Harris Campaign Raises Potential Advisers Act Pay-to-Play Rule Considerations *(Plus 8 Important Pay-to-Play Reminders)*

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Vice President Kamala Harris appears increasingly likely to secure the Democratic presidential nomination and has not yet indicated whom she will select as her running mate. If she selects a current state or local official, then contributions to her campaign by employees of investment advisers could be limited by Rule 206(4)-5 under the U.S. Investment Advisers Act of 1940 (the "Pay-to-Play Rule").[1] It is our view that until such time as Harris selects a running mate, contributions to her campaign (or related PACs) should not trigger the Pay-to-Play Rule—however, there is no SEC guidance on this point and therefore a possibility that the SEC could take a different view. If Harris selects a running mate who is a current state or local official, such as a state governor, then contributions to her campaign made after such selection would likely be subject to the Pay-to-Play Rule.

Below we provide a brief overview of the rule and some of the common compliance foot faults we have seen in the industry. Investment advisers should consider reminding employees of their political contribution policies and the magnitude of possible ramifications of any Pay-to-Play Rule violation.

Overview of Advisers Act Pay-to-Play Rule

Contributions made to or solicited on behalf of state and local officials are subject to the Pay-to-Play Rule, which applies to both registered and exempt reporting advisers that provide advisory services (i) to a state or local government entity or (ii) to an investment pool in which a state or local governmental entity invests. The three key components of the rule are as follows:

- **Two-Year Compensation "Timeout"**—prohibits an adviser from receiving compensation for providing advisory services to a state or local government entity within a two-year period after the adviser or any of its covered associates makes a

[1] Contributions to the Trump-Vance Republican presidential ticket do not implicate the rule because Trump does not currently hold any office, and Vance holds federal office as a U.S. senator.

non de minimis political contribution to an official of a government entity or candidate for such office who is or will be in a position to influence the award of advisory business.

- There is a de minimis exception that permits a covered associate to contribute:
  - $350 per election to a candidate for whom the covered associate is entitled to vote; and
  - $150 per election to a candidate for whom the covered associate is not entitled to vote

  (with primary and general elections considered separate elections).

- **Solicitor Ban**—prohibits an adviser from paying third parties to solicit government entities for advisory business unless such third parties are "regulated persons" (registered broker-dealers, registered investment advisers or municipal advisors) that are themselves subject to pay-to-play restrictions.

- **Restriction on Coordinating Contributions**—prohibits an adviser or any of its covered associates from soliciting or coordinating: (1) contributions to the holder of an elected office of a government entity to which the adviser is providing or seeking to provide advisory services or a candidate for such office; or (2) payments to a political party of a state or locality where the investment adviser is providing or seeking to provide advisory services to a government entity.

In general, advisers and covered associates are prohibited from doing indirectly anything that would be prohibited if done directly.

8 Important Reminders

1. Government Officials Include Unsuccessful Candidates and State Officials Running for Federal Office.

"Government official" includes candidates (whether ultimately successful or not) for elected state or local office and incumbent state and local officials if such person can (or if elected would be able to) directly or indirectly influence the hiring of an investment adviser by a state or local government entity. Candidates for federal office are also "government officials" if they are currently state or local office incumbents who otherwise satisfy the definition (such as where a state governor is running for federal office).

- In prior presidential elections, we have seen a number of instances where covered associates have inadvertently triggered a timeout by making contributions to federal candidates who also held state or local office.

- In certain instances, it may be difficult to determine whether a particular official is in a position to "indirectly" influence the selection of an investment adviser. This may require investment advisers to review the laws and administrative regulations applicable to particular elected officials in order to understand the scope of authority of a particular office. The SEC's enforcement of the Pay-to-Play Rule indicates that even a tenuous connection between an official and the process for adviser selection/retention can be deemed sufficient indirect influence to implicate the rule.

2. Timeout Can Impact Fees from Investors beyond Public Pensions.

"Government entity" means any state or political subdivision of a state, including all state and local governments; their agencies, authorities and instrumentalities; and all pools of assets sponsored or established by the foregoing. As a result, the definition includes public pension plans, as well as other pools of public capital such as state university endowments.

3. Know Your Covered Associates.

We routinely see compliance issues resulting from confusion over the application of the term "covered associate." The definition includes: any general partner, managing member or executive officer, or individual with similar status or function; any employee who solicits a government entity for the adviser and any person who supervises, directly or indirectly, such employees; and any PAC controlled by the adviser or any of its covered associates.

- Issues commonly arise with respect to the supervisory chain. Note that anyone who is in the chain of supervision for employees who solicit government entities will be considered a covered associate, which includes the supervisors of direct supervisors. The definition can also extend to individuals employed by affiliates, such as the adviser's parent company.

4. Remember the Look-Back and Look-Forward.

The two-year compensation timeout includes a "look-back" and a "look-forward." With one significant exception, a contribution made by a person in the two years *before* becoming a covered associate (as a new hire or via promotion) can trigger a timeout, whether or not the adviser is aware of the contribution. The exception provides that a contribution made by a natural person more than six months prior to becoming a covered associate will not trigger the timeout unless the employee, after becoming a

covered associate, solicits any clients (not simply government clients). In addition, the look-forward provides that a timeout will continue even after the departure of the covered associate that made the contribution.

- For example, an enforcement action settled on September 15, 2022, involved a parent company officer that made a $1,000 campaign contribution to a state governor. Less than six months later, the parent company officer became head of the segment that oversaw the adviser and consequently an indirect supervisor of covered associates and thereby himself a covered associate. As a result of the look-back, the officer's prior contribution triggered a compensation timeout under the Pay-to-Play Rule with respect to funds the adviser managed on behalf of a state university. Without admitting or denying the SEC's findings, the adviser consented to a cease-and-desist order and to a censure and agreed to pay a $45,000 civil penalty.[2]

5. The Pay-to-Play Rule Is Strict Liability.

Enforcements can result and have resulted from honest mistakes in compliance without any intent to influence the investment decisions of government entities. For example, as noted above, when hiring a covered associate, there is no exception for an adviser's lack of knowledge regarding the covered associate's prior contributions.

- The Pay-to-Play Rule includes a limited returned contribution exception where a covered associate contributed no more than $350 to a candidate the covered associate was not entitled to vote for (exceeding the $150 limit), provided the adviser discovers the error within four months of the contribution and within 60 days of discovery the covered associate obtains a return of the contribution. This exception may be used only two times (or in the case of advisers with more than 50 employees, three times) per 12-month period. However, the exception may be used only once per covered associate, regardless of the time period.

6. PAC Contributions Should Be Reviewed Too.

A PAC is treated as a covered associate under the rule only if the adviser or any of its covered associates has the ability to direct or cause the direction of the governance or the operations of that PAC.

In addition, although contributions to some PACs may be outside the scope of the rule, contributions to PACs may be covered if they effectively circumvent the Pay-to-Play Rule; i.e., if the contribution would violate the rule's and the general Advisers Act prohibitions against doing indirectly what would be prohibited if done directly.

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[2] https://www.sec.gov/files/litigation/admin/2022/ia-6127.pdf.

- Compliance departments should review contributions to PACs to confirm whether a PAC is focused on elections in a particular state or locality or whether it has earmarked funds to support a few named candidates that include covered government officials.

- Investment advisers may also choose to require that a covered associate donating to a PAC procure written representations from the PAC that (i) the covered associate does not control the PAC and (ii) the contribution will not be used to make contributions to candidates that would violate the Pay-to-Play Rule if made by the covered associate directly.

7. Beware Fundraising Activities.

The rule's restriction on coordinating contributions also prohibits investment advisers, covered associates and their controlled PACs from soliciting or fundraising on behalf of a covered government official or candidate if the adviser is currently providing, or is seeking to provide, advisory services to a government entity in that state or locality.

8. Don't Forget Other Pay-to-Play and Lobbying Restrictions.

Some state and local governments maintain their own pay-to-play and lobbying regulations, which may include flat prohibitions, contribution limits and/or disclosure requirements that may be different from and in some cases more restrictive than the Pay-to-Play Rule requirements.

Similarly, given the ambiguity involved in interpreting the Pay-to-Play Rule, some advisers have adopted political contribution and gift policies and procedures that are more restrictive than the Pay-to-Play Rule to enable clearer and more consistent application and to reduce the risk of inadvertent violations. An adviser's contribution policies may apply to a broader group of employees than just those that would meet the definition of covered associate, or to all employees, and may also extend to employee spouses, partners or other household members. As a reminder, a contribution that does not trigger the Pay-to-Play Rule but that otherwise violates an adviser's policies and procedures may still result in a deficiency or enforcement.

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Please reach out to your Debevoise contact or one of the authors if you have any questions about the scope or application of the Pay-to-Play Rule.

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