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Contribution Caution: Mitigating Risks From Pay-To-Play

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With the record-breaking campaign expenditures[1] of the 2014 midterm elections behind us, and the 2016 campaign cycle already heating up, this is an ideal moment for investment advisers (including advisers to venture capital funds and certain private equity and hedge funds) to ensure that they have mechanisms in place to verify compliance with the U.S. Securities and Exchange Commission's pay-to-play rule.[2] The SEC has ramped up enforcement of the rule: the first case charged under the rule settled last year,[3] and the director of the SEC's Division of Enforcement has declared it to be a current priority.[4]

The rule, which is intended to prevent investment advisers from using campaign contributions to exert improper influence over existing and prospective investments by public sector clients (e.g., pension funds), carries potentially significant consequences for even small-dollar violations made without any intent to influence a current or potential investor.[5] For example, in the first charges brought under the rule, an adviser faced the loss of over $250,000 in fees earned over two years from two clients — a state pension fund and a city pension fund — and a $35,000 fine, all because of less than $5,000 in campaign contributions made by a co-founder of the fund to candidates for state and municipal office.[6]

Because the rule covers even very small donations, does not require any improper intent, and bars advisers from receiving any compensation from a government entity client, even a single $200 donation by an employee of an adviser to an unsuccessful candidate for office could violate the rule and require the adviser to forgo hundreds of thousands, if not millions, of dollars in compensation from a government entity client for two years.[7]

While the rule sweeps broadly and imposes substantial consequences, the SEC has granted applications for exemptions where advisers have demonstrated that they had appropriate policies and procedures in place to comply with the rule, that improper contributions were promptly identified, and that employees who made such contributions were unaware they would violate the rule.

In particular, in the three instances where the SEC has issued an exemptive order to an adviser, the adviser had compliance procedures in place requiring pre-clearance of political contributions, the contributor was able to establish that he did not intend to influence a government entity's selection of an investment adviser and did not realize the contribution would violate the rule, and on learning of the contribution, the adviser promptly responded by placing fees from the relevant client in escrow and ensuring the contributor requested a refund of the contribution.[8]

Notably, two of the orders cover contributions made to candidates' campaigns for federal office where

the recipient candidates held state or local office at the time the contribution was made, highlighting an easy to miss aspect of the rule: the rule applies equally to contributions to candidates who in their current position have influence over a state or local pension fund (even if they are running for federal office), as it does to contributions to a candidate who, if elected, would have influence over a state or local pension fund.

Given the breadth of contributions covered under the rule, advisers should consider policies and procedures even broader than the rule, such as:

- Implementing policies and procedures that include pre-clearance of all political contributions;

- Including the rule in annual compliance training and certification processes for employees, partners and others whose role at the adviser makes them subject to the rule; and

- Conducting periodic checks of contributions made by covered associates in jurisdictions where the adviser has government-entity clients by searching publicly available contribution disclosure databases.

Although burdensome, such policies can help prevent, or at least identify and address, contributions that require advisers to forgo payment for advisory services to public pension funds and other government-entity clients.

While the constitutionality of the rule is currently being challenged in federal court, the outcome and timing of that litigation are uncertain, and thus advisers must continue to comply with the rule for now.[9] Given enhanced press attention to the role of contributions in elections, and some recent high-profile pay-to-play settlements, we expect the SEC will continue active enforcement of the rule while also issuing exemptions in appropriate circumstances.

Additional Background on the Rule

The rule applies to all investment advisers registered (or required to be registered) with the SEC, as well as exempt reporting investment advisers.[10] The rule prohibits investment advisers from receiving compensation for advisory services provided to a government entity[11] for two years after a contribution to an official or a candidate to be an official of that government entity[12] is made by the investment adviser or a covered associate of the adviser.[13] As discussed above, although the rule's prohibitions apply only to adviser clients that are state and local government entities, contributions to a candidate for federal office still violate the rule if, at the time of the contribution, the candidate holds a state or local office with influence hiring an investment adviser.[14]

There are limited exceptions, in particular, low-dollar contributions by a covered associate (up to $350 per election if they are entitled to vote for the recipient candidate, and up to $150 if they are not).[15] Additionally, an adviser may "cure" a violation due to a contribution of $350 or less by a covered associate if the contribution is identified within four months and a return of the contribution is obtained within 60 days of discovery by the adviser.[16]

As discussed above, if a violation occurs, an adviser may apply to the SEC for an exemption.[17] There are substantial costs in applying for an exemption and a high degree of uncertainty as to success, however, so fashioning strong compliance procedures should be a high priority.

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[1] Chris Cilliza, 2014 Will Be the Most Expensive Midterm Election Ever, Washington Post, The Fix, (Oct. 22, 2014), http://www.washingtonpost.com/blogs/the-fix/wp/2014/10/22/2014-will-be-the-most-expensive-midterm-election-ever/ ("The total price tag for the 2014 midterms ... will be nearly $4 billion, according to projections released Wednesday by the Center for Responsive Politics. That would make it the most expensive midterm election in history ....").

[2] Rule 206(4)-5. When it adopted the rule, the SEC also amended the books-and-records requirements of SEC Rule 204-2 by adding 204-2(a)(18) and added a provision to SEC Rule 206(4)-3 at 206(4)-3(e).

[3] TL Ventures Inc., Order Instituting Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act if 1940, Making Findings, and Imposing Remedial Sanctions and a Cease and Desist Order, Advisers Act Release No. 3859 (June 20, 2014). The relevant pension funds were investors in investment pools to which TL Ventures Inc. was an investment adviser.

[4] See Kyle Glazier, SEC's Top Cop: More Muni Enforcement, Not Less, The Bond Buyer (Nov. 10, 2014 3:57pm), http://www.bondbuyer.com/news/washington-enforcement/secs-top-cop-more-muni-enforcement-not-less-1067831-1.html; see also William Alden, Venture Capital Firm Settles S.E.C. Charges Over 'Pay-to-Play', N.Y. Times (June 20, 2014, 1:35pm), http://dealbook.nytimes.com/2014/06/20/venture-capital-firm-settles-s-e-c-charges-over-pay-to-play/ (quoting the SEC Director of Enforcement: "We will use all available enforcement tools to ensure that public pension funds are protected from any potential corrupting influences ... As we have done with broker-dealers, we will hold investment advisers strictly liable for pay-to-play violations").

[5] While contributions to political action committees (PACs) and independent expenditure-only political committees (super PACS), independent expenditures, and other contributions that are not made directly to a candidate generally do not violate the rule, contributions that are made to circumvent the rule's prohibitions (for example if a contribution to a PAC was known to be provided for the benefit of a particular political official) violate the rule's prohibition on doing anything indirectly that the rule

otherwise prohibits. See SEC Staff Responses to Questions About the Pay to Play Rule (July 27, 2012) at 6, http://www.sec.gov/divisions/investment/pay-to-play-faq.htm; see also SEC Rule 206(4)-5 Adopting Release, Release No. IA-3043 (July 1, 2010) at 46-49, 96-97. Additionally, the rule prohibits advisers and covered associates from coordinating or soliciting any person or PAC to make a payment to a political party of a state or locality where the adviser has or seeks a government entity client. See Rule 206(4)-5(a)(2)(ii), SEC Staff Responses to Questions About the Pay to Play Rule (July 27, 2012) at 7.

[6] See TL Ventures Inc., supra note 3.

[7] While certain low-dollar contributions are subject to exceptions from the rule, they are very narrow — for example up to $350 in contributions by an employee per election to candidates they are eligible for vote for (i.e., they live in the candidate's district), and just $150 to candidates for whom they are not, are excepted from the Rule. See Rule 206(4)-5(b)(1); see also Rule 206(4)-5(b)(2)-(3).

[8] See In the Matter of Crestview Advisors LLC, Order Under Section 206A of the Investment Advisers Act of 1940 and Rule 206(4)-5(e) thereunder Granting an Exemption from Rule 206(4)-5(a)(1) thereunder, Advisers Act Release No. IA-3997 (Jan. 14, 2015) (granting application of Nov. 14, 2012, as amended March 26, 2014, July 11, 2014, and Nov. 13, 2014); In the Matter of Ares Real Estate Management Holdings, LLC, Order Under Section 206A of the Investment Advisers Act of 1940 and Rule 206(4)-5(e) thereunder Granting an Exemption from Rule 206(4)-5(a)(1) thereunder, Advisers Act Release No. IA-3969 (Nov. 18, 2014) (granting application of Dec. 23, 2012, as amended April 28, 2014 and July 15, 2014); In the Matter of Davidson Kempner Capital Management LLC, Order Under Section 206A of the Investment Advisers Act of 1940 and Rule 206(4)-5(e) thereunder Granting an Exemption from Rule 206(4)-5(a)(1) thereunder, Advisers Act Release No. IA-3715 (Nov. 13, 2013) (granting application of Oct. 16, 2012, as amended July 5, 2013). See also Crestview Advisors LLC, Notice of application for an exemptive order under Section 206A of the Investment Advisers Act of 1940 and Rule 206(4)-5(e), Release No. IA-3987 (Dec. 19, 2014); Ares Real Estate Management Holdings LLC, Notice of application for an exemptive order under Section 206A of the Investment Advisers Act of 1940 and Rule 206(4)-5(e), Release No. IA-3957 (Oct. 22, 2014); Davidson Kempner Capital Management LLC, Notice of application for an exemptive order under Section 206A of the Investment Advisers Act of 1940 and Rule 206(4)-5(e), Release No. IA-3693 (Oct. 17, 2013).

[9] The rule is being challenged in the D.C. Circuit for exceeding the SEC's authority by regulating campaign contributions and restricting free speech in violation of the First Amendment. See N.Y. Republican State Comm. v. SEC, No. 14-1194 (D.C. Cir. 2015). The D.C. Circuit previously upheld the similar, and in some ways more restrictive,MSRB Rule 37 (on which Rule 206(4)-5 was patterned) on a First Amendment challenge. See Blount v. SEC, 61 F.3d 938 (D.C. Cir. 1995). However, certain Supreme Court decisions since then have altered First Amendment law as applied to campaign expenditures and aggregate limits on campaign contributions, in particular as to restrictions on political contributions. See generally McCutcheon v. FEC, 572 U.S. --, 134 S. Ct. 1434 (2014); Citizens United v. FEC, 558 U.S. 310 (2009).

[10] See Rule 206(4)-5(a); see also Investment Advisers Act §§ 203(b)(3), (l)-(m); Rule 203(l)-1; Rule 203(m)-1; Rule 204-4(a).

[11] This term is defined to include a state or local government agency or authority, pools of assets sponsored by such an entity, and certain investment pools. See Rule 206(4)-5(f)(3), (5); see also Investment Company Act §§ 3(c)(1), (7), (11).

[12] This term is defined to include an official with influence over that government entity's hiring of investment advisers, such as a role in appointing someone to a board with authority to hire an investment adviser. See Rule 206(4)-5(f)(6).

[13] This term is defined to include general partners, managing members, executive officers, and others with similar functions; employees who solicit a government entity and supervisors of such employees; and PACs controlled by the adviser or a person who is covered associate. See Rule 206(4)-5(f)(2).

[14] Investment advisers and covered associates are also prohibited from: a) providing or agreeing to provide payment to any person not subject to the rule to solicit a government entity on behalf of the adviser; b) coordinating or soliciting any person or PAC to make: 1) a contribution to an official of a current or prospective government client; 2) or payment to a political party of a state or locality where the adviser has a current or prospective government client; and c) doing anything indirectly, which if done directly, would result in a violation of the rule. See Rule 206(4)-5(a)(2), (d).

[15] See Rule 206(4)-5(b)(1).

[16] An adviser may only "cure" a contribution three times per year (if it has more than 50 employees) or twice per year (if it has 50 or fewer employees), and may use such an exemption only once for a given covered associate. See Rule 206(4)-5(b)(3)(ii).

[17] See discussion of exemptions supra; see also Rule 206(4)-5(e).