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Key Steps for Fund Managers to Avoid Scrutiny Under the SEC's Pay-to-Play Rule

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The SEC's recent settlement involving a "pay-to-play" rule violation by a private equity firm is a timely reminder for fund managers, especially with the November elections approaching.

As a refresher, Rule 206(4)-5 of the Investment Advisers Act – known as the "pay to play" rule – prohibits investment advisers from receiving compensation for providing advisory services to state and municipal entities for two years after the adviser or one of its "covered associates" makes certain political contribution to candidates for public office. Note that the SEC Enforcement Division staff periodically reviews public campaign contribution reports (which are publicly available online) to identify donations by individuals associated with investment advisers.

In the recent SEC settlement, an employee and covered associate of an SEC-registered investment adviser contributed $4,000 to the political campaign of a state government official, whose position had the ability to influence the selection of investment advisers for the state board of investment. The state had a pre-existing investment in private equity funds managed by the firm. This contribution triggered the pay-to-play rule restrictions and as a result, the entity was fined as part of a cease and desist order.

Pitfalls to Avoid

Despite the rule's complexities, fund managers who permit political contributions can avoid common mistakes by being aware of these key points:

- Look back for new covered associates:
    - The rule applies to certain contributions made by new covered associates (*e.g.*, newly promoted to a covered associate role or newly hired employees) before they start at the firm. Specifically, the rule applies to their political contributions made within two years of becoming a covered associate if the individual solicits government clients, or six months if not. (Rule 206(4)-5(b)(2))

- Contributions to federal candidates holding state office:
  - The rule also applies to contributions to federal candidates *if* they hold a state or municipal government position at the time of the contribution (*e.g.*, a state governor running for federal office). (Rule 206(4)-5(f)(6))
- PACs or party donations earmarked for a candidate:
  - The rule prohibits doing indirectly what the rule would prohibit if done directly. Contributions to PACs or political parties can potentially trigger the rule *if* they are specifically earmarked for a particular candidate.
- VC firms are not exempt from the rule:
  - The pay-to-play rule applies to *all* investment advisers, including exempt reporting advisers, not just registered ones.

Steps to Stay Compliant

With the November elections drawing near, political donation requests will increase. Fund managers should keep these four strategies in mind:

- **Follow your policies:**
  - Adhere to the written compliance policy, including the maintenance of any preclearance logs and proper documentation.
- **Train your personnel:**
  - Ensure all covered associates understand the pay to play rule, its application to their donations, and the firm's internal policies and preclearance requirements.
- **Be vigilant**:
  - Provide personnel with questionnaires and pre-approval reminders. Investigate any prior political donations by new hires.
- **Act quickly:**
  - If a potential issue arises, take immediate steps to mitigate. Early detection can allow for corrections, such as using the exception for "returned" contributions if the amount does not exceed $350, is discovered within four months, and then returned within 60 days after discovery. (Rule 206(4)-5(b)(3))

By keeping these tips in mind, fund managers can smoothly navigate the pay-to-play rule and steer clear of potential issues.

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