ALERT

Past Political Contributions Matter: Recent SEC Settlement Highlights the "Look-Back" Provision and Strict Liability Nature of the SEC's Pay-to-Play Rule

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SCHULTE ROTH + ZABEL

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On Aug. 19, 2024, the US Securities and Exchange Commission (the "SEC") charged Obra Capital Management, LLC ("Obra Capital") with violations of Rule 206(4)-5 under the Investment Advisers Act of 1940, otherwise known as the "Pay-to-Play Rule" (the "Rule"), arising out of a $7,150 campaign contribution made by an individual prior to joining Obra Capital.[1] This campaign contribution was made to a government official in Michigan who had influence over hiring investment advisers for the Michigan Public Employees' Retirement Fund (the "Michigan Pension Fund"), which was an investor in a fund managed by Obra Capital (the "Obra Fund"). Notably, the Michigan Pension Fund had been an investor in the Obra Fund for several years prior to the hiring of the individual who made the contribution. And perhaps even more notably, this campaign contribution was made several months prior to the individual becoming a "Covered Associate" (as defined by the Rule[2]) of Obra Capital. By virtue of Obra Capital continuing to provide investment advisory services for compensation to the Obra Fund in which the Michigan Pension Fund was invested after hiring the individual, Obra Capital violated the Rule and agreed to pay a $95,000 fine to settle the charges.

As the momentum of the 2024 election season accelerates, and a record number of campaign contributions are made, this case serves as a very timely reminder to investment advisers (registered advisers and exempt reporting advisers alike) that the Rule includes a "look-back" provision that brings into scope contributions made by an individual prior to becoming a Covered Associate of an adviser. Additionally, this case reminds investment advisers that the SEC will bring actions entirely devoid of any intent to influence state or local pension plan investment decisions.

New Hires and Internal Job Changes

The Rule includes a "look-back" provision that attributes contributions made by an individual within two years of becoming a Covered Associate to the investment advisory firm, regardless of whether the individual was associated with the investment adviser at the time the contribution was made. This "look-back" period is reduced to six months for those Covered Associates who are not involved in the solicitation of investors.[3]

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[1] *See* Press Release, US Securities and Exchange Commission, *SEC Charges Investment Adviser for Pay-To-Play Violation Involving a Campaign Contribution* (Aug. 19, 2024), available at link.

[2] *See* 17 CFR § 275.206(4)-5(f)(2).

[3] *See* 17 CFR § 275.206(4)-5(a)(1) and 17 CFR § 275.206(4)-5(b)(2).

If an adviser learns of a problematic political contribution prior to the commencement of an individual's employment, the adviser may need to delay the hiring of the individual, change the job function, or worse, rescind the offer of employment in order to continue to earn compensation from the relevant state pension plan investor. In the event the adviser is not aware of this contribution until after employment of the individual commences, and the adviser continues to earn a fee from the relevant state pension plan investor, the adviser has violated the Rule - regardless of the adviser's knowledge of the contribution, or intent to influence the investor.

As an example, if a newly hired employee makes a contribution to the Harris/Walz campaign a month before employment commences as a Covered Associate at an investment adviser, and the adviser manages a fund with Minnesota pension plan investors, the firm and the employee would find themselves in an unfortunate position of having to either delay the start of employment, terminate the employment offer or forego receiving compensation associated with the Minnesota pension plan's investment.

Importantly, this "look-back" applies not only to new employees who become Covered Associates once hired but also to existing employees who become Covered Associates during the course of their employment.[4] If an employee was previously not a Covered Associate, but later becomes a Covered Associate, the "look-back" period would apply to all political contributions made by the individual in the prior six months, or two years (as the case may be).

Key Takeaways

Investment advisers should consider building political contributions diligence into their new hire onboarding process to avoid the surprise pitfalls that the "look-back" provision can create when hiring new employees.

In addition, as a means to reduce the pitfalls of the "look-back" provision that can result in the context of internal promotions and changes in job functions of existing employees, managers should consider requiring *all* employees to pre-clear their political contributions regardless of whether or not the employee is technically a Covered Associate at the time the contribution is made. Managers should also maintain a list of the employees the adviser considers to be Covered Associates under the Rule, as required by the corresponding recordkeeping requirements.[5]

For a more in-depth political contributions rule overview, please see Schulte's "SEC Political Contributions Rule Refresher" *Alert* published earlier this summer.[6]

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[4] *See* US Securities and Exchange Commission, Final Rule, Political Contributions by Certain Investment Advisers, Release No. IA-3043; (July 1, 2010) at 59 n.203, available at link. ("The 'look back' applies to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the rule. A person becomes a covered associate for purposes of the rule's look-back provision at the time he or she is hired or promoted to a position that meets the definition of 'covered associate' in rule 206(4)-5(f)(2).")

[5] *See* 17 CFR § 275.204-2(a)(18)(i)(A).

[6] Schulte Roth & Zabel, *Alert: SEC Political Contributions Rule Refresher* (July 9, 2024), available at link.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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