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PAY TO PLAY

The SEC's Pay to Play Rule Is Here to Stay: Tips for Hedge Fund Managers to Avoid Liability

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A federal appeals court recently rejected a challenge to the SEC's pay to play rule. The rule – Rule 206(4)-5 under the Investment Advisers Act of 1940 – was adopted by the SEC to prevent "pay to play" arrangements between public officials and investment advisory firms. It applies to all registered investment advisers (except for reporting and foreign private advisers), including those managing hedge funds, traditional large investment funds, venture capital funds, private funds and non-U.S.-based funds. The rule restricts those firms and their employees from making political contributions to officials with some level of control over the investment decision-making of public pension plans and other government entities. Last week, in *New York Republican State Committee v. SEC* (NYSC), the U.S. Court of Appeals for the D.C. Circuit threw out a lawsuit seeking to set aside the pay to play rule.

This latest development has put a spotlight on Rule 206(4)-5, a rule which is extremely broad and can be confusing in its application. With the 2016 elections quickly approaching, it is important that affected firms re-examine their efforts to comply with the rule – especially given the heightened level of SEC scrutiny in this area, as indicated by recent enforcement activity.

In a guest article, Justin V. Shur and Gerald P. Meyer, a partner and an associate, respectively, at Molo Lamken, discuss the facts and findings of NYSC; analyze liability under the pay to play rule; clarify penalties for non-compliance; and offer tips to prevent and mitigate violations. For additional insight from Shur, see "*FCPA Considerations for the Private Fund Industry: An Interview with Former Federal Prosecutor Justin Shur*," The Hedge Fund Law Report, Vol. 7, No. 20 (May 23, 2014); "*How Private Fund Managers Can Manage FCPA Risks When Investing in Emerging Markets*," The Hedge Fund Law Report, Vol. 6, No. 2 (Jan. 10, 2013); and "*Political Intelligence Firms and the STOCK Act: How Hedge Fund Managers Can Avoid Potential Pitfalls*," The Hedge Fund Law Report, Vol. 5, No. 14 (Apr. 5, 2012).

Facts and Findings of NYSC

The New York Republican State Committee and the Tennessee Republican Party initiated the action in NYSC, seeking to have the SEC's rule invalidated in order to enable their members to freely solicit and receive contributions from investment advisers during the upcoming elections. The plaintiffs argued that the rule would restrict their ability to raise money and that it violated both the Administrative Procedure Act and the First Amendment to the U.S. Constitution.

Specifically, the plaintiffs argued that the rule violated the First Amendment by restricting otherwise lawful campaign contributions and by subjecting money managers to political contribution limits that are more stringent than the general federal limits without sufficient justification. That lack of justification, the plaintiffs further argued, also made the rule arbitrary and capricious and a violation of the SEC's rulemaking authority. The court, however, dismissed their claims without ever addressing the merits.

The court held that such challenges to the SEC's pay to play rule were required to be brought within 60 days of its creation. Since Rule 206(4)-5 was created in 2010, the court concluded that the suit – filed in 2014 – was time-barred. Consequently, neither the plaintiffs' challenge nor any other direct challenge to the rule may proceed in court.

Despite the dismissal, the organizations or others may still petition the SEC to repeal or amend the rule (and potentially challenge an adverse ruling in court, circumventing the 60-day rule). In that case, however, any plaintiff would likely raise the same arguments under the First Amendment, using the Supreme Court's decision striking down a similar campaign finance regulation in McCutcheon v. FEC as a roadmap.

A well-armed challenge to Rule 206(4)-5 following the McCutcheon blueprint would show, generally, that existing regulations adequately address quid pro quo corruption. The SEC cannot simply regulate the appearance of corruption by enacting a "prophylaxis-upon-prophylaxis" rule that regulates otherwise lawful, constitutionally protected conduct. At least for now and for the foreseeable future, the SEC's pay to play rule will remain in force.

The Rule Is One of Strict Liability

Rule 206(4)-5 was adopted in the wake of pay to play scandals involving public pension funds in California, New York, New Mexico and other states. The rule restricts the ability of investment advisers and certain employees (i.e., "covered associates") to make political contributions to a public official or candidate who is or would be in a position to influence the selection of advisers for public pension funds and other government entities. Such contributions can trigger a two-year "time out," banning advisers from receiving compensation for advisory services to government entities.

The rule also contains restrictions on the use of third-party consultants to obtain government business, as well as the "bundling" of contributions. Specifically, the rule prohibits any direct or indirect payments to a third-party solicitor of government clients unless that solicitor is a "regulated person" independently subject to similar pay to play rules. It also prohibits bundling, barring firms from coordinating their associates' contributions or soliciting others to make political contributions to officials of government entities to which the firm seeks to provide services.

While the rule was designed to deter pay to play arrangements between investment advisory firms and public officials, it applies even without proof of a quid pro quo arrangement. With the exception of de minimis contributions by individual employees (i.e., $350 or less and, in some instances, $150 or less), any contribution within the scope of the rule will trigger the two-year ban, regardless of whether the contribution had – or was intended to have – any influence on the selection of the adviser. The absence of intent or impact is no defense to a violation.

Penalties for Non-Compliance Can Be Severe

The rule's broad application is significant, as an adviser's failure to comply with Rule 206(4)-5, even if inadvertent, could subject it to substantial penalties, loss of business and other sanctions. A triggering contribution, for example, could cause a firm to be ineligible to solicit or provide services to a government entity. And, if a firm earned any compensation for providing such services within the "time out" period, it could be subject to complete disgorgement of all fees and commissions earned with respect to those services. Thus, a single impermissible contribution – no matter how benign – could result in an adviser losing millions of dollars in fees.

Such consequences are not merely hypothetical. The SEC has stepped up its enforcement efforts in this area; just last year, the SEC brought an action against the private equity firm TL Ventures Inc. for an alleged violation of the rule. In that action, the SEC claimed that an associate of the firm made two political contributions: $2,000 to the Governor of Pennsylvania and $2,500 to a candidate for Mayor of Philadelphia. The contributions triggered the two-year ban, as the Governor appoints six of the eleven trustees of the Pennsylvania State Employees' Retirement System and the Mayor appoints three of the nine members of the Philadelphia Board of Pensions and Retirement. The SEC then alleged that TL Ventures failed to comply with the ban and thus violated the rule because, following the contributions, the firm continued to do business with both public pensions.

Tips to Prevent and Mitigate Violations

To reduce the risk of liability in this area, firms covered by the rule should establish and enforce appropriate policies and procedures reasonably designed to promptly identify triggering contributions and avoid potential violations of the two-year ban. In crafting those policies and procedures, investment advisers should:

- Know which employees are considered covered associates. According to the rule, "covered associate" includes any general partner, managing member, executive officer or other individual with a similar status or function; any employee who solicits a government entity for the investment adviser and any person who supervises such employee; and any political action committee controlled by the investment adviser or any of its covered associates;
- Develop procedures requiring new and existing employees covered by the rule to disclose prior contributions internally;
- Implement a training program for covered associates regarding compliance with the rule and the firm's related policies and procedures;
- Institute internal, pre-clearance requirements for contributions by covered associates;
- Create a process through which triggering contributions can be promptly identified, as advisers that become aware of violations may petition the SEC for an exemption from the ban and may even be able to correct a violation by obtaining a return of the contribution; and
- Update procedures for contracting with placement agents and other third-party consultants that solicit government business to ensure compliance with the rule's restrictions on the use of such consultants.

In developing and implementing such measures, firms should consider not just the SEC's rule, but all applicable rules imposing pay to play restrictions, including any similar state and local regulations.

While no policy or procedure can ever guarantee that a violation of Rule 206(4)-5 will not occur, the SEC will consider an adviser's efforts to comply with the rule an important factor when determining what, if any, action to take in response to an alleged violation. By taking reasonable steps to prevent, identify and remediate potential violations, investment advisers and other covered firms can effectively manage risks associated with the rule, assist their employees and protect their business.

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