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# SEC's Pay-to-Play Crackdown: Settlement Sends Strong Message on Political Contributions

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On August 19, 2024, the U.S. Securities and Exchange Commission (SEC) settled with a registered investment adviser (Adviser),[1] whereby the Adviser paid a $95,000 civil money penalty in addition to being censured for violations of Rule 206(4)-5, the SEC's "pay-to-play" rule for investment advisers (Pay-to-Play Rule).[2] As we have previously written,[3] the SEC continues to take a vigorous approach with respect to Pay-to-Play Rule-related enforcement actions. With U.S. state and federal elections approaching, the settlement is a reminder that investment advisers should remain focused on reviewing their policies, procedures, and associated controls to ensure they do not violate the Pay-to-Play Rule and similar laws, rules, and regulations. We examine the details of the settlement below.

## Pay-to-Play Rule

The Pay-to-Play Rule is a preventive measure aimed at addressing pay-to-play abuses by certain investment advisers and/or their "covered associates"[4] with regard to government officials[5] who have influence over the selection of investment advisers to manage government client assets (e.g., state or public pension plans, state and local government employees' retirement plans, and state-sponsored university endowment funds). Accordingly, the Pay-to-Play Rule prohibits SEC-registered investment advisers and exempt reporting advisers from offering investment advisory services for compensation (i.e., receipt of advisory fees and carried interest) to a government client/investor for two years following a contribution made by such adviser or their covered associates, including a person who becomes a covered associate within two years after a contribution is made (even if the individual was not yet affiliated with the adviser when the contribution was made) (Look-Back Provision), to state and local government officials or candidates who are in a position to influence the selection of certain investment advisers (subject to certain exceptions).[6] Importantly, the Pay-to-Play Rule is a strict liability rule, which means it does not mandate demonstrating a quid pro quo arrangement or actual intent to influence the government official or candidate.

## Factual Background

In 2017, a state public pension fund (SPPF) invested approximately $100 million in a closed-ended fund advised by the Adviser (Fund), which was a "covered investment pool"[7] under the Pay-to-Play Rule, and was not able to increase or withdraw its investment from the Fund. On December 30, 2019, an individual, who was not yet an employee of the Adviser, made a $7,150 campaign contribution to a government official from the state where the SPPF was located. On July 1, 2020–less than two years later–the Adviser hired the individual, who, by virtue of their employment and the role held with the Adviser, became a covered associate, and pursuant to such employment, solicited government entities for the Adviser by attending and participating in meetings with government entities that invested or were solicited to invest in funds advised by the Adviser.

The SEC determined that the office of the government official had influence over the selection of members of the SPPF board, who in turn had influence on the investments made by the SPPF. During the two years after the contribution of the covered associate (whose contribution was not eligible for the return of contribution exemption under Rule 206(4)-5(b)(3)),[8] the Adviser continued to provide investment advisory services for compensation to the Fund, and thereby to the SPPF. Such investment advisory services continued after the individual became a covered associate and before the two-year prohibition on receiving compensation for investment advisory services expired.

In the settlement, the SEC determined that the Adviser violated the Pay-to-Play Rule because (i) the SPPF was a government entity; (ii) the campaign contribution was provided by a covered associate; (iii) the recipient of the campaign contribution was an official of a government entity because the campaign contribution recipient was running for a position in a government entity that would have authority to influence the hiring of investment advisers for such government entity; (iv) the individual's campaign contribution triggered the Pay-to-Play Rule's two-year "cooling-off" period, which encompasses not only campaign contributions by persons who are covered associates at the time the contribution was made but also contributions by the person who become a covered associate, by virtue of the position they are hired for, within two years after the contribution is made, thus prohibiting the Adviser from providing investment advisory services for compensation to the government entity; and (v) the Adviser continued to provide investment advisory services for compensation to the Fund in which the SPPF invested–thereby receiving advisory fees attributable to the government entity within the two years following the campaign contribution.

Without admitting or denying the SEC's findings, the Adviser was censured, ordered to cease and desist from committing or causing further violations of the Pay-to-Play rule, and ordered to pay a civil money penalty of $95,000.

## Dissent

One Commissioner issued a dissenting statement (Dissent) regarding the settlement.[9] The Dissent argued that the rule's rigid application in this case fails to distinguish between genuine misconduct and technical violations, particularly when neither the "past contribution nor [the covered associate's] present solicitation had any nexus to the ongoing fees received by [the Adviser]." The Dissent highlighted concerns about the distinction between a contribution to a government official and the solicitation of government entities in other states. The dissenting statement emphasized that the enforcement was excessive, particularly because the contribution did not influence the Adviser's selection. Specifically, "no rational connection" exists between fees received from a past investment decision and a later contribution to a different official, especially in cases involving closed-end funds (as in this settlement), where investors cannot withdraw their money for the life of the fund, rendering the prior decisions irreversible.

## Key Takeaways

The settlement serves as a potent reminder of the existence of the Pay-to-Play Rule and underscores the necessity for investment advisers to implement robust controls regarding their campaign contributions and those of their covered associates, including, but not limited to, additional training, prohibitions on and/or preclearance procedures for campaign contributions, reporting, monitoring of publicly available information to ensure compliance, and/or periodic audits. While not mandatory, one recommended approach is to extend preclearance procedures for all political contributions made by employees and not only covered associates.

Furthermore, this settlement stresses that investment advisers should understand that the Look-Back Provision attributes past contributions of an individual to an investment adviser if such individual later becomes a covered associate of the investment adviser. Investment advisers should carefully evaluate their onboarding and vetting processes for new employees to ensure they capture any past campaign contributions made by individuals as they might later become covered associates. Similarly, advisers should evaluate their processes with respect to current

employees as they may also become covered associates. This proactive approach can help investment advisers avoid inadvertently violating the SEC's Pay-to-Play Rule, which can attribute prior contributions of an individual to the investment adviser once such individual becomes a covered associate, potentially leading to large regulatory penalties.

Notably, and as the Dissent points out, the SEC focused on the fact that the individual solicited government entities in general as a covered associate. Once the individual, as a covered associate, solicited any government entity, the individual's past contribution meant that the Adviser could no longer earn fees from the SPPF even if the individual's past contribution and current solicitation were unrelated to the Adviser's receipt of advisory fees from the SPPF. Given this lack of nexus, this settlement highlights the fact that an actual quid pro quo arrangement or actual intent to influence an investment decision is not required to violate the Pay-to-Play Rule. Stated plainly, the timing of the investment decision does not matter if the Pay-to-Play Rule is otherwise violated. The SEC's rigid application of the rule could penalize technical violations even if there is very little or no nexus between the political contributions and the ongoing advisory fees received.

Compliance procedures should be tailored to an investment adviser's specific risks, investors, and business model. In that vein, this settlement may be indicative of the SEC's increased focus on enforcement of the Pay-to-Play Rule (especially during election season), and investment advisers should be aware that even minor infractions can lead to monetary penalties and corresponding reputational risk.

Please contact any of the listed authors of this Client Alert or your usual Lowenstein Sandler contact if you have any questions with respect to this SEC settlement; Pay-to-Play Rule policies, procedures, and/or associated trainings; or any other related legal or compliance matters.

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[1] https://www.sec.gov/files/litigation/admin/2024/ia-6662.pdf.

[2] *See* 17 CFR §275.206(4)-5.

[3] *See*, e.g., https://www.lowenstein.com/news-insights/publications/client-alerts/sec-pay-to-play-rule-rears-its-head-again-in-time-for-election-season-im.

[4] Covered associates include (i) any general partner, managing member, or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any of its covered associates. *See* 17 CFR §275.206(4)-5(f)(2).

[5] Officials are defined as individuals who either hold or are seeking to hold political offices with the ability to directly or indirectly influence the hiring of investment advisers (or appoint individuals capable of doing the same) on behalf of a government entity. *See* 17 CFR §275.206(6)

[6] *See* 17 CFR §275.206(4)-5(b)(1).

[7] *See* 17 CFR §275.206(4)-5(f)(3).

[8] The Pay-to-Play Rule contains a few exemptions, but these are very narrow, and it is difficult to cure a violation once it has occurred. To meet the requirements of the return contribution exception, the contribution must not exceed $350 (a "de minimis exemption"), the adviser must have discovered the contribution within four months of the date of the contribution, and, within 60 days after learning of the contribution, the contributor must obtain a return of the contribution. *See* Rule 206(4)-5(b)(3). Further, a de minimis exception does not exist for solicitation activities. Here, the covered associate's contribution did not qualify for an exception under Rule 206(4)-5(b)(3) because the contribution exceeded the $350 limit and it was not returned within 60 days after the Adviser learned of the contribution.

[9] https://www.sec.gov/newsroom/speeches-statements/peirce-statement-obra-capital-management-081924#_ftn1.

## Contacts

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