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SEC Announces First Pay-to-Play Enforcement Action

June 30, 2014

On June 20, 2014, the Securities and Exchange Commission (SEC) announced its first enforcement action under the Pay-to-Play Rule, Rule 206(4)-5 of the Investment Advisers Act of 1940 (Advisers Act).[1] The SEC order charges that TL Ventures Inc. (TL Ventures), an investment adviser to venture capital funds, violated the Pay-to-Play Rule by continuing to provide compensatory advisory services to city and state pension funds after a "covered associate"[2] (the SEC did not identify such person or his or her position within the firm) had made campaign contributions to the Mayor of Philadelphia and the Governor of Pennsylvania.

The Pay-to-Play Rule

The Pay-to-Play Rule was adopted by the SEC in 2010 and is a prophylactic rule designed to curtail "pay-to-play" practices by investment advisers seeking to manage state and local government assets.[3] Among other things, the rule prohibits an investment adviser from providing investment advisory services for compensation to a state or local government entity if the investment adviser or any of its covered associates made a political contribution to an elected official or a candidate for such elective office within the preceding two years, and the elective office is in a position to direct or otherwise influence the award of the government entity's investment advisory business. For purposes of the rule, an investment adviser to a pooled investment vehicle in which a government entity invests is treated as though the investment adviser were providing investment advisory services directly to the government entity.

The two-year "time out" applies to registered investment advisers, exempt reporting advisers, foreign private advisers and other investment advisers required to register under the Advisers Act. Notably, an investment adviser is subject to the two-year "time out" even if it is unaware of a political contribution made by a covered associate. Moreover, the two-year "time out" applies even if the covered associate who made the political contribution has since left the investment adviser or had made the contribution within six months prior to becoming a "covered associate."[4] The Pay-to-Play Rule does not require a showing of actual intent to influence an official. The rule contains exceptions for certain de minimis contributions, permitting an individual to contribute up to $350 per election to a candidate for whom he or she can vote and up to $150 per election to a candidate for whom he or she cannot vote.

The SEC Order

According to the SEC order, TL Ventures advises venture capital funds in which the Pennsylvania State Employees' Retirement System (SERS) and the City of Philadelphia Board of Pensions and Retirement (Philadelphia Retirement Board) have invested since 1999 and 2000, respectively. In 2011, a covered associate of TL Ventures made a $2,500 contribution to the campaign of a candidate for Mayor of Philadelphia and a $2,000 contribution to the Governor of Pennsylvania. Given that the Mayor of Philadelphia and the Governor of Pennsylvania have the authority to appoint board members of the Philadelphia Retirement Board and SERS, respectively, the SEC found that they are officials with the ability to influence the selection of investment advisers by those pension funds. TL Ventures thus violated Rule 206(4)-5 and Section 206(4) of the Advisers Act by continuing to render compensatory investment advisory services to the venture capital funds after the 2011 contributions.

Without admitting or denying any wrongdoing, TL Ventures agreed to be censured and to pay disgorgement of $256,697, prejudgment interest of $3,197 and a civil penalty of $35,000.

Implications

The order against TL Ventures highlights the importance of establishing stringent guidelines on political contributions by an investment adviser and its employees and solicitors. Investment advisers should conduct due diligence on any past contributions prior to onboarding a government entity client and prior to hiring or promoting a new employee or engaging a solicitor. As noted above, an investment adviser can violate Rule 206(4)-5 regardless of whether it has knowledge of a contribution made by a covered associate. Indeed, it is not apparent from the facts presented in the SEC order that TL Ventures was aware of the contributions made by its covered associate in 2011. The order also demonstrates that even a small political contribution can result in a Pay-to-Play Rule violation and trigger SEC enforcement action, so long as its value is above the de minimis thresholds.

If you have any questions regarding the SEC enforcement action or the Pay-to-Play Rule, please feel free to contact your regular Proskauer lawyer or any of the lawyers listed in this alert.

[1] The SEC's press release announcing the enforcement action can be found here. A copy of the SEC order can be found here. The order also charged TL Ventures for failing to register as an investment adviser, in violation of Section 203(a) and Section 208(d) of the Advisers Act.

[2] "Covered associates" is defined under Rule 206(4)-5 to include, among other persons, (i) any general partner, managing member or executive officer, or other individual with a similar status or function; and (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee.

[3] The SEC's adopting release can be found here. For an overview of Rule 206(4)-5, please see our prior alert.

[4] Rule 206(4)-5(b)(2) provides an exception for contributions made by a covered associate more than six months prior to becoming a covered associate. However, the exception does not apply if such covered associate solicits clients on behalf of the investment adviser after becoming a covered associate.

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