

Reproduced with permission from Pension & Benefits Daily, 175 PBD, 09/10/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

## Recent SEC ‘Pay-to-Play’ Enforcement Action Alert—What Public Pension Plans Need to Know



BY SUZANNE M. DUGAN AND RAYMOND M. SAROLA

**T**he U.S. Securities and Exchange Commission (SEC) recently settled its first enforcement action under its “pay-to-play” rule for investment advisers. This action demonstrates the increasing focus of the SEC on pension issues, but public pension fund trustees, staff and counsel are the first line of defense and need to be familiar with the SEC rule and its implications. The rule also applies to certain investment advisers providing services to government-run savings plans, such as Internal Revenue Code Section 457 plans, and those with responsibility for such plans

*Suzanne M. Dugan (sdugan@cohenmilstein.com) is special counsel at Cohen Milstein Sellers & Toll PLLC in Washington, D.C. She leads the firm’s Ethics and Fiduciary Counseling practice, which provides guidance to pension funds and other entities. She has more than 20 years of legal experience, including service as special counsel for ethics to the New York State comptroller and as general counsel to the New York State Ethics Commission. Raymond M. Sarola (rsarola@cohenmilstein.com) is an associate at the firm, working in its Ethics & Fiduciary Counseling practice in Philadelphia. He formerly served as a senior policy advisor & counsel in the New York City Mayor’s Office of Pensions & Investments.*

should similarly understand the rule and its implications.

### THE SEC Rule

Securities and Exchange Commission Rule 206(4)-5 (the “Rule”) prohibits investment advisers from providing compensatory advisory services for a period of two years following a political contribution by the adviser or certain of its “covered associates” to a public official or candidate who is or would be in a position to influence the selection or retention of advisers to manage public pension funds or other government client assets. The rule covers any “gift, subscriptions, loan, advance, deposit of money or anything of value made for the purpose of influencing” a political election in excess of *de minimus* thresholds (\$350 or \$150 depending on election) regardless of whether there is any evidence of intent to influence a public official.

---

**“Individuals with responsibility for public pension plans and government-run savings plans should be aware of some of the key implications of Rule 206(4)-5 and the TL Ventures enforcement action.”**

---

Motivating the SEC in the adoption of this rule in 2010 was its desire “to protect public pension plans and other government investors from the consequences of pay-to-play practices by deterring advisers’ participation in such practices.”<sup>1</sup> The SEC has noted that it will use all available enforcement tools to ensure that public pension funds are protected from any potential corrupting influences.<sup>2</sup>

<sup>1</sup> SEC Release No. IA-3043, at 25.

<sup>2</sup> SEC Press Release No. 2014-120.

**Recent Enforcement Action.** On June 20, 2014, the SEC announced the first resolution of an enforcement action under the pay-to-play rules. TL Ventures Inc., a Pennsylvania private equity firm, agreed to disgorge advisory fees and pay civil monetary penalties for its violations in a total amount of nearly \$300,000.

TL Ventures obtained investments from the Pennsylvania State Employees' Retirement System ("SERS") and the City of Philadelphia Board of Pensions and Retirement ("Philadelphia Retirement Board") in 1999 and 2000. Both public pension funds are run by boards of trustees, with the Governor of Pennsylvania appointing six of the eleven SERS trustees and the Mayor of Philadelphia appointing three of the nine members of the Philadelphia Retirement Board.

The political contributions that triggered the Rule were made in 2011 by an associate of TL Ventures in the amount of \$2,500 to a candidate for Mayor of Philadelphia, and a second contribution in the amount of \$2,000 to the Governor of Pennsylvania. TL Ventures continued to provide investment advisory services, and received compensation for those services, to SERS and the Philadelphia Retirement Board for the two years after the triggering contributions in violation of the Rule.

### Important Aspects of the Rule Highlighted by Enforcement Action

Individuals with responsibility for public pension plans and government-run savings plans should be aware of some of the key implications of Rule 206(4)-5 and the TL Ventures enforcement action:

- The SEC Order notes that the Rule does not require a showing of *quid pro quo* or actual intent to influence an elected official or candidate. In the press release accompanying its Order in TL Ventures, the SEC stated that it "will hold investment advisers strictly liable for pay-to-play violations."<sup>3</sup>

- The Rule applies at all times when an investment adviser is receiving compensation from a public fund, not just at the point when a decision to hire an adviser is made. This is highlighted by the fact the private equity funds at issue in TL Ventures were in wind-down mode at the time of the triggering contributions.

- The rule applies specifically to investment advisers of pooled investment vehicles such as private equity funds, hedge funds and other alternative investment vehicles, but the nature of these investments poses some unique challenges in applying the rule. For example, the rule applies to subadvisers to covered investment pools, such as underlying advisers in a fund-of-funds structure, but does not require subadvisers to "look through" the feeder fund to determine whether any of its assets came from government entities. Note, however, that the rule contains a specific prohibition against any acts done *indirectly* that would violate the rule had they been done directly.

- In addition, the compensation structures of alternative investments do not always lend themselves to a simple calculation of what portion of fees were

"earned" during any particular period. A determination of the proper method for calculating fees "earned" during a particular period under the rule will likely depend on the specific facts at issue with a particular investment.

### Suggestions for Trustees and Staff

Given the harms caused by the pay-to-play practices that motivated Rule 206(4)-5 and the challenges in the rule's application, public pension funds and those responsible for government savings plans should be sure they fully understand this rule and its implications.

- Public pension funds should become familiar with the options available if a violation of the SEC rule occurs. The rule does not direct a government entity to withdraw its assets from any investment adviser. Rather, the rule specifically contemplates the provision of uncompensated advisory services for a reasonable period of time. This provision both enables an adviser to act consistently with its fiduciary obligations and allows the government client sufficient time to replace the adviser or to redeem or transfer their assets. This is particularly important with alternative investment vehicles that invest in illiquid assets and typically restrict the ability of limited partners to redeem committed capital.

- Public pension funds should consider developing and implementing written policies in this area. Such policies would be designed to confirm compliance with Rule 206(4)-5 by investment advisers who receive fees from the government.

- These policies may include requirements that advisers make a certification of compliance at or before the time an initial investment is made, with an ongoing obligation to report throughout the life of the investment. Pension funds might also consider requiring annual compliance certification from advisers.

- Funds should also consider including in their policies a ban on future investment transactions with investment managers who fail to comply with the procedural or substantive requirements of the funds' policies or with Rule 206(4)-5.

- Government funds should also consider including in investment advisory contracts provisions that address remedial actions if a violation of the Rule occurs.

- Policies and procedures and other measures undertaken to address the SEC rule should be regularly reviewed to ascertain that they remain relevant and effective and reflect current best practices, as is true with any aspect of an effective ethics and compliance program.

### Conclusion

Public pension plans should be attentive to Rule 206(4)-5 and the implications of the recent TL Ventures enforcement action, which play an important role in restoring the public confidence in both the marketplace for investment advisory services and state and local governments' administration of public pension plans.

<sup>3</sup> *Id.*