# The "Pay to Play" Saga Continues: Update on Two Important Decisions Issued Regarding SEC Rule

*By: Suzanne M. Dugan*

Public pension attorneys should be aware of two recent decisions regarding SEC Rule 206(4)-5, widely known as the "pay to play" rule.[1] The rule prohibits an investment adviser from receiving compensation for advisory services to a government entity for two years after the adviser or its covered associates makes a political contribution to a public official or candidate who is or would be in a position to influence the award of advisory business.

## Dismissal of Lawsuit Challenging SEC Rule Affirmed On Appeal

In the first instance, the U.S. Court of Appeals for the D.C. Circuit dismissed the petition of the New York Republican State Committee and the Tennessee Republican Party seeking to invalidate the SEC Rule.[2] Plaintiffs brought suit in the district court, which dismissed the suit for lack of subject matter jurisdiction, concluding that courts of appeals have exclusive jurisdiction to hear challenges to rules promulgated under the Investment Advisers Act of 1940. The Court of Appeals affirmed the District Court's decision, and also held that such challenges must be brought within sixty days of promulgation of the rule. The petition was dismissed as time-barred as there were no grounds for an exception in this case. This decision is likely a lethal blow for constitutional challenges to Rule 206(4)-5, the SEC's powerful tool that is designed to "protect public pension plans and other government investors from the consequences of pay to play practices by deterring advisers' participation in such practices."[3]

## SEC Grants First Ever Waiver To The Pay To Play Ban

Following on the heels of the August decision of the D.C. Circuit, on September 22, 2015 the SEC issued an order granting an exemption from Rule 206(4)-5 to Starwood Capital Group Management, LLC.[4] This action represents the first exemption given by the SEC to an investment adviser permitting receipt of compensation from a government entity client for investment advisory services provided to the government entity within the two-year period following a contribution by a covered associate to an official of the government entity. The brief order of SEC staff states that it received no requests for a hearing on a preliminary decision issued in August to waive the ban, and the Commission itself had not ordered a hearing. The order states merely that the matter had been considered and the proposed exemption was found to be appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Investment Advisers Act.

The SEC action ends an effort by Starwood Capital that took more than 18 months and 5 applications to the SEC. According to Starwood, their chief operating officer inadvertently tripped the wire when he made a "spontaneous" $1,000 contribution to an exploratory committee for then Illinois gubernatorial candidate Bruce Rauner. The donation was clawed back nine days later, but automatically disqualified Starwood from receiving compensation from the State Retirement Systems of Illinois for investments in Starwood funds. Starwood stated that the ban would deprive it of about $4 million in compensation, or 4,000 times the amount of the contribution.[5]

In contrast to the SEC's approach in the Starwood matter, in an earlier action in June 2014 the SEC settled its first enforcement action under the rule, with a private equity firm, TL Ventures, paying nearly $300,000 in disgorgement and fines.[6] TL Ventures obtained investments from the Pennsylvania State Employees' Retirement System in two of its private equity funds in 1999 and 2000. TL Ventures also obtained a $10 million investment from the City of Philadelphia Board of Pensions and Retirement in 2000. These private equity funds had lives of ten years with the possibility of extensions of up to two additional years, and the limited partners of these funds were generally restricted from withdrawing their capital during the lives of these funds. 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 $2,000 to the Governor of Pennsylvania.

## Conclusion

The D.C. Circuit case will likely put to rest any remaining challenges to the SEC's pay to play rule. Public pension attorneys need to be familiar with the SEC Rule and should consider developing and implementing written policies designed to confirm compliance with the rule and avoid situations in which an investment adviser is prohibited from receiving compensation

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for advisory services for two years after the advisor or its covered associate makes a political contribution. Note that the rule specifically contemplates the provision of uncompensated services to give the government entity sufficient time to redeem or transfer its assets.

Moreover, the exemption from Rule 206(4)-5 granted to Starwood by the SEC should give comfort to those who were concerned, after the TL Ventures case, that draconian consequences could result from the SEC's enforcement. The Starwood case appears to reflect a measured and thoughtful approach by the SEC, and should calm fears that minor, inadvertent violations will have severe repercussions.

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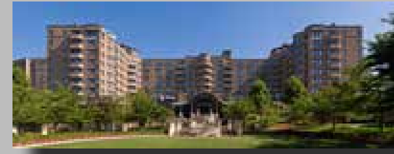
### ENDNOTES

[1]17 C.F.R. § 275.206(4)-5.
[2]New York Republican State Comm. v. S.E.C., ---F.3d ---, D.C. Cir., August 25, 2015 (2015 WL 5010051).
[3]SEC Release No. IA-3043, at 25.
[4]https://www.sec.gov/rules/ia/2015/ia-4203.pdf.
[5]Ed Beeson, "Starwood Capital Gets Final OK For SEC Pay To Play Waiver", *Law 360*, September 23, 2015.
[6]https://www.sec.gov/litigation/admin/2014/ia-3859.pdf.

## Mark Your Calendar



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**2016 Legal Education Conference**
New Orleans, LA (Astor Crowne Plaza)
June 21 - June 24, 2016
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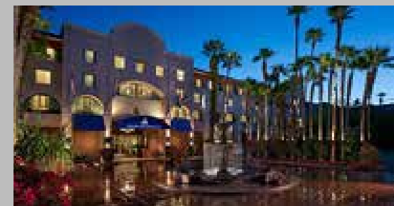

**2017 Winter Seminar**
Tempe, AZ (Tempe Mission Palms Hotel)
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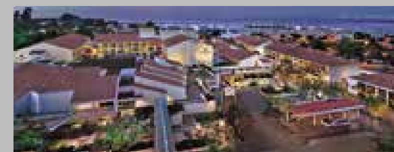

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