

Contribution Caution: Mitigating Risks From Pay-To-Play

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Presentation Overview

- Brief overview of SEC Rule 206(4)-5, the Investment Advisers Act “Pay-to-Play” Rule
 - Applicability
 - Severity of consequences
- Relief under the rule
- Recommendations
- Closing comments and questions



Applicability of Rule 206(4)-5

- The rule applies to nearly all investment advisers, including managers of venture capital, private equity, and hedge funds, if their funds have public sector investors (e.g., pension funds)
- Exempt reporting advisers are subject to the rule

Applicability of Rule 206(4)-5 (cont.)

- Campaign contributions by “covered associates” can require managers/advisers to forego any compensation for two years from a public sector client or investor
- Contributions to candidates for an office that has influence over the selection of a public sector client’s investment adviser—or candidates who already hold such an office—trigger the restriction
- Cannot do anything indirectly that is prohibited if done directly



Severity of Consequences

- No intent to influence required
- Even small-dollar contributions require the adviser to forego two years of fees from a public sector investor
 - Example: the first charges brought by the SEC under the rule cost an adviser to VC funds \$250,000 in fees earned over two years from two pension fund investors, stemming from less than \$5,000 in campaign contributions by a co-founder to candidates for state and municipal office
- Potential collateral consequences



Relief under the Rule

- Limited exceptions
 - Contributions of not more than \$350 (if entitled to vote for the candidate) or \$150 (if not entitled to vote for the candidate)
 - Adviser can “cure” a contribution of not more than \$350 if promptly identified and returned
- Exemptive relief from the SEC
 - Four exemptions have been granted to date



Recommendations

- Consider policies and procedures broader than the Rule:
 - Pre-clearance of *all* political contributions
 - Including the rule in onboarding and annual compliance training
 - Including the rule in annual certification processes
 - Conducting periodic checks of contributions made by covered associates in jurisdictions where the adviser has public sector investors
 - Search publicly-available contribution disclosure databases for the name of the adviser and covered associates themselves



Recommendations (cont.)

- Broad policies and procedures can help prevent, or at least identify and address, contributions that may violate the rule
- If potentially violative contributions are identified, consider taking remedial steps:
 - Determine if an exception applies (e.g., less than \$150)
 - Return the contribution
 - Escrow fees from the client or investor
 - Apply for exemptive relief



Exemptive Relief

The SEC looks to a number of factors in determining whether to grant an exemption:

- Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Advisers Act
- The remaining factors focus on:
 - The investment adviser's conduct before and after the contribution;
 - The contributor's intent and role at the adviser; and
 - The nature of the contribution itself.



Adviser Factors

- Whether before the contribution, the adviser:
 - Had policies and procedures reasonably designed to prevent violations of this section in place prior to the contribution; and
 - Had no actual knowledge of the contribution (before or at the time the contribution was made).
- Whether, after learning of the contribution, the adviser:
 - Has taken all available steps to cause the contributor to obtain a return of the contribution; and
 - Has taken such other remedial or preventive measures as may be appropriate under the circumstances.



Contributor and Contribution Factors

- Contributor
 - Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment
 - The contributor's apparent intent or motive in making the contribution, as evidenced by the facts and circumstances surrounding such contribution
- Contribution
 - The timing and amount of the contribution
 - The nature of the election (e.g., federal, state or local).



Exemptions Granted

The SEC has granted four exemptions to date.

- The first was granted in November 2013, and the remaining three were granted within a six-month period from November 2014 to April 2015.
- In all four instances, the adviser had compliance procedures in place requiring pre-clearance of political contributions, and upon learning of the contribution, the adviser promptly responded by placing fees from the relevant client /investor in escrow and ensuring that the contributor requested a refund of the contribution.



First Exemption Granted

- A managing member of a hedge fund manager made a \$2,500 contribution to the federal senate campaign of the Ohio State Treasurer
 - Three Ohio public pension plans invested in a fund advised by the hedge fund manager; the Treasurer appoints one trustee to the board that oversees the plans
- The managing member's role with respect to the pension plans was limited and only one investment was made after the contribution
- Return of contribution was secured and fees from the plans for the two-year period were escrowed
- Policies requiring pre-clearance were in place



Second Exemption Granted

- A senior management executive and senior partner of a real estate fund adviser gave \$1,100 to the Governor of Colorado's campaign
 - A Colorado public pension plan invested in the adviser's funds; the Governor appointed three trustees to the board that oversees the pension plan
- No investments were made after the contribution, no solicitation of the fund since 2007, and the contributor had no direct contact with the Governor
- Return of contribution was secured and fees from the plans for the two-year period were escrowed
- Policies requiring pre-clearance were in place



Third Exemption Granted

- A senior investment professional of a private equity fund manager gave \$2,500 to the presidential campaign of the Governor of Texas (Rick Perry)
 - A state public pension plan was an investor in one of the manager's funds that is a "covered investment pool" under the rule; the Governor appointed all trustees to the board that oversees decisions of the pension plan
- The contributor had limited contact with the pension plan and no contact with the Governor regarding the plan's investment in the fund
- Return of contribution was secured and fees from the plans for the two-year period were escrowed
- Policies requiring pre-clearance were in place



Fourth Exemption Granted

- A vice president of a large mutual fund adviser made a \$250 contribution to the Governor of Wisconsin's campaign
 - Certain Wisconsin public pension plans invested in the adviser's funds; the Governor appointed trustees to the boards that oversee the pension plans
- The contributor had limited contact with the pension plans and no contact with the Governor
- Return of contribution was secured and fees from the plans for the two-year period were escrowed
- Policies requiring pre-clearance were in place



Rejected Exemption Application

- A managing director and co-founder of a venture capital fund manager gave \$2,500 to a candidate for Mayor of Philadelphia and \$2,000 to the Governor of Pennsylvania
 - The city retirement board and state employees' retirement system were investors in the manager's funds; the Mayor and Governor appointed officials to the public funds' boards
- The fund manager was in the process of winding down the funds; no recent solicitation
- The SEC settled charges against the manager in June 2014, requiring it to disgorge over \$250,000 in fees from the two-year period



State and Local Rules

- Check applicable state and local pay-to-play rules
- Because parameters differ from the federal rule, lawful conduct at the federal law may violate state or local rules, and vice versa
- State and local consequences may be quite severe



Closing Comments

- Rule is currently being challenged in the DC Circuit
- As election cycle heats up, it is important to assess policies and procedures to prevent potential violations
- Questions



Further Questions?

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