements under the pay-to-play rule, advisers must collect and maintain:

- the names, titles and business and residence addresses of all covered associates;
- all government entities to which the adviser provides or has provided investment advisory services, or which have been investors in any covered investment pool to which the adviser provides or has provided investment advisory services, in the last five years;
- all direct and indirect contributions made by the adviser or its covered associates to an official of a government entity or direct or indirect payments made to a political party or PAC; and
- the name and business address of each regulated person to which the adviser agrees to provide direct or indirect payment to solicit a government entity.

V. Summary

If an investment adviser would like to remain eligible to bid for government contracts, it should take affirmative steps to ensure that the firm and its covered persons do not violate the pay-to-play rule. Robust pay-to-play policies and procedures, as well as pre-clearance of political contributions, are recommended best practices for advisers that seek government clients. Re-education of adviser personnel and covered associates as to the requirements of the rule, especially in light of the upcoming election season, is also advised.[13] An adviser should also consider pre-screening new covered person candidates for the applicability of the rule. Finally, it may be helpful to conduct periodic checks of campaign contribution databases, as well as require quarterly pay-to-play compliance reporting. The SEC may bring enforcement actions for even minor foot-fault violations of the rule. Such cases generally result in disgorgement and fines. Compliance with the relevant recordkeeping obligations is also important, as the SEC regularly reviews pay-to-play recordkeeping as part of adviser exams.

[1] The rule applies to all investment advisers registered (or required to be registered) with the Securities and Exchange Commission (SEC), or unregistered in reliance on the exemption available under section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act) (15 U.S.C. 80b-3(b)(3)), or that is an exempt reporting adviser, as defined in section 275.204-4(a) – which includes venture capital fund advisers and private fund advisers.

[2] A "covered associate" broadly includes (1) a general partner, managing member, executive officer or other individual with a similar status or function; (2) any employee who solicits a governmental entity for the adviser (and any person who supervises, directly or indirectly, such an employee); or (3) a political action committee (PAC) controlled by the adviser or by any of its covered associates.

[3] *See e.g.*, In the Matter of Ancora Advisors LLC, SEC Administrative Proceeding File No. 3-18937 (Dec. 18. 2018), found at https://www.sec.gov/litigation/admin/2018/ia-5077.pdf.

[4] The definition of "contribution" is broad and encompasses any gift, subscription, loan, advance or deposit of money or anything of value made for (1) the purpose of influencing any election for federal, state or local office; (2) payment of debt incurred in connection with any such election; or (3) transition or inaugural expenses of the successful candidate for state or local office.

[5] An "official" means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (1) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an adviser by a government entity; or (2) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.

[6] A "government entity" means any state or a political subdivision of a state, including: (1) any agency, authority or instrumentality of the state or a political subdivision, (2) a pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a "defined benefit plan" as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a state general fund; (3) a plan or program of a government entity; and (4) officers, agents, or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

[7] "Covered investment pool" means: (1) an investment company registered under the Investment Company Act of 1940 (Investment Company Act) that is an investment option of a plan or program of a government entity; or (2) any company that would be an investment company under section 3(a) of the Investment Company Act, but for the exclusion provided from that definition by either section 3(c)(1), 3(c)(7) or 3(c)(11) of that Act.

[8] "Payment" means any gift, subscription, loan, advance, or deposit of money or anything of value.

[9] "Solicit" means: (1) with respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an adviser; and (2) with respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.

[10] "Regulated person" means: (1) a registered investment adviser that has not (and whose covered persons have not) made, coordinated or solicited a contribution within the last two years that would violate the rule; (2) a broker-dealer that is a member of a registered national securities association, so long as such association's rules

prohibit members from engaging in distribution or solicitation activities after making political contributions and the SEC finds, by order, that such rules are at least substantially equivalent to the restrictions imposed on advisers under the rule; and (3) municipal advisors registered under section 15B of the Securities Exchange Act of 1933 and subject to pay to play rules adopted by the Municipal Securities Rulemaking Board (MSRB), provided that the MSRB rules: A) impose substantially equivalent or more stringent restrictions on municipal advisors than the pay to play rule imposes on investment advisers and B) are consistent with the objectives of the pay to play rule.

[11] Staff Responses to Questions about the Pay to Play Rule (https://www.sec.gov/divisions/investment/pay-to-play-faq.htm#v.3).

[12] The rule outlines a number of factors that the SEC will consider, including an assessment of the adviser's compliance environment, the nature of the contribution and the covered associate's intent in making the contribution. Since the rule's adoption, the SEC has granted 16 exemptive orders. *See e.g.* In the Matter of D.B. Fitzpatrick & Co., Inc., Investment Advisers Act Release No. 5496 (May 5, 2020) (order), found at https://www.sec.gov/rules/ia/2020/ia-5496.pdf; D.B. Fitzpatrick & Co., Inc., Investment Advisers Act Release No. 5475 (Apr. 9, 2020) (notice of application), found at https://www.sec.gov/rules/ia/2020/ia-5475.pdf; In the Matter of D.B. Fitzpatrick & Co., Inc., File No. 803-253 (Apr. 9, 2020) (application), found at https://www.sec.gov/rules/ia/2020/803-00253-amended-application.pdf.

[13] For example, even though the rule applies to advisers seeking to influence state and local entities and not federal entities, if a state office holder that has influence over the selection of investment advisers, which could include a sitting state governor, were to be nominated as a Vice Presidential running mate, contributions to that ticket could implicate the rule.