May 1, 2019

Concerns About Pay-to-Play Violations Amplify As 2020 Giving Ramps Up

I. Concerns About Pay-to-Play Violations Amplify As 2020 Giving Ramps Up

As the 2020 Democratic presidential primary election field develops and new candidates join the race, more and more individuals are donating to their presidential candidates of choice. News reports suggest that candidates in the crowded field of presidential contenders have been more aggressive than ever in soliciting online donations from individuals.

For investment advisers, this trend makes compliance with the SEC's Pay-to-Play rule (the "Rule"), found at 17 CFR § 275.206(4)-5, particularly salient. The Rule lacks an intent requirement, meaning that the SEC does not need to prove that a political contribution was intended to influence the selection of an investment adviser. And the SEC's enforcement practices demonstrate that the Commission will bring cases whether or not there is evidence of an intent to influence. At least one of the current Democratic candidates for president is a current state officeholder who may have influence over the selection of investment advisers, and would thus qualify as an "official" within the meaning of the Rule.

Given these risks—and the draconian remedies the SEC may seek to impose if it identifies a violation of the Rule—establishing and enforcing a political contributions compliance program that includes preclearance is critical. Firms should regularly take steps to educate covered associates (broadly defined) about the Rule and take an over-inclusive approach to mandating that covered associates seek preclearance from compliance before making any political contribution. Advisers should also conduct regular testing of covered associate contributions using publicly available data. Other best practices include conducting regular training and, in the event of a contributions mistake, consulting with outside counsel to determine whether to apply for exemption or take any other appropriate action.

II. The SEC's Pay-to-Play Rule

Overview. Rule 206(4)-5 addresses so-called "pay to play" practices in the selection of investment advisers to manage the assets of U.S. state and local government entities (e.g., state pension funds, any state or local government-controlled fund, or any investment program or plan sponsored or established by a state or local government, including participant-directed plans such as 529 tuition plans and 403(b) and 457 retirement plans). The Rule applies to both registered advisers and unregistered advisers—including private equity, venture capital and hedge fund advisers. The rule effectively prohibits investment advisers who advise or seek to advise government entities, as well as certain personnel of such advisers, from making, or causing to be made, greater than *de minimis* political contributions to government officials with authority or influence over the hiring of investment advisers.[1] There is no requirement that a donation must have been given with the intent to influence an investment decision.

Consequences. Contributions made in violation of this rule will result in a two-year "time out" period following the contribution date, during which the investment adviser will not be permitted to receive compensation for providing advisory services to such government entity. The SEC may seek disgorgement of fees received after a donation that violated the Rule as well as penalties, meaning that the potential costs associated with a Rule violation are often significant (and, of course, the mere fact of an SEC investigation imposes unwanted costs).

Covered Associates. The Rule applies only to donations made by individuals who are a "covered associate" of the adviser, defined to include (i) any partner, managing member or executive officer or individual with a similar status or function, (ii) any employee who solicits a government entity for the adviser (and any person who directly or indirectly

[1] Covered associates who are natural persons may contribute up to $350 per election to an official for whom that covered associate is entitled to vote, and a maximum contribution of up to $150 for any other official.

supervises such employee) and (iii) any PAC controlled by the adviser or a covered associate. The test is a functional one, and turns on the nature of a person's activities, not his or her title.

Applicable Government Officials. Not all candidates or officeholders are implicated by the Rule. The Rule defines an "official" as any person who was, at the time of the donation, an incumbent, candidate or successful candidate for office if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an adviser or has the authority to appoint such a person. The Rule does not specify particular types of officials who could influence the hiring of an adviser but, rather, establishes a standard focused on the official's scope of authority. In practice, statewide officials such as governors and treasurers often have the authority to influence the selection of an investment adviser, or appoint someone who does. Candidates for federal office who are current state officeholders or unsuccessful candidates for state office with the ability to influence still fall within the scope of the Rule.

Contributions to PACs. Contributions by covered associates to a political party or political action committee (PAC) could also trigger liability under the Rule if it is a means to do indirectly what the Rule prohibits if done directly. The SEC has issued guidance indicating that it would likely view such a contribution as triggering the Rule if "it is a means to do indirectly what the rule prohibits if done directly (for example, the contribution is earmarked or known to be provided for the benefit of a particular political official)." The SEC has emphasized that the 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." Some PACs have a formal process of issuing confirmation letters when in receipt of contributions acknowledging the limited use of certain funds under the obligations imposed by the Rule.

Exemption Process. The Rule establishes a discretionary exemption application process, whereby advisers may apply to the Commission for exemption from the two-year timeout. The Rule sets out various factors that the Commission will consider in assessing the application, including whether the adviser had a robust compliance system in place, the timing and nature of the contribution and election at issue, and the contributor's apparent motive in making the contribution, among others.

Enforcement Trends. There have been a number of public enforcement actions brought by the SEC, beginning in June 2014 with the proceeding against TL Ventures and continuing up through January 2019. We believe the SEC will continue to be focused on enforcement of the Rule, particularly with the 2020 presidential election season coming up. The settled orders reflect a wide range of monetary penalties, typically in the hundreds of thousands of dollars, but the SEC's ability to pursue a remedy that includes the disgorgement of fees means that the potential monetary impact of an enforcement action is exceptionally high.

III. Potential 2020 Issues

Contributions to some—but by no means all—of the candidates and potential candidates running in the Democratic primary for U.S. president pose obvious potential issues under the Rule, given the authority inherent in the office they currently occupy.

- ***Governor Jay Inslee.*** Jay Inslee, the current governor of Washington, is running for U.S. president as a Democrat. As governor, Inslee likely qualifies as an "official" because his office has the authority to influence the appointment of individuals who, in turn, may select the investment adviser engaged by a government entity. For example, the governor of Washington appoints at least three members of the Washington State Investment Board.

- ***Governor Steve Bullock.*** According to news reports, the current governor of Montana, Steve Bullock, is also considering running for U.S. president. As with Gov. Inslee, Gov. Bullock likely would qualify as an "official." The governor of Montana, for example, appoints several of the members of the Montana Board of Investments.

ATTORNEY ADVERTISING

- ***Governor Larry Hogan.*** Recent news reports suggest that the current governor of Maryland, Larry Hogan, may seek the Republican nomination for U.S. president. Governor Hogan is likely an "official" under the Rule. The governor of Maryland, for example, appoints several of the members of the Board of Trustees of the Maryland State Retirement and Pension System.

- ***Former Statewide Officials.*** Former Colorado Governor John Hickenlooper served in office until January 2019, and is also running for U.S. president. Advisers should be sensitive to the risk that Gov. Hickenlooper was an "official" under the Rule until his term ended. Finally, while former Massachusetts Governor Bill Weld recently became a Republican candidate for U.S. president, he has not held office since 1997, and would be unlikely to generate risk under the Rule.

IV. Developing Robust Compliance

In order to avoid liability for covered associates' donations to candidates running for U.S. president in 2020 (or to any other qualifying officials), advisers should develop and enforce a robust compliance system that exhibits the following features:

- ***Mandatory Over-inclusive Preclearance.*** A robust compliance policy will require all individuals who may arguably be covered associates to preclear any political contribution above a *de minimis* amount through compliance in order to assess potential issues under the Rule. A well-developed policy will clarify that the preclearance obligation may extend to non-monetary contributions (such as hosting an event or providing food), and will extend to donations to political action committees.

- ***Frequent Testing to Ensure Adherence.*** Compliance professionals should conduct regular spot-checking exercises using publicly available contribution data to ensure that covered associates are appropriately adhering to the firm's preclearance policy.

- ***Regular Training for Covered Associates.*** Advisers should organize regular and well-documented training programming to educate covered associates on the requirements of the Rule.

- ***Outside Legal Advice on Potential Violations.*** In the event the adviser discovers a potential violation of the Rule—even a technical or trivial one—the adviser should seek legal advice immediately and may determine it would be prudent for the covered associate to seek a refund of the contribution(s) at issue.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2019 Ropes & Gray LLP

ATTORNEY ADVERTISING