ALERTS

SEC Political Contributions Rule Refresher

July 9, 2024

The US Securities and Exchange Commission ("SEC") continues to charge investment advisers with violations of the "pay-to-play" rule even where there is no intent to influence a state or local pension investment. With the 2024 election season in full swing, it is particularly important for investment advisers to take steps to comply with this highly technical rule that has a strict liability standard.

Just as recently as April 1, 2024, the SEC settled charges against an investment adviser for violations of Rule 206(4)-5 under the Investment Advisers Act of 1940, otherwise known as the "Pay-to-Play Rule" (or "Rule"), due to a $4,000 campaign contribution from one of its covered associates to a candidate seeking a position on the Minnesota State Board of Investment. Together with prior SEC enforcement actions involving Pay-to-Play Rule violations, this case highlights the SEC's continued interest in bringing enforcement actions for violations of the Pay-to-Play Rule, even in the absence of quid quo pro arrangements[1] and for contributions that seem immaterial.[2] Accordingly, investment advisers, including both registered investment advisers and exempt reporting advisers, should take steps to review their compliance policies and procedures to ensure that they are properly designed to comply with the Pay-to-Play Rule.

Overview of the Pay-to-Play Rule

The Pay-to-Play Rule prohibits registered investment advisers and exempt reporting advisers[3] from providing investment advisory services

for compensation to a government entity (defined to mean state and local government bodies and instrumentalities) for two years if the adviser or its "covered associates" make political contributions over a *de minimis* threshold[4] to certain "officials."[5] The Rule defines "officials" as individuals that either hold or are seeking 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.[6] The definition of "covered associate" is broad and it includes an investment adviser's executive officers, employees who solicit government entities on behalf of an investment adviser, and any person who directly or indirectly supervises such employees.[7]

Look-Back and Look-Forward. The Pay-to-Play Rule includes a look-back provision that is applicable to existing employees that become covered associates and new employees that become covered associates once hired.[8] The Rule attributes to an investment adviser the contributions made by an individual within two years of becoming a covered associate, regardless of whether the individual was associated with the investment adviser at the time that the contribution was made. This look-back period is reduced to six months for covered associates who are not involved in the solicitation of clients. Similarly, advisers must "look forward" with respect to political contributions made by covered associates who either stop working for an investment adviser or who otherwise cease to qualify as covered associates. In other words, the covered associate's employer at the time of the contribution is subject to the Rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate for that two-year period or remains employed by the investment adviser.[9]

Soliciting Others to Contribute is Prohibited. The Pay-to-Play Rule also includes a prohibition against coordinating or soliciting any person or Political Action Committee ("PAC") to (i) contribute to an official of a government entity to whom the investment adviser is providing or seeking to provide investment advice and (ii) make any payments 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.[10] The Rule defines solicit in this context to mean "to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment."[11] This broad definition of solicitation limits the ability of an investment adviser and its covered associates to participate in the political campaigns of officials, as any activity that involves

coordinating or soliciting contributions for an official or their political campaign can trigger the Rule's two year time out period.

Not Limited to Cash Contributions. It is important to note that the Pay-to-Play Rule is not limited to cash contributions and that providing an official with "any gift, subscription, loan, advance, or deposit of money or anything of value" can trigger the Rule's two-year time out period.[12] Thus, providing resources other than cash contributions to an official or their political campaign may violate the Rule. The Pay-to-Play Rule does not, however, prohibit covered associates from volunteering their time in support of an official or an official's political campaign, so long as the covered associate is not involved in any fundraising activities.[13]

Anti-circumvention Provision. The Pay-to-Play Rule includes an anti-circumvention provision that prohibits investment advisers and covered associates from doing "anything indirectly which, if done directly, would result in a violation of [the Rule]."[14] For example, a covered associate providing cash to a spouse or friend, with the intent that the cash be given to the political campaign of an official, could violate the Pay-to-Play Rule despite the fact that the contribution was not given to the official directly. Accordingly, this prohibition requires that any potentially covered activity must be carefully vetted to ensure that covered associates are not indirectly acting in violation of the Pay-to-Play Rule, which could trigger the Rule's two-year time out period.

Compliance with the Pay-to-Play Rule. Compliance with the Pay-to-Play Rule requires investment advisers to adopt and maintain policies and procedures designed to prevent improper political contributions from being made. One of the most effective ways for an investment adviser to help prevent improper political contributions is to require pre-clearance of all political contributions made by covered associates, regardless of the dollar amount of the contribution or its intended recipient. Given the complexity of the Rule and its strict liability standard, investment advisers should consider requiring all employees to comply with the same pre-clearance requirements as covered associates.

Training and Testing. Compliance training and testing are also effective at preventing and detecting violations of the Pay-to-Play Rule. Periodic trainings that cover the Pay-to-Play Rule, as well as the investment adviser's policies and procedures on political contributions, are an effective way to educate employees about the complexities of the Rule and prevent violations. Refresher trainings before major elections are

especially helpful, as they are a great way to remind employees of the Pay-to-Play Rule during times when they may be considering how to support their favorite political candidates. Investment advisers should also consider conducting periodic testing of their Pay-to-Play-related policies and procedures by reviewing employee political contributions on public campaign contribution databases. Many compliance-related service providers offer this type of periodic compliance testing for a reasonable fee.

Evaluating Specific Campaign Contributions. It is also important for investment advisers to understand which political offices have influence over the hiring and firing of investment advisers, or are otherwise responsible for appointing individuals that have such influence, as this analysis is essential to determining whether contributions to a political candidate implicate the Pay-to-Play Rule. Generally, political contributions to candidates seeking federal office are not covered under the Rule. However, if, at the time of the contribution, a candidate for federal office holds a state or local political office that makes them an "official" within the meaning of the Pay-to-Play Rule, a political contribution to that candidate may implicate the Rule. Investment advisers should not forget that local and municipal political offices are covered by the Pay-to-Play Rule as well. For example, the Office of the Mayor of New York is significantly involved in the management of all five of New York City's public pension plans[15], with the board of trustees for each pension plan having at least one member that is directly appointed by the mayor.[16]

Investment advisers must also consider how a presidential candidate's running mate may impact the application of the Pay-to-Play Rule. For example, in 2024 a political contribution to the campaign of former President Donald Trump would not implicate the Pay-to-Pay Rule, as former President Trump himself is not an "official" under the Rule. However, if former President Trump were to choose a running mate that currently holds state or local office and is considered an "official" under the Rule, a political contribution to the campaign of former President Trump would implicate the Pay-to-Play Rule.[17] Similarly, a contribution to the campaign of President Joe Biden would not implicate the Pay-to-Play Rule, since neither President Biden nor Vice President Harris are "officials" within the meaning of the Pay-to-Play Rule. This would change, however, if President Biden, for example selects a new running mate who meets the definition of an "official" under the Pay-to-Play Rule.

Contributions to PACs and Parties. Investment advisers must not forget to consider the ways in which contributions to PACs or political parties can implicate the Pay-to-Play Rule. A donation to a PAC or a political party does not always implicate the Pay-to-Play Rule; however, the Rule can be implicated under certain circumstances if the contribution is known to be provided for the benefit of a particular political candidate that is considered an "official" under the Rule.[18] This is because the Pay-to-Play Rule covers direct and indirect contributions and includes a prohibition against doing anything indirectly which would be prohibited if done directly.[19] Therefore, when evaluating any request to make a political contributions to PACs or political parties, investment should evaluate whether the contributions are being directed to benefit a political candidate that is an "official" under the Pay-to-Play Rule.[20]

Fundraisers and Political Events. Investment advisers should also be mindful of the Pay-to-Play Rule's prohibition against coordinating or soliciting contributions to officials and their political campaigns, PACs, and state and local political parties. Because of this broad prohibition, investment advisers should institute pre-clearance requirements for their employees and covered associates with respect to certain activities that may trigger this part of the Pay-to-Play Rule, such as hosting fundraisers for political candidates or otherwise being engaged in a political candidate's fundraising activities.

State and Local Pay-to-Play Rules

Investment advisers should also be aware that many states and municipalities have their own pay-to-play rules, some of which may vary significantly from the SEC's Pay-to-Play Rule. In addition, many states and municipalities, and their related pension plans often require disclosure of political contributions. For example, New Jersey law requires that business entities (including investment advisers[21]) file an annual disclosure statement with the New Jersey Election Law Enforcement Commission if it receives $50,000 or more from agreements or contracts with New Jersey state and local entities.[22] The disclosure statement must be completed even if no political contributions were made during the year. New York City, for example, also has its own pay-to-play law that includes a set of disclosure obligations, including that the principal owners, principal officers and senior managers of an investment adviser register with New York City's "Doing Business Database" in order to provide, or seek to provide, advisory services to New York City pension

funds.[23] Requiring all employees to pre-clear all political contributions enables investment advisers to track political contributions that may require disclosure.

Recent SEC Enforcement Action

The recent SEC Pay-to-Play enforcement action discussed above is an important reminder of the technical and "strict liability" nature of the Rule. In that case, the Minnesota State Board of Investment had already invested in the funds advised by the investment adviser prior to the political contribution. While this could be viewed as a mitigating factor, it did not stop the SEC from filing charges because a *quid pro quo* or intent to influence an elected official or candidate is not required under the Rule. Based on the contribution of $4,000 to a candidate for elected office in Minnesota made after the Minnesota pension allocation had been made, the SEC charged the adviser, who agreed to pay a $60,000 penalty and cease and desist from any future violations of the Rule.

The recent Minnesota case is consistent with the SEC's past enforcement actions in regards to the Rule. On Sept. 15, 2022, the SEC settled enforcement actions against four investment advisers for violating the Pay-to-Play Rule.[24] In all of these cases, the political contributions were less than $1,000 (one contribution was for only $400[25]) and there were no allegations of any intent to influence the allocation of pension investments. Furthermore, each investment adviser already had an established investment advisory relationship with the relevant pension plan prior to the political contributions.

These enforcement actions serve as an important reminder of the SEC's willingness to bring enforcement actions under the Pay-to-Play Rule even where there is no quid pro quo or intent to influence. They also serve to remind advisers about the importance of developing and implementing policies and procedures that include pre-clearance, training and testing in order to ensure compliance with the Rule.

Authored by Allison Scher Bernbach, Michael S. Didiuk, Joseph Daly and Ahsan A. Sayed.

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

---

[1] *See* Schulte *Alert*: SEC Pay-to-Play Rule Update: Recent SEC Enforcement Activity and What it Means for the November Midterms (Sept. 21, 2022) (explaining that none of the Pay-to-Play enforcement actions brought by the SEC in 2024 alleged any intent to actually influence the allocation of pension investments), *available at link*.

[2] *See* Press Release, US Securities and Exchange Commission, 10 Firms Violated Pay-to-Play Rule By Accepting Pension Fund Fees Following Campaign Contributions (Jan. 17, 2017), *available at link*.

[3] *See* Rule 206(4)-5(a)(1) – (a)(2) (the SEC's Pay-to-Play Rule applies to investment advisers registered with the SEC, investment advisers required to register with the SEC, exempt reporting advisers and exempt advisers relying on Section 203(b)(3) of the Advisers Act).

[4] Certain contributions below a de minimis threshold are excepted from the Rule. Covered associates may contribute up to $350 per election to each official that the covered associate is entitled to vote for at the time that the contribution is made and up to $150 per election to each official whom the covered associate is not entitled to vote for at the time of the contribution.

[5] The two-year timeout period applies to investment advisers that provide advisory services to a relevant government entity both directly and/or indirectly through "covered investment pools," which generally include hedge funds, private equity funds, venture capital funds and collective investment trusts, as well as registered investment companies (*e.g.*, mutual funds) that are investment options of a participant-directed plan or program of a government entity (*e.g.*, "529 plans").

[6] *See* Rule 206(4)-5(f)(6) (defining official as "any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective 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.").

[7] *See* Rule 206(4)-5(f)(2) (defining covered associate as "(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 person described in paragraphs (f)(2)(i) and (f)(2)(ii) of this section."). While a "covered associates" family members are not covered by the Rule, due to the anti-circumvention rule (Section 208(d) of the Advisers Act), firms will include spouses/spousal equivalents and family members sharing the home in their pre-clearance policies as a best practice.

[8] *See* Securities and Exchange Commission, Final Rule, Political Contributions by Certain Investment Advisers, Release No. IA-3043; (July 1, 2010) (hereinafter*, Final Rule*) at 59, *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).")

[9] *See id*.

[10] See Rule 206(4)-5(a)(2)(ii) (". . . [it shall be unlawful] . . .To coordinate, or to solicit any person or political action committee to make, any: (A) Contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or (B) 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.")

[11] *See* Rule 206(4)-5(f)(10)(ii)

[12] *See* Rule 206(4)-5(f)(7) (defining payment as "any gift, subscription, loan, advance, or deposit of money or anything of value.").

[13] *Final Rule* at 23 ("[The Pay-to-Play Rule] does not in any way impinge on a wide range of expressive conduct in connection with elections. For example, the rule imposes no restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches, and other conduct.")

[14] *See* Rule 206(4)-5(a)(2)(ii) (". . . [it shall be unlawful] . . .To coordinate, or to solicit any person or political action committee to make, any: (A)

Contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services; or (B) 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.")

[15] *See* New York City Office of Payroll Administration: NYC Pension Plans, *available at link* (New York City's public pension plans include (1) the New York City Employees' Retirement System, (2) the New York City Board of Education Retirement System, (3) the New York City Fire Pension Fund, (4) the New York City Police Pension Fund, and (5) the Teachers' Retirement System of the City of New York.)

[16] *See* Employees Retirement System: Board of Trustees, *available at link*; Board of Education Retirement System: Board of Trustees, *available at link*; New York City Administrative Code § 13-316; New York City Fire Department: Fire Commissioner, *available at link*; New York City Administrative Code § 13-202; New York City Police Department: Police Commissioner, *available at link*; Teachers' Retirement System of the City of New York: Our Retirement Board, *available at link*. (The board of trustees of each of New York City's pension plans either (A) have a trustee appointed by the New York City mayor to serve as the mayor's representative or (B) have a trustee that is a New York City official directly appointed by the mayor (i.e., the mayor appoints the police commissioner of New York City, who serves on the board of trustees for the New York City Police Pension Fund).)

[17] For example, former Vice President Mike Pence served as the Governor of Indiana during the 2016 presidential election. Because the Board of Trustees for the Indiana Public Retirement System is composed of trustees that are appointed by the Governor of Indiana, a donation to former President Donald Trump's campaign in 2016 would have implicated the Pay-to-Play Rule. *See* IN Code § 5-10.5-3-2(a) (2021).

[18] *See* Release n. 154 (Noting that "[c]ontributions to political parties" would not "trigger the rule's two-year time out unless they are a means to do indirectly what the rule prohibits if done directly (for example, the contributions are earmarked or known to be provided for the benefit of a particular political official)."); SEC Staff, "Staff Responses to Questions About the Pay to Play Rule," Question II.5, *available at link* (noting that "a chain of contributions through PACs made for the purpose of avoiding the pay to play rule, would violate the rule's, and section 208(d) of the Advisers

Act's, general prohibitions against doing anything indirectly which would be prohibited if done directly.").

[19] *See* 206(4)-5(d) (" . . . it shall be unlawful for any investment adviser registered (or required to be registered) with the Commission . . . or that is an exempt reporting adviser, or any of the investment adviser's covered associates to do anything indirectly which, if done directly, would result in a violation of this section."). See also Section 208(d) of the Advisers Act.

[20] PACs and political parties sometimes provide written representations upon request, stating for example that political contributions will not be earmarked for specific candidates or will only be spent on overhead costs associated with the PAC's or political party's operations.

[21] *See* NJ Rev Stat § 19:44A-20.27(d) (2023) (Defining "business entity" as a "for-profit entity that is a natural or legal person, business corporation, professional services corporation, limited liability company, partnership, limited partnership, business trust, association or any other legal commercial entity organized under the laws of this State or of any other state or foreign jurisdiction.").

[22] *See* NJ Rev Stat § 19:44A-20.27(a) (2023).

[23] *See* Local Law No. 34 (2007) of the City of New York § 37; *see also* New York City Campaign Finance Board: Doing Business FAQs, *available at link*. (Noting that "proposing on or holding a contract for the investment of [New York City] pension funds" is a type of transaction that falls within New York City's "doing business regulations.").

[24] *See In re Asset Management Group of Bank of Hawaii,* Advisers Act Release No. 6127 (Sept. 15, 2022*); In re Canaan Management, LLC*, Advisers Act Release No. 6126 (Sept. 15, 2022); In re Highland Capital Partners, LLC, Advisers Act Release No. 6128 (Sept. 15, 2022); *In re StarVest Asset Management, Inc.*, Advisers Act Release No. 6129 (Sept. 15, 2022).

[25] *In re StarVest Asset Management*, Inc., Advisers Act Release No. 6129 (Sept. 15, 2022).

Related People

Allison Scher Bernbach

Partner

New York

Michael Didiuk

Partner

New York

Joseph Daly

Associate

New York

Ahsan Sayed

Associate – admitted in New York and Texas only

Washington, DC

Practices

INVESTMENT MANAGEMENT

Attachments

Download Alert