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Alert

SEC Pay-to-Play Rule Update: Recent SEC Enforcement Activity and What It Means for the November Midterms

September 21, 2022

On Sept. 15, 2022, the U.S. Securities and Exchange Commission ("SEC") settled enforcement actions against four investment advisers for violating Rule 206(4)-5 under the Investment Advisers Act of 1940, as amended (the "Pay-to-Play Rule").[1]

The Pay-to-Play Rule. Among other things, the Pay-to-Play Rule prohibits advisers from providing investment advisory services for compensation to a government entity within two years after the adviser or one of its "covered associates" makes a contribution to an official of the government entity that is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by the government entity or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by the government entity.[2] Compliance with the Pay-to-Play Rule requires a high degree of care because the technical requirements of the rule are very specific and intent is irrelevant. In light of the upcoming elections, it is particularly important for investment advisers, including exempt reporting advisers[3], to focus on compliance with the Rule.

The Recent Enforcement Cases. In all four cases, political contributions of $1,000 or less by personnel of investment advisers mandated a two-year "time-out" from receiving fees from the pension plans invested in funds managed by the advisers because the recipient of the contribution was an "official" of the pension plan due to the recipient's role with respect to the pension plan. Notably, in all of the cases, the investment advisers had established advisory relationships with the pension plans prior to the contributions. None of the cases involved allegations of any intent to actually influence the allocation of pension investments – the very type of quid pro quo arrangement the Pay-to-Play Rule is designed to address. In fact, in three of the cases, the investments by the pension plans were made *years before* the political contributions were made and the funds were closed-end funds with no redemption rights.

These settlements demonstrate the SEC's continued aggressive enforcement of the Pay-to-Play Rule[4] and other prophylactic rules.[5] Moreover, violations of the Pay-to-Play Rule are easily detected by the

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[1] *See In re Asset Management Group of Bank of Hawaii*, Advisers Act Release No. 6127 (Sept. 15, 2022); *In re Canaan Management,* LLC, Advisers Act Release No. 6126 (Sept. 15, 2022); *In re Highland Capital Partners, LLC*, Advisers Act Release No. 6128 (Sept. 15, 2022); *In re StarVest Asset Management, Inc*., Advisers Act Release No. 6129 (Sept. 15, 2022).

[2] Rule 206(4)-5(f)(6).

[3] Three of the four cases were brought against exempt reporting advisers.

[4] The Division of Enforcement has aggressively enforced the Pay-to-Play Rule in the past, including the enforcement actions for Pay-to-Play Rule violations brought against 10 investment advisers following an investigative sweep in 2017. In those cases, the investment advisory firms have agreed to pay penalties ranging from $35,000 to $100,000 to settle charges that they violated the Pay-to-Play Rule by receiving compensation from public pension funds within two years after campaign contributions made by the firms' associates to elected officials or political candidates in a position to influence the pension funds. *See* SEC, *Press Release: 10 Firms Violated Pay-to-Play Rule by Accepting Pension Fund Fees Following Campaign Contributions* (Jan. 17, 2017), available at https://www.sec.gov/news/press-release/2017-15.

Staff due to the increasing public availability of information about many political contributions. Coupled with the strict liability nature of the statute, political contributions by personnel of investment advisers make for “low hanging fruit.”

What Should Investment Advisers Be Doing? This aggressive enforcement – and strict liability – make it critically important for investment advisers to maintain robust policies and procedures designed to prevent improper contributions from being made in the first place. While the Pay-to-Play Rule provides for an exception to the two-year “time out” for returned contributions, this exception is only available when the contribution has been discovered within four months of being made, is less than $350 and is returned within 60 calendar days from the date of discovery. Pre-clearance of all political contributions – irrespective of the recipient or the amount – helps to prevent improper contributions, as does periodic training. Electronic records searches can help identify contributions that may not have been cleared, as can reviews of publicly available information about contributions. Advisers also should keep in mind that contributions to candidates for federal office may be covered by the Pay-to-Play Rule if the candidate is currently a state officeholder at the time of the contribution. Additionally, contributions to PACs, political parties and other committees require heightened diligence with respect to the ultimate recipient of the funds.[6] In light of the upcoming midterms, now is a good time to remind your personnel of your policy with respect to political contributions, including, if applicable, the need to pre-clear all contributions.

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[5] Schulte Roth & Zabel, *Alert: SEC Custody Rule Update: Takeaways from Recent Enforcement* (Sept. 19, 2022), available at https://www.srz.com/images/content/1/8/v2/185185/091922-SRZ-Alert-SEC-Custody-Rule-Update-Takeaways-from-Recent-E.pdf.

[6] A contribution to a PAC, political party or other committee does not necessarily trigger the two-year “time-out” under the Pay-to-Play Rule unless it is a means to do indirectly what the rule prohibits if done directly (e.g., the contribution is earmarked or known to be provided for the benefit of a particular political official). *See* Political Contributions by Certain Investment Advisers, Advisers Act Release No. 3043, 75 Fed. Reg. 41017, 41030 n. 154 (July 14, 2010); SEC Staff, “Staff Responses to Questions About the Pay to Play Rule,” Question II.5, available at https://www.sec.gov/divisions/investment/pay-to-play-faq.htm. Therefore steps must be taken to ensure that the allocation of such contribution is not for the benefit of an otherwise prohibited recipient. In addition, the Pay-to-Play Rule prohibits advisers and their “Covered Associates” from *coordinating or soliciting any person* (including a non-natural person) or PAC to make any payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity. *See* Rule 206(4)-5(a)(2)(ii); SEC Staff, “Staff Responses to Questions About the Pay to Play Rule,” Question V.3, available at https://www.sec.gov/divisions/investment/pay-to-play-faq.htm.