

Client Alert

November 21, 2013

SEC Grants Rare Exemptive Relief from Pay-to-Play “Time-Out” Provision

By Kelley A. Howes

In what may be a case of first impression, the SEC recently granted exemptive relief from Rule 206(4)-5(a)(1) of the Investment Advisers Act of 1940, the “time-out” provision of the pay-to-play rule. In general, Rule 206(4)-5(a)(1) prohibits a registered investment adviser from providing investment advisory services for compensation to a government entity within two years after an adviser or any of its covered associates contributes money to an official of the government entity.

A registered investment adviser that manages a private fund requested the exemptive relief. Three of the investors in the fund are Ohio pension plans. The plans’ board of trustees oversees investment decisions and the Treasurer of the State of Ohio appointed one of the trustees.¹

In the spring of 2011, a managing member and senior investment professional of the investment adviser contributed to the federal senate campaign of the incumbent Ohio State Treasurer. (The executive’s wife made a similar contribution.)

The pay-to-play rule applies to contributions made to government “officials” of a state or local government entity, defined to include any *incumbent*, candidate or successful candidate for elective office, if the office:

- is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser; or
- 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.

In this case, the investment adviser’s executive mistakenly believed that the adviser’s pay-to-play rules allowed any contributions to federal campaigns. The investment adviser’s compliance department discovered the questionable contribution during a routine test of campaign contribution databases for the names of employees.

The adviser appears to have taken swift and deliberate action to address the compliance breach including:

- obtaining the government official’s agreement to return the full amount of the contribution (which subsequently occurred);

¹ Although the investment adviser’s “client” may be viewed as the fund itself and not the government entity, Rule 206(4)-5(c) provides that the pay-to-play prohibitions apply to “covered investment pools,” including private funds, in which a government entity invests. Under the Rule, the investment adviser to such a covered investment pool is treated as though the adviser is providing investment advice directly to the government entity.

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- establishing an escrow agreement into which all fees paid by the pension plans were deposited for a two-year period beginning on the date of the contribution; and
- revising the adviser's pay-to-play policies to require covered employees to pre-clear all campaign contributions to avoid similar misunderstandings of the policy.

Rule 206(4)-5(e) provides that the Commission can exempt an investment adviser from the time-out provision upon consideration of several enumerated factors including, among other things, whether the investment adviser:

- adopted and implemented policies and procedures reasonably designed to prevent violations of the rule before the contribution was made;
- had actual knowledge of the contribution prior to or at the time of the contribution;
- took all available steps to cause a return of the contribution; and
- took such other remedial or preventive measures as would be appropriate under the circumstances.

Applying these factors, the Commission determined that the requested exemptive relief was necessary and appropriate in the public interest, and consistent with the protection of investors and the purposes of the Advisers Act based upon the information in the application, including the following:

- each pension plan determined to invest in the fund on an arm's-length basis before the date of the contribution, and only one investment was made by the pension plans after the contribution;
- the executive's contact with and influence on the pension plans were limited;
- the investment adviser adopted pay-to-play policies consistent with Rule 206(4)-5, and it implemented appropriate compliance testing procedures prior to the date of the contribution;
- no employees of the investment adviser were aware of the contribution prior to its discovery by the adviser's compliance team;
- the executive requested and obtained the return of the contribution; and
- the contribution was consistent with the executive's prior pattern of political contributions, the executive did not solicit other employees to contribute to the campaign and there was no apparent intent to influence the pension plans' selection of the fund or the adviser.

This case demonstrates the value of a strong compliance culture at an advisory firm. The relief is in large part predicated on specific and prompt efforts made to correct the error and to prevent any opportunity for similar errors in the future. In addition, the investment adviser was able to demonstrate that the contribution was made without the intent to violate the prohibition, it was discovered through the exercise of internal compliance testing and the violation was promptly resolved and disclosed. All of these factors resulted in the Commission granting the requested relief under Rule 206(4)-5(e).

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That said, the adviser did take some lumps. After the contribution in question occurred in the spring of 2011, the adviser placed the fees earned on the relevant accounts in escrow. Additionally, obtaining exemptive relief, while ultimately resulting in a positive outcome for the adviser, took a significant amount of time and was likely an expensive proposition.

While relief is available in situations of inadvertent “foot faults” related to this rule, and the Commission has shown its willingness to grant such relief, a better use of advisers’ time and money might be to evaluate their pay-to-play policies to ensure that they clearly describe the prohibitions to which covered associates are subject, and are designed to ensure compliance with the Rule. In fact, some advisers might want to follow the lead of the adviser in this case and require covered associates to pre-clear all political contributions, rather than incurring the expense of making an inadvertent violation right.

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