COMPLIANCE REMINDER: PAY-TO-PLAY AND THE 2020 ELECTION CYCLE

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U.S. Asset Management and Investment Funds Alert

By: Alexander D. Selig, Sonia R. Gioseffi

INTRODUCTION

As the November 2020 elections approach, investment advisers and other financial institutions who do business with, or seek to do business with, public pension plans and other government entities should revisit their compliance policies and procedures regarding political contributions as the contributions may pose a material compliance risk.

Most firms likely already have policies and procedures in place that address the requirements of Investment Advisers Act of 1940, as amended, Rule 206(4)-5 (the SEC Rule)[1] and other similar rules with respect to political contributions made by the firm and its personnel. As the election heats up, it is important for investment advisers and other financial institutions to ensure that the appropriate individuals are aware of these policies and procedures, including any pre-clearing or self-reporting requirements. Given the U.S. Securities and Exchange Commission (SEC) staff's strict interpretation of the SEC Rule, the low threshold for triggering the SEC Rule, as well as the draconian consequences of a violation, it is all the more important that the appropriate individuals are aware of their compliance obligations.

THE SEC PAY-TO-PLAY RULE

The SEC Rule prohibits “Covered Advisers” from providing paid advisory services to a government entity for two years after the adviser or any of its Covered Associates (as defined below) has made a political contribution to an “official” of the government entity, or has solicited from others or coordinated political contributions to an “official” of the government entity. Accordingly, a payment to a political action committee (PAC) or political party that is soliciting funds to support an official could be treated as a political contribution made directly to such official.

A “Covered Associate” includes: (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 PAC controlled by the investment adviser or by any person described in prongs (i) or (ii) above.

An “official” means any individual (including any election committee of the individual) who was, at the time of the contribution, a candidate (whether or not successful) for elective office or holds the office of a government entity, if the office (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity or (ii) 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 a government entity. Where the

governor has, for example, appointment power over the board of a state pension plan, both the current governor with respect to *any* office for which the governor is campaigning as well as any candidates for governor would be deemed an "official" with respect to that state pension plan.

Under the SEC Rule, individuals may contribute up to the de minimis amount per election without triggering the two-year "time-out" on advisory fees. The de minimis amount is $150 in an election where an individual may not vote for the candidate and $350 in an election where an individual may vote for the candidate.

In addition, the SEC Rule has a potentially broad application given its catchall provision that prohibits a person from doing indirectly what the person would have been prohibited from doing directly.

OTHER PAY-TO-PLAY RULES

Investment advisers and other financial institutions should also consider any other applicable pay-to-play rules. Such rules include those promulgated by the Municipal Securities Rulemaking Board (MSRB), the Commodity Futures Trading Commission (CFTC)[2], and FINRA.[3] These rules are similar in scope to the SEC Rule.

There are also state and local pay-to-play requirements that may apply with respect to doing business with state or local public pension plans and other government entities. In addition, pursuant to contractual representations, a financial institution may have agreed that it has not and will not violate pay-to-play policies or similar requirements of the government entity. Accordingly, any financial institution that is doing business with, or seeks to do business with, a government entity should be mindful of applicable law and contractual requirements.

SEC ENFORCEMENT AND TAKEAWAY

As mentioned, the SEC staff has strictly interpreted the SEC Rule, and violations for contributions that are slightly over the de minimis amounts have resulted in enforcement actions. Pursuant to enforcement actions, firms have been required to disgorge fees and pay monetary penalties. Accordingly, in light of the approaching 2020 election and the possibility of increased scrutiny by the SEC and other regulatory agencies, as well as contractual prohibitions, investment advisers and other financial institutions should review their compliance policies and procedures with respect to political contributions. Firms with questions regarding compliance with, or enforcement of, federal, state, or local pay-to-play rules should seek outside legal counsel.

FOOTNOTES

[1] For an in depth analysis on the SEC Rule, please see the previous K&L Gates alert, "Impact of Pay-to-Play Rules in the 2016 Election Cycle."

[2] For additional details on the pay-to-play rules promulgated by the MSRB and CFTC, please see the previous K&L Gates alert, "Impact of Pay-to-Play Rules in the 2016 Election Cycle."

[3] For additional details on the FINRA pay-to-play rules affecting capital acquisition brokers (CABs), please see the previous K&L Gates alert, "FINRA Capital Acquisition Brokers Now Subject to Pay-to-Play Rules."

