Political Law Alert

Akin Gump
STRAUSS HAUER & FELD LLP

SEC Fines Four Investment Advisers for Violating Federal Pay-To-Play Restrictions

September 27, 2022

The latest round of penalties assessed for violations of the U.S. Securities and Exchange Commission (SEC) pay-to-play rule highlight the strict liability nature of Rule 206(4)-5. This month, the SEC announced five-figure civil penalties against four firms whose personnel made prohibited contributions of $1,000 or less, including a contribution of just $400.[1]

The severity of the fines prompted one SEC commissioner to issue a public statement[2] urging the commission to revisit its pay-to-play rule. Commissioner Hester M. Peirce questioned the public benefit achieved by these enforcement actions, and suggested that the SEC should consider ways of better tailoring the rule to prevent quid pro quo arrangements without hindering political engagement. In her words:

"the Pay-to-Play Rule is an exceedingly blunt instrument. It does not require any evidence of an actual quid pro quo … [it] simply does not concern itself with whether the official would or could have prevented the adviser from playing without first paying[.]"

The Pay-to-Play Rule

Rule 206(4)-5 under the Investment Advisers Act prohibits investment advisers from providing investment advisory services "for compensation" to a state or local government entity if the adviser, or a covered associate of the adviser, has made a political contribution to certain state or local government officials in the prior two years. Covered associates include general partners, managing members, executive officers of an investment adviser, employees who solicit a government entity for the investment adviser and any persons who supervise such employees. The rule prohibits contributions to candidates for, and incumbents holding, any elective office which has the authority to directly or indirectly influence the hiring of an investment adviser or to appoint a person with such authority.

Contact Information

If you have any questions concerning this alert, please contact:

Political Law:

Melissa L. Laurenza
Partner
mlaurenza@akingump.com
Washington D.C.
+1 202.887.4251

Kenneth A. Gross
Senior Political Law Counsel and Consultant
kgross@akingump.com
Washington D.C.
+1.202.887.4133

Kevin Paulsen
Associate
kpaulsen@akingump.com
Washington D.C.
+1 202.887.4155

Global Investment Adviser Regulatory:

Jason M. Daniel
Partner
jdaniel@akingump.com
Dallas
+1 214.969.4209

Brian T. Daly
Partner
bdaly@akingump.com
New York
+1 212.872.8170

William K. Wetmore
Partner
wwetmore@akingump.com
San Francisco
+1 415.765.9572

Takeaways for Advisers, Sponsors and Managers

One: This is a Strict Liability Regime

The significant penalties imposed in these matters illustrate a majority of SEC commissioners' commitment to broadly enforcing the pay-to-play rule:

- In one matter, a $1,000 contribution to the campaign of a California gubernatorial candidate in 2018 while the covered associate's employer was managing funds for the Regents of the University of California resulted in a fine of $95,000, even though the employee had attempted to obtain a refund of the contribution.
- In a similar matter, the SEC imposed a $70,000 penalty for a contribution that barely exceeded Rule 206(4)-5's de minimis exception, which permits contributions of up to $350 per election to an elected official or candidate for whom an individual is entitled to vote and up to $150 per election to an official or candidate for whom they are not. According to the SEC's order, two covered associates made contributions of $1,000 and $400 to an unsuccessful candidate for New York City mayor in the 2021 election. The SEC found both contributions to be in violation of the rule because two New York City retirement systems (whose board memberships are influenced by the mayor) paid the investment adviser for advisory services during the period following the contributions.
- In the remaining two matters released by the SEC, a $1,000 contribution by an employee who was not a covered associate at the time of the contribution but who, just three months later, was promoted to a covered associate position resulted in a $45,000 fine against the adviser and another $1,000 contribution made to an unsuccessful candidate which was refunded resulted in a $95,000 fine against the adviser.

These four matters highlight the strict liability application of the rule.

Two: Actual Improper Influence or Corruption is Not a Factor

As Commissioner Peirce noted, each of the four investment advisers sanctioned "had a longstanding, existing advisory relationship with the government client when the contributions were made" and "the political candidates who received the contributions had attenuated influence over the government entities' adviser selection." These facts offer little evidence of a quid pro quo, which is not required under the current rule.

Three: Exempt Advisers Should Also Be Concerned

It is also notable that three of the four actions were against investment advisers that were not registered with the SEC. It is therefore likely that these actions did not arise from inspections and instead arose from a comparison of public information regarding persons filing for exemptions as a venture capital fund adviser versus public databases of contributions. These enforcement actions appear to demonstrate a return for the SEC to rigorous enforcement of strict liability rules as was common during its "broken windows" enforcement approach.

Four: Lasting Reputational Impacts for Violations

The investment advisers must now pay penalties—ranging from $45,000 to $95,000. More importantly, these advisers also agreed to be subject to ongoing cease and desist orders and will have to call these violations out in their regulatory filings (e.g.,

Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Adviser (Form ADVs)) and likely in their due diligence questionnaires and similar marketing documents.

The SEC's strict enforcement in these matters should put the regulated community on notice—a single, seemingly minor pay-to-play violation will not go unnoticed and may result in significant civil liability. Investment advisers and others contracting for government services should review political contributions compliance procedures to mitigate the risk of violations of SEC Rule 206(4)-5, MSRB Rule G-37, or any of the numerous state and local pay-to-play laws.

The Akin Gump Political Law team will continue to monitor developments to keep clients informed on this and other key issues, including any potential amendments to the SEC's pay-to-play rule. We are available to develop and implement compliance programs, conduct due diligence and pre-clear contributions for businesses covered by federal, state and local pay-to-play rules.

[1] Advisers Act Releases 6126, 6127, 6128, 6129 (Sept. 15, 2022), *available at*
https://www.sec.gov/litigation/admin/2022/ia-6126.pdf,
https://www.sec.gov/litigation/admin/2022/ia-6127.pdf,
https://www.sec.gov/litigation/admin/2022/ia-6128.pdf and
https://www.sec.gov/litigation/admin/2022/ia-6129.pdf, respectively.

[2] Statement of Commissioner Peirce (Sept. 15, 2022), *available at*
https://www.sec.gov/news/statement/peirce-statement-pay-play-rule-settlements-091522.

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