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Private Fund Advisers Must Pay Close Attention to Nuances under Pay-to-Play Restrictions in Light of Upcoming Elections Nationwide

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As the elections approach nationwide, advisers to private investment funds with current or prospective state or local government entity investors should be mindful of political activities by their personnel which could raise concerns under existing pay-to-play regulations. Given the magnitude of governmental plan investors in private funds, in addition to a potential loss of revenue, even the disclosure of a pay-to-play inquiry could result in significant reputational implications with current and prospective private fund investors. Accordingly, every private fund adviser should ensure that it complies with the relevant regulations and also aspire to avoid even the slightest suggestion of impropriety with respect to political contribution activities which could be imputed to the firm.

Rule 206(4)-5 under the Investment Advisers Act of 1940 prohibits an investment adviser from receiving compensation from a covered government entity for a period of two years following a disqualifying contribution made by the adviser or a certain category of employees (including those classified as independent contractors) known as "Covered Associates" (discussed below). While seemingly straightforward, Rule 206(4)-5 contains a number of nuances to which private fund advisers should pay close attention. In particular, for the reasons described further below, investment advisers with current or prospective government entity clients in Indiana should exercise caution and consider consulting with experienced counsel before making any contributions directly to, or directly for the benefit of, the vice presidential candidacy of Governor Michael Pence and/or the Trump/Pence Republican ticket.

Indirect Contributions Also Implicate Pay-to-Play Restrictions

Although the SEC has stated that contributions by a Covered Associate's family members are not explicitly prohibited by Rule 206(4)-5, the SEC has reminded advisers that both Rule 206(4)-5 and Section 208(d) of the Advisers Act prohibit an adviser from doing anything indirectly which would be prohibited if done directly. Accordingly, advisers should remind personnel that any political contributions from financial accounts held jointly by an employee and his or her spouse, partner or other familial relationship could be viewed by the SEC staff as contributions, in whole or in part, by the employee.

Contributions made by a private fund adviser or its Covered Associates to a political party, political action committee (PAC) or other committee or organization also could trigger a two-year ban on the receipt of compensation under Rule 206(4)-5 if it is a means to do indirectly what the Rule prohibits if done directly. In this analysis, the SEC has stated that it likely would view such a contribution as implicating Rule 206(4)-5 where (i) the adviser or any of its Covered Associates has the ability to direct or cause the direction of the governance or the operations of the PAC receiving the contribution or (ii) the contribution is earmarked or known to be provided for the benefit of a particular political official. Rule 206(4)-5 also prohibits private fund advisers and their Covered Associates from coordinating or soliciting any person or PAC to make any payment to a political party of a state or locality where the investment adviser is providing or is seeking to provide investment advisory services to a government entity.

A Government Official's "Indirect" Influence Can Trigger Disqualification

Rule 206(4)-5 defines an official of a government entity to include any official who (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by the government entity or (ii) has the 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.

The inclusion of the "indirect" responsibility or influence component presents an issue to which private fund advisers must be especially attuned. On the first point, Rule 206(4)-5 encompasses elected officials who have the legal authority to hire or retain the adviser. Generally, executive or legislative officers who hold a position with influence over the hiring of an investment adviser are considered government officials under the Rule. In consideration of this element, private fund advisers should determine whether the official in question serves as an *ex officio* member of a governing body of any state entity or government-related pension plan.

On the second point, private fund advisers should determine whether the office held or sought by the official has the statutory authority to appoint a member of a governing body of any state entity or government-related pension plan. The SEC has supported its position in this respect by reasoning that a person appointed by an elected official is likely to be subject to that official's influences and recommendations. It is also important to remember that the SEC has taken the position that it is the scope of authority of the particular office of an official, and not the influence actually exercised by the individual, that would determine whether the individual has influence over the awarding of an investment advisory contract for purposes of Rule 206(4)-5.

While a determination of indirect responsibility or influence is a highly facts and circumstances-driven analysis, advisers generally should consider viewing a state government hierarchy as a pyramid, and the higher the official in the pyramid, the more likely that official will be viewed by the SEC as holding at least indirect influence over the administration of the state government entity plan in question.

As a reminder, an official is defined as a person (including any election committee for such person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a state or political subdivision of a state. Accordingly, contributions to federal candidates and officeholders are not covered under the Rule unless they are simultaneously state officeholders or candidates, respectively. This particular scenario is present with the current Republican vice presidential nominee. Indiana Code at Section 5-10.5-3-2 provides that the board of trustees of the Indiana Public Retirement System is composed of nine trustees nominated by various Indiana state government officials and appointed by the governor. Therefore, it can be presumed that the current Republican vice presidential nominee is a government official for purposes of Rule 206(4)-5.

Which Individuals Are "Covered Associates"

Rule 206(4)-5 defines a "Covered Associate" of an investment adviser 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 PAC controlled by the investment adviser or by any of its Covered Associates. For purposes of this definition, the SEC has stated that whether a person is an executive officer depends on his or her function, not title. For example, an officer who is the chief executive of an advisory firm but whose title does not include "president" is nonetheless an executive officer for purposes of the Rule. This clarification reflects the SEC's goal of tailoring the Rule to apply to those officers of an investment adviser whose position in the organization is more likely to incentivize them to obtain or retain clients for the investment adviser.

Frequently, and especially in larger organizations, employees' roles in a firm evolve and change through promotions and reassignments. As mentioned above, the SEC staff also interprets the term "employee" to include "independent contractors" acting on behalf of an investment adviser. Accordingly, the list setting forth an adviser's "Covered Associates" for purposes of the Rule should be reviewed on a periodic basis in light of the frequency of personnel changes in the adviser's organization.

Donations of Covered Associates' Time

The SEC staff has stated that they would not consider a donation of time by a Covered Associate to be a contribution for purposes of Rule 206(4)-5, provided that (i) the adviser has not solicited the Covered Associate's efforts and (ii) the adviser's resources, such as office space and telephones, are not utilized. A Covered Associate's donation of his or her time generally would not be viewed as a contribution under the Rule if such volunteering were to occur during non-work hours, if the Covered Associate were using vacation time, or if the adviser is not otherwise paying the Covered Associate's salary (e.g., an unpaid leave of absence).

Recordkeeping Requirements

In connection with the adoption of Rule 206(4)-5, the recordkeeping requirements under Advisers Act Rule 204-2 were amended to add specific requirements applicable to registered investment advisers related to political contributions. Specifically, Rule 204-2 requires registered investment advisers to keep records of:

- The names, titles and business and residence addresses of all Covered Associates of the investment adviser;
- All government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any private fund to which the investment adviser provides or has provided investment advisory services, as applicable, in the past five years;
- All direct or indirect contributions made by the investment adviser or any of its Covered Associates to an official of a government entity, or direct or indirect payments to a political party of a state or political subdivision thereof, or to a PAC; and
- The name and business address of each registered (i) investment adviser, (ii) broker-dealer, or (iii) municipal advisor subject to rules of the Municipal Securities Rulemaking Board (MSRB) to whom the investment adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on the investment adviser's behalf.

Relief May Be Available under Certain Circumstances

The ban on compensation under Rule 206(4)-5 will not be implicated for political contributions below certain threshold amounts. Specifically, Covered Associates are permitted to contribute up to $350 to a candidate for which they are entitled to vote, and $150 to a candidate for which a Covered Associate was not entitled to vote (i.e., any other candidate). This exemption is available only to Covered Associates that are natural persons. The dollar amount thresholds are applied on a per election basis and, under both exceptions, primary and general elections would be considered separate elections. Under the Rule, each Covered Associate, taken separately, would be subject to the dollar limit exceptions. In other words, the limit applies per Covered Associate and is not an aggregate limit for all of an adviser's Covered Associates.

Where an otherwise disqualifying contribution in excess of $150 to an officeholder or candidate for whom a Covered Associate was not entitled to vote would result in a prohibition on a receipt of fees, Rule 206(4)-5 allows for a "self-help" remedy where such contribution is: (i) discovered within four months of the date of such contribution; (ii) $350 or less; and (iii) returned within 60 calendar days of the date of discovery. An investment adviser availing itself of this option is limited, in any calendar year, to (i) two instances if the adviser has 50 or fewer employees, and (ii) three instances if the adviser has more than 50 employees. In any event, an investment adviser may not rely on the exception more than once with respect to contributions by the same Covered Associate of the investment adviser regardless of the time period.

Private fund advisers should be aware of the potential for Covered Associates to misinterpret the complexities of Rule 206(4)-5 and consider whether all political contributions should be pre-cleared by experienced compliance personnel. Compliance personnel reviewing political contribution requests also should be mindful of the potential for multiple Covered Associates' contributions to appear coordinated for the benefit of a particular state government candidate or officeholder. The SEC has expressly acknowledged the potential for the "bundling" of a large number of small employee "de minimis" contributions to constitute an indirect violation of the Rule.

Finally, where an adviser has a Covered Associate who made a political contribution in excess of the *de minimis* thresholds and is unable to avail itself of the self-help option, it may apply to the SEC for an order exempting it from the two-year compensation ban. In the adopting release for Rule 206(4)-5, the SEC articulated a number of nonexclusive factors that it would consider in determining whether to grant relief from disqualification. From 2010 through the present, the SEC has considered at least 13 requests for an exemption from the two-year ban on the receipt of compensation from a government entity following a disqualifying contribution. For a variety of reasons, all 13 requests have been granted by the SEC.

Additional Restrictions May Exist at the State, Municipality or Plan Level

Prior pay-to-play incidents and political realities have resulted in a myriad of pay-to-play prohibitions at the state, municipality and plan levels. These prohibitions may be either specific or general in nature and may apply to employees, independent contractors or other individuals or entities, including placement agents, solicitors and other marketers acting on behalf of an investment adviser beyond those defined as Covered Associates under Rule 206(4)-5. While a comprehensive examination of these prohibitions is beyond the scope of this alert, this is a dynamic and ever-changing area of compliance, and investment advisers should be familiar with any relevant provisions applicable to current and prospective state government plan clients.

Impending Effectiveness and Adoption of MSRB and FINRA Pay-to-Play Rules Will Require that Investment Advisers Utilize Only Registered Placement Agents to Solicit Government Entity Clients.

Rule 206(4)-5 makes it unlawful for any investment adviser subject to the Rule or any of the adviser's Covered Associates to provide or agree to provide, directly or indirectly, payment to any third party to solicit government clients for investment advisory services on its behalf, unless such third parties are registered (i) investment advisers, (ii) broker-dealers, or (iii) municipal advisors subject to the rules of the MSRB. However, the SEC also has clarified that it would not recommend enforcement action against an investment adviser or its Covered Associates under Rule 206(4)-5 for payments to unregistered third-party solicitors until FINRA and the MSRB have adopted equivalent pay-to-play rules for broker-dealers and municipal advisors, respectively.

On February 17, 2016, the MSRB announced that previously proposed amendments to MSRB Rule G-37, regarding political contributions and related prohibitions on the municipal securities business, were deemed approved by the SEC on February 13, 2016 under provisions of the Securities Exchange Act of 1934. The amendments were set to take effect yesterday, August 17, 2016, extending the MSRB's municipal securities dealer pay-to-play rule to municipal advisors, including those acting as third-party solicitors.

On March 29, 2016, the SEC issued an Order instituting proceedings to determine whether to approve or disapprove proposed rule changes to adopt FINRA Rules 2030 and 4580, which would establish pay-to-play and related rules. These proposals had been filed previously with the SEC by FINRA on December 16, 2015. Comments on the SEC's March 29, 2016 Order were due on April 25, 2016, with any rebuttal comments due on May 19, 2016.

Accordingly, given that the MSRB pay-to-play rule applicable to municipal advisors became effective on August 17, 2016, and FINRA's pay-to-play rules applicable to broker-dealers are well along the way towards adoption, investment advisers should expect the ban on compensation to third-party unregistered solicitors to government entities to become effective in the near future. Investment advisers should ensure that they obtain appropriate representations and other assurances from registered third-party solicitors, including that they are not be subject to any disqualification under amended MSRB Rule G-37 or the proposed amendments to FINRA Rules 2030 and 4580.

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