
Pay-to-Play Update: A Quartet of Recent Settlements Underscores the Breadth of Risk Posed by Rule 206(4)-5

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With the midterm elections less than a month away and political campaign activity in full swing, the Securities and Exchange Commission (SEC) has demonstrated a renewed interest in “pay-to-play” enforcement after a long hiatus. As advisers are considering the risk profile of their businesses, attention to pay-to-play issues—and their draconian consequences—is warranted.

Investment Advisers Act Rule 206(4)-5 (the Rule) is intended to deter investment advisers from using campaign contributions, by the firm or certain covered individuals, to exert improper influence over existing or prospective investments by public sector clients (e.g., public treasuries, endowments, pension funds). But the consequences of violating the Rule can seem severe in comparison to the often small-dollar contributions made by individual employees without any apparent intent to influence a current or potential investor. Violations of the Rule can lead to significant fines and prohibitions on investment advisers from receiving any compensation from a government entity for two years.

Four investment advisers recently found out the hard way how easy it is to violate the Rule when they settled administrative proceedings on a neither-admit-nor-deny basis focused on the following conduct:

- **Asset Management Group of Bank of Hawaii** (Bank of Hawaii) – An officer of the Bank of Hawaii, who indirectly supervised solicitors of investment advisory services, made a \$1,000 campaign contribution to the Governor of Hawaii. The contribution was made on July 26, 2018, and the officer oversaw the solicitors from September 2018 to October 2019. The Governor has the ability to influence the selection of investment advisers for the University of Hawaii. Specifically, the Governor appoints all 11 members of the Regents’ board, which has influence over the selection of investment advisers for the university.
- **Canaan Management, LLC** – A covered associate made a \$1,000 campaign contribution to the campaign of a candidate for Governor of California. After the contribution was made, the covered associate attempted to receive a return of the contribution, but the contribution exceeded the amount in the relevant exception and the return was not completed within 60 days.¹ The Governor has the ability to influence the selection of investment advisers for the

Regents of the University of California. Specifically, the Governor serves on and appoints 18 other members of the board of the Regents, which has influence over the selection of investment advisers for University of California endowment funds.

- **StarVest Management, Inc.** – A covered associate made a \$1,000 campaign contribution to an unsuccessful candidate for Mayor of New York. A second covered associate made a \$400 campaign contribution to the same candidate. The Mayor of New York has influence over selecting investment advisers and pooled investment vehicles for the New York City pension systems because the Mayor appoints at least one member of the pension systems' boards, which have influence over the selection of investments and pooled investment vehicles for the pension systems.
- **Highland Capital Partners LLC** – A covered associate made a \$1,000 campaign contribution to an unsuccessful candidate for Governor of Massachusetts. After the contribution was made, the covered associate sought and obtained the return of the contribution.² The Governor had the ability to influence the selection of investment advisers for the Massachusetts Pension Reserves Investment Management Board (PRIM). Specifically, the Governor is on the board of PRIM and appoints two other members. The PRIM board has influence over investments by PRIM and the selection of investment advisers and pooled investment vehicles for the pension plan.

SEC Commissioners Mark Uyeda and Hester Peirce dissented from these orders. As Commissioner Peirce's **dissent** explained, all four enforcement actions involved "one-time, small-dollar contributions by one or two people, and all the investment advisers had established advisory relationships with the relevant government entities before the contributions occurred." Moreover, three of the actions involved investments in closed-end funds, and in the fourth, the contributor was not covered by the Rule at the time of the contribution and only became a covered associate upon a later promotion. Commissioner Peirce noted that none of the SEC's orders find that any of the investment advisers solicited new or additional business from any government entity at the time of or after the contributions.

Key takeaways from these recent settlements include:

- ***The focus on higher education.*** In two of the settlements, contributions to the respective governor led to a violation of the Rule due to the governor's oversight of public university funds. This is an area of some complexity, and there is substantial variation among the states as to whether governors oversee university funds, or whether a governor is responsible for, or can influence the outcome of, the hiring of an investment adviser by the entity. The higher education relationship can also pose questions regarding the authority of the elected official and university boards over other aspects of the university, such as university health system endowment and pension funds.
- ***Tenuous connections are enough.*** The SEC has pursued actions even when the connections between elected officials and investment decision makers are tenuous at best. In all likelihood, the Governor of Hawaii is not remotely involved in the actual selection of investment advisers to manage University of Hawaii funds. Yet this does not matter under the Rule. The fact that the Governor appoints the Regents, who have some influence

over the selection, is enough.

- ***The need to look back when hiring or promoting.*** In the Bank of Hawaii settlement, the \$1,000 contribution was made in July 2018, and the individual did not become a “covered associate” until September 2018. Yet the “look-back” provision of the Rule brings in contributions made by individuals who, although they were not covered associates at the time of the contribution, become covered associates within six months of the contribution (except for solicitors).³ A similar fact pattern is at issue in a pending [application](#) for an exemption.
- ***It is better to be proactive.*** In two of the settlements, attempts were made to receive a return of the contribution, but it was too little, too late. The ability to avoid a violation or seek exemption through timely reactive steps is very narrow. It is much better to focus on proactive compliance measures to prevent violations from occurring in the first place.

Now is a good time for advisers to review their policies and procedures to ensure that contributions to campaigns are highlighted as a potential trip wire. Some advisers implement preclearance for all political contributions so that compliance can review and confirm that each planned contribution is acceptable. Additionally, periodic compliance checks of public campaign contribution databases for donations (or the use of a vendor to conduct such periodic checks) would be prudent in order to (1) assess the effectiveness of the adviser’s policies and (2) be aware of issues promptly if a contribution is made. Finally, it is worth considering supplemental training, compliance attestations, and/or compliance alerts for personnel in order to highlight this issue.

Our team has experience designing and working with clients to implement effective pay-to-play policies and procedures focused on meeting the expectations of regulators, as well as seeking exemptions in the event of violations and defending conduct before relevant SEC personnel.

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1. In order to take advantage of the Rule’s exception, 17 C.F.R. § 275.206(4)-5(b), the contribution in question must not have exceeded \$350, and the contributor must obtain a return of the contribution within 60 calendar days of the date of discovery of such contribution by the investment adviser.
 2. This did not cure the violation because the size of the contribution was too great to fall within the exception to the Rule.
 3. 17 C.F.R. § 275.206(4)-5(b)(2).

Authors



**Benjamin
Neaderland**
PARTNER

✉ benjamin.neaderland@wilmerhale.com

☎ +1 202 663 6340



Thomas K. Bredar
COUNSEL

✉ thomas.bredar@wilmerhale.com

☎ +1 212 295 6343