SPOTLIGHT ON

The "Pay-to-Play" Rules Under the Advisers Act

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The 2020 presidential election is arguably the most heated election in U.S. history. As over 14 million Americans have caste their ballots, the election season is already in full swing. Investment advisers may wish to refresh their knowledge on Rule 206(4)-5 under the Advisers Act, otherwise known as the "Pay-to-Play Rule" (hereinafter the Rule), and its compliance obligations, as further described in this Spotlight.

Background on the Rule

Rule 206(4) prohibits any investment adviser registered with the SEC, investment adviser required to be registered with the SEC, foreign private adviser, or exempt reporting adviser from providing investment advisory services for compensation to a government entity within two years after a contribution to an official of a government entity made by the investment adviser or any covered associate of the investment adviser. The Rule also applies to investment advisers, including exempt reporting advisers, to a covered investment pool in which a government entity invests or is solicited to invest as though the adviser were providing or seeking to provide investment advisory services directly to the government entity. The Rule imposes a strict liability where the SEC is not required to show *quid pro quo* or *scienter* (actual intent) to influence an elected official or candidate.[1] Although simple in principle, the Rule and its multiple aspects present a number of complexities.

A. Definitions[1]

Covered Associates — This term generally includes an adviser's principals, executive officers, employees who solicit government entities for the adviser (and those persons' supervisors), and any political action committee or ("PAC") controlled by the advisers or any covered associate. Only a natural person, or a PAC controlled by natural persons or the adviser, can be covered associate; a parent company cannot be a covered person.[2]

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[1] *In the Matter of Sofinnova Ventures, Inc.*, IA Rel No.4958 (July 10, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4958.pdf.

[1] O'Malley, Walsh and Watts, *Investment Adviser's Legal and Compliance Guide*, §2.04 (2020ed).

[2] See SEC, "Staff Responses to Questions About the Pay-to-play Rule" Q.II.1 (updated as of Nov.8, 2011).

Government Entities — The term includes: (1) all state and local governments; (2) all agencies and instrumentalities of state and local government and (3) all public pension plans and other collective government funds. It also includes generally officers, agents, and employees of a state or political subdivision acting in their official capacity.

Covered Officials — The term generally means an incumbent, successful candidate for an elective office of a government entity if the office is directly or indirectly responsible for (or can influence the outcome of) the hiring of an investment adviser. It also includes such persons who have the authority to appoint any other person who is directly or indirectly responsible for (or can influence the outcome of) the hiring of an investment adviser. The determination depends on the facts and circumstances of the office. The Rule does not differentiate between popularly elected member(s) of a public pension board and participant-elected member(s). The board member would be an official if he or she met the definition of a covered official at the time of a contribution.[3] Note that the term generally does not apply to the elective office at the Federal level unless a candidate currently holds an office at the state of local level that otherwise makes the person an "official."

Covered Investment Pools — This term is defined as (i) 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 (ii) 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), Section 3(c)(7) or Section 3(c)(11) of that Act.

B. Prohibitions

The Rule contains the following three general prohibitions[4]:

(1) **"Two-year time out"**—The Rule prohibits an adviser from receiving compensations for providing advisory services to a government entity for two (2) years after the adviser, or any covered associate makes a political contribution to a public official or a government entity that is in a position to influence the award of the advisory business. Under the "look back" provision, the two-year compensation ban would continue in effect after the covered associate making the contribution left the advisory firm and would apply to any new adviser that hired the covered associate within two (2) years of the date of the contribution.

[3] Id at Q.III.2 (posted on Mar. 22, 2011.

[4] See Lemke and Lins, *Regulation of Investment Advisers*, §2:190 (2020ed); O'Malley, Walsh and Watts, *Investment Adviser's Legal and Compliance Guide*, §2.04 (2020ed).

Technically, the Rule does not prohibit an adviser from providing advisory services to a government client, even after triggering the two-year time out. Instead, the adviser is prohibited from receiving compensation for providing such services during the time out.

The term "political contribution" generally means any gift, subscription, loan, advance, deposit, or anything of value made for the purpose of influencing an election for federal, state, or local office. In addition to conventional campaign donations, monetary contributions include payments for debts incurred in a federal, state, or local election, transition or inaugural expenses, or expenses incurred by an adviser for hosting a fundraiser. Note that the SEC has brought an enforcement action involving allegations of "in-kind" non-monetary contributions, which is discussed in a section below.

(2) **Ban on third party solicitors**—The Rule prohibits an adviser from paying a third-party solicitor to solicit government entities for advisory business unless such third party is registered as a broker-dealer or investment adviser and subject to pay-to-play restrictions. This prohibition does not apply to an adviser's employees or covers associates, although these persons' contributions may trigger the two-year time out. A registered broker-dealer or registered municipal advisor also must be subject to pay-to-play rules adopted by FINRA (Rule 2030) or the MSRB (Rule G-37).

(3) **Coordinating or soliciting others** — The Rule prevents an adviser from soliciting from others or coordinating contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or even seeking government business (which includes responding to RFPs). These restrictions are intended to prevent an adviser from circumventing the Rule's prohibition on direct contributions to certain elected officials such as, for example, by "bundling" a large number of small employee contributions to influence an election or making contributions (or payments) indirectly through a state of local political party.[5]

C. Exceptions

The Rule includes the following two exceptions from the two-year time out ban:

(1) **The de minimus exception** — The Rule permits individuals to make aggregate contributions of up to $350 per election to an elected official or candidate for whom the individual is entitled to vote, and up to $150 per election to an elected official or candidate for whom the individual is not entitled to vote. A covered associate can contribute separately up to the full amount in both the primary and general elections without triggering the time out.

[5] See Inv. Adv. Act. Rel. No. 3043 at 94 (July 1, 2010), available at https://www.sec.gov/rules/final/2010/ia-3043.pdf.

(2) **The returned contribution exception** — If the covered associate is not entitled to vote for an official, but the adviser discovers within four months a contribution of up to $350 to the official, the adviser or covered associate must obtain a return of the contribution within 60 days of discovery. This exception may be used only once per advisory employee. The adviser, however, may rely on this exception no more than three times per calendar year if the adviser has more than 50 employees or no more than twice per calendar year if the adviser has 50 or fewer employees.

Advisory firms could formally petition the SEC for a special exemption for other instances of improper contributions. A special exemption is rarely granted and subject to a lengthy, multi-factor test. An example will be discussed in a later section.

D. The Catch-all provision

The Rule also includes a "catch-all" provision that prohibits acts done indirectly which would violate the Rule, such as an adviser or its covered associates directing or funding contributions through third parties, such as consultants, attorneys, family members, political action committees or "PACs". Unlike the aforementioned prohibitions, a violation of the catch-all provision requires a showing of intent to circumvent the Rule.

The SEC staff has clarified that a PAC contribution would not trigger the two-year time out, where a PAC is established to fund general party political activities, or the campaigning candidates would not be considered officials. However, if the contribution to a PAC is earmarked or known to be provided for the benefit of a particular political official, the adviser is at the risk of violating the catch-all provision, as the contribution, if done directly, would trigger the two-year time out.

SEC Enforcement of the Rule

The SEC has brought a number of enforcement cases alleging violations of the Rule, in a variety of circumstances, ranging from actions against Wall Street titans to small local advisers. The Commission has also brought enforcement actions under analogous rules.

1. Lime Rock Management[6]: Classic Pay-to-Play Violation

Lime Rock was an SEC-registered investment adviser headquartered in Westport, CT. In 2004, a public pension plan in Ohio, STRS, invested approximately $40 million in Lime Rock Partners III, LP., a private equity fund advised by Lime Rock. In October 2015, a covered associate of Lime Rock made a $1,000 campaign contribution to the Governor of Ohio, who had the ability to influence the selection of investment advisers for STRS by appointing one member of the

[6] *In the Matter of Lime Rock Management LP*, IA Rel No. 4611 (January 17, 2017), available at https://www.sec.gov/litigation/admin/2017/ia-4611.pdf.

board of STRS. In 2006, STRS invested approximately $43 million in another private equity fund advised by Lime Rock. During all relevant times, Lime Rock continued to provide investment advisory services to STRS for compensation to the funds.

Lime Rock violated the Pay-to-Play Rule. As a public pension plan, STRS was a government entity. The contributor was a covered associate of Lime Rock. The recipient of the contribution was the Governor of Ohio, whose office had the authority to appoint people who could influence Lime Rock's hiring. The private equity funds were covered investment pools. Under the Rule, the contribution triggered a two-year time out on Lime Rock, providing STRS advisory services for compensation. During the two years after the contribution, Lime Rock continued to provide STRS servicesfor compensation, and therefore, violated the Rule.

2. **Adams Capital Management, Inc[7]: ERA in Violation**

Adams Capital Management, Inc. was an exempt reporting adviser located in Sewickley, PA. In 2000, the Pennsylvania State Employees' Retirement System ("SERS"), a public pension plan, invested $30 million in a venture capital fund advised by Adams Capital Management. In January 2014, a covered associate of Adams Capital Management made a $500 campaign contribution to the Treasurer of Pennsylvania, who was also a candidate for Governor of Pennsylvania. In August 2014, the same covered associate made a $500 campaign contribution to the campaign of the Governor of Pennsylvania. The offices of Treasurer and Governor of Pennsylvania both had the ability to influence the selection of investment advisers for SERS. Specifically, the Treasurer was on the board of SERS, and the Governor could appoint six members of the board of SERS. The SERS board had influence over investments by SERS and the selection of investment advisers and pooled investment vehicles for the pension fund. During a portion of the two years after the contributions, Adams Capital Management continued to provide investment advisory services to SERS for compensation to the fund.

Adams Capital Management violated the Pay-to-Play Rule. SERS was a government entity. The contributor was a covered associate of Adams Capital Management. The recipients were both officials of government entities because the offices they were associated with or sought to become associated with had the authority to influence the hiring of investment advisers. The fund was a covered investment pool. The two contributions triggered a two-year time out on Adams Capital Management. The adviser continued to provide advisory services for compensation to the fund and therefore violated the Rule. Note that in this case, the adviser was in violation even though SERS did not increase the plan's investment in the fund after the contributions, as the Rule does not require a showing of quid pro quo.

[7] *In the matter of Adams Capital Management, Inc.*, IA Rel No. 4617 (January 17, 2019), available at https://www.sec.gov/litigation/admin/2017/ia-4617.pdf.

3. Goldman Sachs[8]: In Kind Contribution

Neil Morrison was a vice president in the investment banking division of Goldman Sachs and responsible for soliciting municipal underwriting business from the Commonwealth of Massachusetts Treasurer's Office. Starting in November 2008, Morrison began actively assisting Cahill, the incumbent Treasurer of Massachusetts. Morrison solicited contributions for fundraisers and arranging for others to solicit contributions for Cahill. Between July and September 2009, Morrison's campaign work included interviewing campaign consultants, preparing and reviewing campaign documents, participating in campaign conference calls, and attending campaign meetings during Goldman work hours. When Cahill officially announced his candidacy for Governor of Massachusetts, Morrison's campaign work increased dramatically, including the number of campaign telephone calls made during work hours and the number of e-mails that he sent using his Goldman Sachs' e-mail account. Starting in September 2009, Morrison became one of Cahill's most trusted campaign advisers. As the Treasurer of Massachusetts, Cahill had the authority to appoint the persons who were responsible for hiring broker dealers for municipal securities business. Within two years of Morrison's campaign activities for Cahill, Goldman engaged in municipal securities business with issuers associated with Cahill as Treasurer of Massachusetts and as a candidate for Governor and received fees over $7 million in connection with its services.

Goldman Sachs violated Rule G-37, the pay-to-play rule under the Municipal Securities Rulemaking Board. During his Goldman work hours and use of Goldman resources such as phones, e-mails or office space, Morrison's campaign activities constituted valuable undisclosed "in-kind" campaign contributions to Cahill attributable to Goldman. Morrison was a covered associate. The recipient, Cahill, was an incumbent Treasurer and gubernatorial candidate who had and would have the authority to influence the outcome broker dealer recruitment for municipal securities business. Morrison's "in-kind" political contribution triggered a two-year ban on Goldman from underwriting municipal securities with issuers associated with Cahill. Note, a monetary political contribution was not present that in this case, but Morrison's extensive campaign engagement using Goldman's resources nevertheless constituted valuable and substantial "in-kind" contributions.

4. Apollo Management[9]: Exemption from the Two-Year Timeout

Apollo Management LP was an alternative investment management firm registered with the SEC as an investment adviser. Apollo provided discretionary investment advisory services to private funds. Two of the investors (Client A and Client B) in one or more of Apollo funds were state pension plans in Ohio. The Governor of Ohio had the authority to appoint one out of nine board members of Client B. Apollo Management had strict policies and procedures

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[8] *In the Matter of Goldman Sachs & Co.*, Exchange Act Rel No. 67934 (September 27, 2012), available at https://www.sec.gov/litigation/admin/2012/34-67934.pdf.

[9] *In the matter of Apollo Management, LP*, IA Rel No. 5102 (January 28, 2019), available at https://www.sec.gov/rules/ia/2018/803-00244-application.pdf.

governing political contributions, including a pre-clearance of all contributions. On April 22, 2016, Stephanie Drescher, Apollo's Global Head of Business Development & Investor Relationship Management, donated $1,000 to then Ohio Governor and GOP presidential candidate John Kasich. Drescher forgot to pre-clear this contribution. She did not attend any campaign event for Kasich and did not contact him or his campaign staff. The contribution was not motivated by any desire to influence the award of the investment advisory business. Drescher genuinely believed Kasich was the candidate in the GOP field most in line with her views, and she also donated to Hillary Clinton's presidential campaign. Drescher did not solicit or coordinate any other contributions for Kasich. She did not participate in soliciting Client A or Client B for their investments in Apollo funds. Apollo Management periodically conducted searches of public records for employees' contributions, pursuant to its Political Contributions Policy, which went above and beyond what was required by the Pay-to-Play Rule. Apollo Management's compliance department discovered Drescher's contribution and realized that a two-year ban had been triggered. Drescher was asked to obtain a return of the contribution. Apollo Management promptly updated its compliance to establish an escrow and notified Client A and Client B of the contribution. Apollo Management indicated to the clients that compensation attributable to the Client for two years following the contribution date would be placed in escrow and that the compensation would be refunded in a way permissible under applicable laws. Apollo Management also restricted Drescher from communicating with Client A and Client B, or any other covered government entity, for two years. Apollo Management then sought exemptive relief from the two-year time out from the SEC.

In determining whether to grant an exemption, Rule 206(4)-5(e) provides that the SEC will consider, among other factors:

(1) 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 Act;

(2) Whether the investment adviser:

(i) before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of the Rule;

(ii) prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution; and

(iii) after learning of the contribution

(a) has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain return of the contribution; and

(b) has taken such other remedial or preventive measures as may be appropriate under the circumstances;

(3) 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;

(4) The timing and amount of the contribution which resulted in the prohibition;

(5) The nature of the election (e.g., Federal, State or local); and

(6) The contributor's apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.

As explained below, each of these factors weighed in favor of granting the relief requested in Apollo Management.

The SEC determined that, given the nature of the contribution, and the lack of any evidence that Apollo Management or Drescher intended to, or actually did, interfere with the Clients' merit-based process for the selection or retention of advisory services, so the Clients' interests were best served by allowing Apollo Management and its Clients to continue their relationships uninterrupted. Additionally, Apollo Management had adopted and implemented a policy, which was <u>fully compliant with and even more rigorous</u> than the rule's requirements, well <u>before</u> the contribution date. The SEC did not impute Drescher's contribution to Apollo because Drescher acted solely as an individual when making the contribution. At no time did anyone else at Apollo Management know of the contribution. After learning of the contribution, Apollo Management caused Drescher to obtain a full refund of the contribution and then established an escrow account for all compensation attributable to the Client's investments. Apollo Management swiftly remediated the error by fully executing its compliance policy. Lastly, the SEC acknowledged that the 2016 Presidential race generated a tremendous amount of interest throughout the country, and the $1,000 contribution was made in the heat of a highly competitive Presidential campaign in which Kasich raised nearly $19 million. The SEC granted Apollo Management's request for an exemptive relief.

Compliance Tips

Given the complexities of the Pay-to-Play Rule and the frequency of SEC enforcement actions, most advisers should consider one of two approaches for dealing with political contributions.

First, some advisers may simply place a ban on any political contributions and apply it either to all employees or to management persons and employees who solicit clients only.

Second, some advisers may require management persons and employees who solicit clients or even all employees to obtain pre-clearance for all political contributions.[10]

Alternatively, Advisers should consider conducting periodic searches of public records for employees' political contributions or requiring employees to self-report every quarter. Additionally, Advisers should require training of employees especially during an election year on key definitions and identify covered employees and covered officials. Finally, Adviser may extend their compliance policies and procedures to cover spouses, although not specifically required by the Rule, as the Rule's restrictions apply to both direct and indirect contributions and payments.[11]

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[10] O'Malley, Walsh and Watts, *Investment Adviser's Legal and Compliance Guide*, §2.04 (2020ed).

[11] Id.