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Fiduciary concerns, complexities with the SEC's pay-to-play rule

BY RAYMOND M. SAROLA | NOVEMBER 24, 2014

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The Securities and Exchange Commission's recent announcement of its first enforcement action under the "pay-to-play" rule it adopted in 2010 demands the attention of those responsible for governmental retirement plans to understand the regulation and its implications in order to secure the maximum protection for their beneficiaries.

The rule — Securities and Exchange Commission Rule 206(4)-5 — represents the SEC's strongest effort against pay-to-play practices in which investment advisers make political contributions to public officials in attempts to obtain business they might not otherwise win from public defined benefit and deferred compensation plans and other governmental retirement savings funds.

It prohibits investment advisers from receiving compensation for advisory services to a government entity for two years after the advisory firm or any covered employee makes a political contribution to a public official or candidate who is or would be in a position to influence the award of investment advisory business by public retirement funds. The rule allows covered employees to make contributions up to $350 per official or candidate per election in which they can vote, or $150 for other elections.

Contributions by investment firms in any amount would trigger a violation of the rule.

The SEC enforcement action concerned a private equity firm, TL Ventures; the Pennsylvania State Employees' Retirement System, which invested in TL Ventures funds in 1999 and 2000; and the Philadelphia Board of Pensions and Retirement, which invested in a TL Ventures fund in 2000. In 2011, an employee of TL Ventures who was regarded as a "covered associate" under the rule made campaign contributions of $2,000 to the governor of Pennsylvania and $2,500 to a mayoral candidate in Philadelphia. The governor appoints six of the 11 trustees of PennSERS, and the mayor appoints three of the nine members of the Philadelphia board, bringing these contributions within the scope of the rule.

The SEC found that TL Ventures continued to receive compensation for advisory services after its employee made contributions in excess of the limits contained in the pay-to-play rule and ordered TL Ventures, which did not admit or deny the SEC findings, to disgorge advisory fees and pay civil monetary penalties totaling $300,000.

The application of this rule is broad and complex, as highlighted by the TL Ventures action, and includes the following key issues of which retirement plan trustees and staff should be aware.

The rule applies at all times where an investment adviser is seeking or receiving compensation for advisory services by a government client, from the initial determination to invest through the life of the investment. For instance, the private equity funds at issue in the TL Ventures action were more than 10 years old and in wind-down mode when the triggering political contributions were made.

The rule includes within its purview investment advisers of pooled investment vehicles. Beside private equity, they include hedge funds and other alternative investments. The nature of such investments, however, poses unique challenges in interpreting and applying the rule. For instance, 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. When an investment adviser receives a management fee based on assets under management plus a performance fee equal to a percentage of returns, or carried interest, a number of approaches may be proper for determining the amount of fees subject to any “timeout” period. A determination of the proper method for calculating fees earned during a particular period subject to the rule will likely depend on the specific facts at issue with a particular investment. Notably, the SEC's order against TL Ventures did not disclose the method used to calculate the fees subject to disgorgement.

Any political contribution within the scope of the rule that exceeds the contribution thresholds will trigger the two-year “timeout” from receiving compensation from a government client, regardless of whether there was any evidence the contribution had, or was intended to have, any influence on investment adviser selection. The SEC acknowledged the difficulty of proving subjective intent and addressed that challenge by implementing a strict liability rule. While the absence of intent or impact is no defense to a violation, there is an opportunity for investment advisers who become aware of a triggering contribution to petition the SEC for an exemption from the rule, or in some cases to correct the violation by obtaining a return of the contribution.

Public retirement plan executives should become familiar with the options available if a violation of the SEC rule occurs.

The rule provides for advisory firms that violated the rule to give the public plan sufficient time to redeem or transfer its assets on an uncompensated basis. This provision 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 retirement plans should develop and implement written policies that confirm compliance with this rule by investment advisers. These policies may include a requirement that advisers make a certification of compliance before an initial investment is made, with an ongoing obligation to recertify throughout the life of the investment.

Public plans might also wish to include in their policies a ban on future investment transactions with investment managers who fail to comply with the procedural or substantive requirements of the rule. And public plans should consider including in investment advisory contracts or side letters provisions that address remedial actions if a violation of the rule occurs. For instance, a contract might specify that if a violation occurs, the adviser will continue to provide services under the contract without compensation for up to two years while the pension fund seeks efficient means to transfer its assets. Other remedial measures might require the investment manager to repay the amount paid or promised to a placement agent involved in winning the business.

The SEC's pay-to-play rule benefits not only public retirement funds and their beneficiaries but also investment advisers who will no longer face pressures to make political contributions to keep pace with their competitors. In short, the rule benefits everyone except those investment advisers that seek an unfair advantage in the marketplace for government advisory business. Pay-to-play practices have caused and continue to threaten substantial harm to public retirement plans, but the SEC has responded to these practices with a strong rule to deter and remedy future violations.

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