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SEC Pay-to-Play Rule Rears Its Head Again in Time for Election Season

By Jimmy Kang, Jeremy Cantor, and Scott H. Moss

On April 15, 2024, the U.S. Securities and Exchange Commission (SEC) settled with a registered investment adviser (Adviser),[1] whereby the Adviser paid a $60,0000 civil money penalty of 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] While Pay-to-Play Rule-related enforcement actions are nothing new,[3] with political campaigns in full swing and candidates vying for attention, the settlement is a stark reminder that investment advisers should review 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 who have influence over the selection of investment advisers to manage government client assets. 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 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).[5] Importantly, the Pay-to-Play Rule does not mandate demonstrating a quid pro quo arrangement or actual intent to influence the government official or candidate.

Factual Background

Between 2007 and 2013, a state investment board (SIB) invested approximately $300 million in funds advised by the Adviser (Funds), which were "covered investment pools[6] under the Pay-to-Play Rule. On April 4, 2022, a covered associate of the Adviser made a $4,000 campaign contribution to a candidate running for a position on the SIB board of directors (Board). Of note, the Board had influence over investments made by the SIB and the selection of advisers and pooled investment vehicles for the SIB. During the two years after the contribution, the Adviser continued to provide investment advisory services for compensation to the Funds, and thereby to the SIB.

In the settlement, the SEC determined that the Adviser violated the Pay-to-Play Rule because (i) the SIB was a government entity; (ii) the campaign contribution was provided by a covered associate; (iii) the recipient of the campaign contribution was a government entity official 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 campaign contribution triggered the Pay-to-Play Rule's two-year "cooling-off" period 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 Funds in which the SIB invested–thereby receiving advisory fees and carried interest attributable to the government entity within the two years following the campaign contribution. As a result, the SEC found that the Adviser willfully violated the Pay-to-Play Rule.

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[1] https://www.sec.gov/files/litigation/admin/2024/ia-6590.pdf.
[2] *See* 17 CFR §275.206(4)-5.
[3] *See* e.g., https://www.sec.gov/news/press-release/2017-15 (SEC settlement on January 17, 2017 with ten firms for Pay-to-Play Rule Violations) and https://www.sec.gov/enforce/ia-6126-s (SEC settlement on September 15, 2022 with four firms for Pay-to-Play Rule Violations).
[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] *See* 17 CFR §275.206(4)-5(b)(1).
[6] *See* 17 CFR §275.206(4)-5(f)(3).

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 $60,000.

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. All of these 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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