CLIENT UPDATE

SEC SETTLES FIRST "PAY-TO-PLAY" ENFORCEMENT ACTION

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On June 20, 2014, the Securities and Exchange Commission (the "SEC") settled its first enforcement action under its "pay-to-play" rule, Rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Advisers Act").[1] The enforcement action also included allegations that the firm, a venture fund manager (the "Manager"), along with an affiliated firm, should have been registered under the Advisers Act because they should have been "integrated" for purposes of this determination.[2]

The enforcement action is important because it confirms that the SEC will hold investment advisers strictly liable for pay-to-play violations. In this case, the political contribution occurred more than a decade after the state agencies invested in the private fund. The case emphasizes the importance of adopting and implementing effective "pay-to-play" policies.[3] The aspect of the case involving the "integration" of the two firms to determine their registration status demonstrates the importance for affiliated unregistered investment advisers to confirm that they are sufficiently separate from their affiliates in analyzing registration issues.

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1 In the Matter of TL Ventures Inc., Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, SEC Release No. IA-3859 (Jun. 20, 2014).

2 *Id.*; In the Matter of Penn Mezzanine Partners Management, L.P., Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, SEC Release No. IA-3858 (Jun. 20, 2014).

3 States and some pension funds themselves may also have campaign contribution limitations which pay-to-play policies should take into account.

PAY-TO-PLAY

Rule 206(4)-5 under the Advisers Act[4] prohibits, among other things, the receipt of compensation for providing investment advisory services to a U.S. state or local government entity (including government pension plans) within two years of a contribution by the investment adviser or a "covered associate"[5] of the investment adviser to an "official"[6] of a government entity (the "Two-Year Timeout").

The SEC found that a covered associate of the Manager made $4,500 in contributions in 2011 to the Mayor of Philadelphia and the Governor of Pennsylvania. The SEC also found that both the Mayor and the Governor were "officials" because they had the ability to appoint a subset of the members of the boards of two government pension plans: City of Philadelphia Board of Pensions and Retirement and Pennsylvania State Employees' Retirement System (the "Pension Plans"). During 1999 and 2000, both of these Pension Plans had committed to invest approximately $85 million in funds managed by the Manager (the "Funds"). The Manager violated the Two-Year Timeout by continuing to provide investment advisory services to the Fund and to receive advisory fees attributable to the investments of the Pension Plans during the two-year period following the political contributions.

There were no allegations that the contributions were made with the intent of influencing state or local government officials to invest in other funds managed by the Manager or to maintain the Pension Plans' existing investments in the Funds (which, in any event, appear to have been in wind down mode at the time of the contributions). In fact, the SEC specifically noted that the rule "does not require a showing of *quid pro quo* or actual intent to influence an elected official or candidate."

It is noteworthy that the SEC did not specify (i) whether the Manager had policies to prevent violation of the "pay-to-play" rule, (ii) whether the covered associate had reported the political contributions to the Manager, (iii) when the Manager had gained knowledge

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[4] Client Update: SEC Adopts New Pay-to-Play Rule (July 12, 2010), available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=8200106a-2f07-49b1-a3e6-99f1b0470e06.

[5] A "covered associate" includes, among other persons, any general partner, managing member or executive officer of the investment adviser; any employee who solicits a government entity (or any person who supervises such a person); and any political action committee controlled by the investment adviser or any of the above-mentioned persons.

[6] An "official" includes any incumbent or candidate for elective office of a government entity who either (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity or (ii) has authority to appoint any person who directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.

of the contributions or (iv) whether the Manager had taken any steps after it became aware of the contributions to have the contributions returned. All of these facts could have influenced whether the Manager could have applied for an exemption from the Two-Year Timeout.[7]

REGISTRATION

The Manager and an affiliated private fund manager (the "Affiliated Manager") had separately filed as "exempt reporting advisers" in reliance on the venture capital fund adviser exemption (Section 203(l) of the Advisers Act) and the private fund adviser exemption (Section 203(m) of the Advisers Act), respectively. Section 203(l) provides an exemption for advisers who provide advice solely to venture capital funds and Section 203(m) provides an exemption to an adviser who only provides advice to private funds and has less than $150 million in assets under management.

The SEC alleged that the Manager and the Affiliated Manager improperly relied on these exemptions, because the two firms were operationally integrated and, therefore, should be treated as a single firm. When viewed as a single firm, the Manager and Affiliated Manager could not rely on the exemptions because (i) the firms provided advice to private funds that were not venture capital funds and (ii) the firms had assets under management in excess of $150 million.

In the past, the SEC staff has set forth certain standards for avoiding the integration of two affiliated investment advisers for purposes of determining whether one or both firms should be registered. In particular, the SEC staff has focused on whether (i) the investment adviser is adequately capitalized; (ii) there is a buffer between the two advisers (*e.g.*, a majority of the members of the board of directors of the adviser are independent of the other adviser); (iii) the employees, officers and directors of investment adviser who are engaged in the day-to-day investment advisory business are also engaged in the investment advisory business of the affiliated adviser; (iv) the investment advice is decided and communicated by the investment adviser itself (and the advice is based on sources other than the affiliated investment adviser); and (v) the adviser keeps its investment advice confidential until communicated with clients.[8]

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[7] *See, e.g.*, Davidson Kempner Capital Management LLC, Notice of Application, SEC Release No. IA-3693; Oct. 17, 2013) (seeking an exemption from the "pay-to-play" rule with respect to a contribution to the Ohio State Treasurer).

[8] Richard Ellis, Inc., SEC Staff No-Action Letter (Sep. 17, 1981).

In this enforcement action, the SEC pointed to the following factors to support its conclusion that the two firms should be integrated for purposes of determining their ability to rely on the exemptions:

- *Control relationship*. The firms were under common control because two individuals held controlling stakes in both firms.
- *Overlapping operations and employees with no separation policies*. The firms had significantly overlapping operations, employees and associated persons (including two of the three members of the Affiliated Manager's investment committee, who also served as managing directors at the Manager), but there were no policies or procedures designed to keep the entities separate or protect investment advisory information from disclosure to the other firm.
- *Held out to the public as a single firm*. The firms distributed marketing materials referring to the two firms as being a "partnership" (including sharing back office functions), the Affiliated Manager's employees used their e-mail at the Manager to conduct business and communicate with outside parties and the members of the investment committee of the Affiliated Manager (who were also managing directors of Manager) solicited investors for the funds of the Affiliated Manager who were past investors in the funds sponsored by the Manager.

SANCTIONS

In addition to a cease-and-desist order that prohibits the Manager from future violations of the "pay-to-play" rule and the registration provisions of the Advisers Act, the SEC also required the Manager to pay disgorgement of $256,697 (along with prejudgment interest of $3,197) and a civil money penalty in the amount of $35,000. The SEC did not specify whether this disgorgement related to (i) the fees received by the Manager during the Two-Year Timeout with respect to the government pension plan investors or (ii) the fees it received as an investment adviser when it was acting as an unregistered investment adviser (presumably since March 30, 2012). However, from the scale of the fees and the fact that the Affiliated Manager did not pay any disgorgement in its companion settlement, it appears that the disgorgement was solely related to the violation of the "pay-to-play" rule.

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Please do not hesitate to contact us with any questions.

July 2, 2014