July 1, 2014

Paying for Playing: SEC Brings First Pay-to-Play Action against an Investment Adviser

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The SEC has brought the first action under the "pay-to-play" rule adopted under the Investment Advisers Act. Andrew Ceresney, director of the SEC Enforcement Division, served notice that the SEC "will hold investment advisers strictly liable for pay-to-play violations" and that broker-dealers will be held to a similar standard.

The SEC also found that two affiliated exempt reporting advisers were operationally integrated for the purposes of determining exemption from registration requirements. Accordingly, the SEC charged the adviser, as an integrated entity, with failing to register as an investment adviser.

Pay-to-Play Violation: Rule 206(4)-5 under the Investment Advisers Act provides that investment advisers (whether registered or unregistered) are prohibited from providing advisory services in exchange for compensation to a government client for two years after the adviser or certain officers or employees of the adviser make a campaign contribution to certain elected officials or candidates related to that government client.

The SEC charged a venture capital firm whose associate contributed to candidates in the Philadelphia mayoral campaign and the Pennsylvania gubernatorial campaign in 2011. The Mayor of Philadelphia appoints three members of the Philadelphia Board of Pensions and Retirement and the Governor of Philadelphia appoints six members of the board of the Pennsylvania State Employees' Retirement System. Both public pension plans had been investors in the firm's venture capital funds since 2000, and the firm provided advisory services to the pension funds.

The SEC found that the firm continued to receive compensation for advisory services it provided to the public pension plans for two years after the associate made the campaign contributions, in violation of the pay-to-play rule. As part of a settlement, the adviser was censured and ordered to disgorge more than $250,000, and pay a civil money penalty of $35,000.

Investment advisers should pay attention to this action, which indicates that the SEC has begun to enforce the new "pay-to-play" rule aggressively; in this case the government clients in question first paid advisory fees in connection with its investments in the subject funds more than a decade before the associate contributed to the campaigns. Moreover, the charges relate to a time period when the funds were winding down (but the adviser was still receiving fees). Accordingly, investment advisers should ensure that they have robust internal procedures to monitor political contributions by employees and officers, including those made to preexisting government clients, and to act immediately when pay-to-play rules may be triggered.

Failure to Register/Integration: The SEC's second charge is also noteworthy. The SEC found that the two affiliated advisers, who separately claimed to be exempt reporting advisers (one as an adviser solely to venture capital funds, and the other as an adviser to private funds with less than $150 million in AUM) were significantly

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operationally integrated and thus should have been integrated into a single investment adviser for purposes of determining whether they were required to register with the SEC.[1] Once integrated, the SEC found, the adviser did not qualify for either of the exemptions. The SEC charged the firm with failing to register itself and its affiliate as investment advisers.

The SEC said that the two firms were operationally integrated because, among other things, the entities reported in their Form ADV that they were under common control, and employees of one firm held ownership stakes in the other firm and in the other firm's general partner and management company entities. Additionally, the two firms had a number of overlapping employees and overlapping operations without policies and procedures to separate the two entities. The SEC also noted that the firm's marketing materials indicated that the firms worked together as a "partnership" and described the benefit of one firm being able to outsource its back office functions to the other.

Investment advisers in similar situations that seek to claim exemptions from registration with the SEC should consult with counsel familiar with registration requirements of investment advisers and carefully review their relationships with affiliates to determine if they should be integrated for purposes of the SEC's registration rules.

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[1] The exemption from registration for an adviser that solely advises one or more venture capital funds is contained in Section 203(l) of the Investment Advisers Act. The exemption from registration for advisers to private funds that have regulatory assets under management in the United States of less than $150 million is contained in Rule 203(m)-1 of the Investment Advisers Act.

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