Pay To Play Cases: How to Lose $530.5 Million of Investments for $2900

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Overview: The "pay to play" rule, Investment Advisers Act Rule 206(4)-5 (the "Rule") is designed to prevent investment advisers from obtaining investment management business from State and local government sponsored plans and programs ("government entities") in return for political contributions or fund raising. It prohibits registered investment advisers and exempt reporting advisers from managing for compensation the assets of certain government entities, including pension funds and endowments, during a two-year time out period following a political contribution (over a *de minimis* threshold) by the adviser or certain of its executives or employees (known as "covered associates") to a government official who is in (or is seeking) a position that has influence over the selection of certain investment advisers to manage pension and other assets.

The notion of "influence" is not just direct influence but also includes the ability to appoint another person that could influence the hiring of an investment adviser. Pursuant to the *de minimis* exception to the Rule, covered associates (natural persons) are permitted, to give $350 to a candidate for whom they are entitled to vote and $150 to a candidate for whom they are not entitled to vote.

The focus of the Rule is on State and local officials but includes a State or local official running for federal office. And the notion of "contribution" goes well beyond cash campaign contributions and includes "anything of value" such as the use of firm telephones and office space on behalf of a candidate, especially during office hours.

The SEC has brought several cases against firms for violating this Rule. Consequently, advisers should pay particularly careful attention to campaign contributions and fund raising efforts by their covered associates. Past political contributions of new hires must also be considered as these will be attributed to the adviser.

The Rule prohibits acts done indirectly, which if done directly, would violate the Rule. Consequently, payments made through attorneys, family members or friends as a means to circumvent the Rule would not be permitted. Depending on the facts and circumstances, payments to political action committees ("PACs") and political parties might also violate the Rule according to the Rule's adopting release,

Release No. IA-3043, effective September 13, 2010 (the "Release"). Careful analysis of how a PAC or political party will disburse its funds should be undertaken prior to any contribution. The Release suggests that such contributions could effectively operate as a funnel to the campaigns of government officials in violation of the Rule.

We have summarized several relevant cases below. While the amount of money contributed to political candidates in the cases is trivial, the consequences for the adviser can be devastating. Many of the firms cited are no longer in business; the survivors must disclose the Rule's violation in Form ADV which may not be helpful to fund raising efforts:

In the Matter of OAKTREE CAPITAL MANAGEMENT, L.P., Advisers Act Release 4960 (July 10, 2018). From 2007 through 2015, the following public pension funds invested in funds managed by Oaktree Capital Management, L.P. (the "Adviser"): (i) the California State Teachers' Retirement System ("CalSTRS"): $300 million; (ii) the Employees' Retirement System of Rhode Island ("ERS"): $20 million; (iii) the Water and Power Employees' Retirement Plan of the city of Los Angeles ("WPERP"): $18.5 million; (iv) the Los Angeles City Employees' Retirement System ("LACERS"): $72 million; and (v) the Los Angeles Fire and Police Pension System ("LAFPP"): $120 million (total pension fund investments: $530.5 million).

In September of 2014 a covered associate of the Adviser contributed $500 to a candidate for California State Superintendent of Public Instruction (the "Superintendent"). In the same month a covered associate contributed $1000 to the Treasurer of Rhode Island who was running for Governor of Rhode Island. This contribution was returned to the covered associate. In April of 2016 a covered associate contributed $1400 to the campaign of a candidate for Mayor of Los Angeles. This contribution was also returned at the request of the covered associate (total contributions: $2900).

The Superintendent is a member of CalSTRS board which has influence over the selection of investment advisers for the pension plan.

The offices of Treasurer and Governor of Rhode Island both have the ability to influence the selection of investment advisers for ERS through the Rhode Island Investment Commission (the "RIC"). RIC selects advisers for ERS. The Treasurer is on RIC's board and the Governor selects three members of the board.

Finally, the Mayor of Los Angeles has the ability to influence the selection of advisers for WPERP, LACERS and LAFPP. The Mayor appoints at least one member of each board.

The Adviser continued to provide investment advisory services to the five pension plans identified above for compensation following the three campaign contributions described above in violation of the pay to play Rule.

In the Matter of ADAMS CAPITAL MANAGEMENT, INC., Advisers Act Release 4617 (Jan. 17, 2017). Adams Capital Management, Inc. (the "Adviser"), an exempt reporting adviser, managed a $30 million investment by the Pennsylvania State Employees' Retirement System ("SERS") since 2000. In January of 2014 a covered associate of the Adviser contributed $500 to the Treasurer of Pennsylvania who was

running for Governor. In August of 2014 the covered associate contributed $500 to the campaign of the Governor. The covered associate asked for the return of this contribution. The offices of Treasurer and Governor both had the ability to influence the selection of investment advisers for the SERS pension fund. The Adviser continued to provide investment advisory services for compensation following the two $500 campaign contributions to the client in violation of the pay to play Rule.

In the Matter of AISLING CAPITAL MANAGEMENT, LLC, Advisers Act Release 4616 (Jan. 17, 2017). In 2005, New York City Employees' Retirement System ("NYCERS") invested $7 million in Aisling Capital II, L.P. In 2008, NYCERS invested $14 million in Aisling Capital III, L.P. In December of 2011 and April of 2012 a covered associate of Aisling Capital Management, LLC (the "Adviser") contributed $1000 and $500 to the Manhattan Borough President who is on the NYCERS board and has the ability to influence who manages funds for the NYCERS pension. During the two year period following the campaign contributions the Adviser continued to manage funds for NYCERS for compensation in violation of the Rule.

In the Matter of ALTA COMMUNICATIONS, INC., Advisers Act Release 4614 (Jan. 17, 2017). In 2003, Massachusetts Pension Reserves Investment Management Board ("PRIM") invested $50 million in Alta Communications IX, L.P. (the "Fund") managed by Alta Communication, Inc. (the "Adviser"). In February 2014 a covered associate of the Adviser contributed $500 to the Treasurer of Massachusetts. The Treasurer is on PRIM's board and appoints one member of that board. The Adviser continued to manage PRIM's investment in the Fund for compensation during the two year period following the covered associate's campaign contributions in violation of the Rule.

In the Matter of COMMONWEALTH VENTURE MANAGEMENT CORP., Advisers Act Release 4615 (Jan. 17, 2017). In 1998, Massachusetts Pension Reserves Investment Management Board ("PRIM") invested $50 million in Commonwealth Capital Ventures II, L.P. (the "Fund") managed by Commonwealth Venture Management Corp. (the "Adviser"). In 2013 and 2014 covered associates gave a total of three $500 campaign contributions to a candidate running for Governor of Massachusetts. One of the covered associates also solicited campaign contributions by co-hosting a fundraising event at which attendees contributed to the campaign of the candidate for Governor. The Governor is on PRIM's board and has the ability to appoint two members to PRIM's board. The Adviser continued to manage PRIM's investment in the Fund for compensation during the two year period following the covered associates' campaign contributions in violation of the Rule.

In the Matter of CYPRUS ADVISORS, INC., Advisers Act Release 4613 (Jan. 17, 2017). In 1999, four New York City public pension plans (Teachers Retirement System of the City of New York, New York City Police Pension Fund, New York City Fire Pension Fund and New York City Employees' Retirement System (collectively, the "Pension Plans")) invested $175 million in Cypress Merchant Banking Partners II, L.P. (the "Fund") managed by Cyprus Advisors, Inc. (the "Adviser"). In May of 2013, a covered associate of the Adviser contributed $400 to a candidate for Mayor of New York City. The Mayor appoints at least one member of the board of each of the Pension Plans. The Adviser continued to manage the Pension Plans' investment in the Fund for compensation during the two year period following the covered associates' campaign contributions in violation of the Rule.

In the Matter of FFL PARTNERS, LLC, Advisers Act Release 4610 (Jan. 17, 2017). In 2009, the Core Retirement Investment Trust, a Wisconsin state public pension plan (the "Plan") invested $50 million in Fleischer & Lowe Capital Partners III, L.P. (the "Fund") managed by FFL Partners, LLC (the "Adviser"). In March of 2012, a covered associate of the Adviser made a $10,000 campaign contribution to a candidate for Governor of Wisconsin. The Governor appoints several members of the Plan's board of trustees. The Adviser continued to manage the Plans' investment in the Fund for compensation during the two year period following the covered associates' campaign contributions in violation of the Rule.

In the Matter of LIME ROCK MANAGEMENT LP, Advisers Act Release 4611 (Jan. 17, 2017). In 2004, the State Teachers' Retirement System of Ohio, a public pension plan (the "STRS") invested $30 million in Lime Rock Partners III, L.P. ("Fund I") managed by Lime Rock Management LP (the "Adviser"). In 2006, STRS invested $43 million in Lime Rock Partners IV, L.P. ("Fund II") managed by the Adviser. In 2008, STRS invested $75 million in Lime Rock Partners V, L.P. ("Fund III" and together with Fund I and Fund II, collectively, the "Funds") managed by the Adviser. In October of 2015, a covered associate of the Adviser made a $1,000 campaign contribution to a candidate for Governor of Ohio. The Governor appoints one member of the STRS board. The Adviser continued to manage STRS' investment in the Funds for compensation during the two year period following the covered associates' campaign contributions in violation of the Rule.

In the Matter of NGN CAPITAL LLC, Advisers Act Release 4612 (Jan. 17, 2017). In 2008, four New York City public pension plans (Teachers Retirement System of the City of New York, New York City Police Pension Fund, New York City Fire Pension Fund and New York City Employees' Retirement System (collectively, the "Pension Plans")) invested $50 million in BioMed Opportunity II, L.P. (the "Fund") managed by NGN Capital LLC (the "Adviser"). In 2013, a covered associate of the Adviser made three campaign contributions to a candidate for Mayor of New York City totaling $1,425 as well as an additional $500 contribution to a different candidate for Mayor. The Mayor appoints at least one member of the boards of the Pension Plans. The Adviser continued to manage the Pension Plans' investment in the Fund for compensation during the two year period following the covered associates' campaign contributions in violation of the Rule.

In the Matter of PERSHING SQUARE CAPITAL MANAGEMENT, L.P., Advisers Act Release 4608 (Jan. 17, 2017). In 2011 and 2012, Massachusetts Pension Reserves Investment Management Board ("PRIM") invested $192 million in Pershing Square, L.P. (the "Fund") managed by Pershing Square Capital Management, L.P. (the "Adviser"). In August of 2013 a covered associate of the Adviser gave a $500 campaign contributions to a candidate running for Governor of Massachusetts. The Governor is on PRIM's board and has the ability to appoint two members to PRIM's board. The Adviser continued to manage PRIM's investment in the Fund for compensation during the two year period following the covered associates' campaign contributions in violation of the Rule.

In the Matter of THE BANC FUNDS COMPANY, L.L.C., Advisers Act Release 4609 (Jan. 17, 2017). In 2002 the Illinois Teachers' Retirement System ("TRS"), a public pension plan, invested $50 million in Banc Fund VII, L.P. ("Fund I") managed by The Banc Funds Company, L.L.C. (the "Adviser"). In 2005, TRS invested $45 million in Banc Fund VII, L.P. ("Fund II" and together with Fund I, collectively, the "Funds").

In October of 2013 a covered associate of the Adviser gave a $1,000 campaign contribution to a candidate running for Governor of Illinois. The Governor appoints six members to TRS's board. The Adviser continued to manage TRS's investment in the Funds for compensation during the two year period following the covered associates' campaign contribution in violation of the Rule.

In the Matter of TL VENTURES INC., Advisers Act Release 3859 (June 20, 2014). In 1999, Pennsylvania State Employees' Retirement System ("SERS") a public pension plan, invested $35 million in TL Ventures IV ("Fund I") managed by TL Ventures Inc. (the "Adviser"). In 2000, SERS invested $40 million in TL Ventures V ("Fund II" and together with Fund I, collectively, the "Funds"). Also in 2000, the Philadelphia Retirement Board ("PRB") invested $10 million in Fund II. In April of 2011 a covered associate of the Adviser gave a $2,500 campaign contributions to a candidate running for Mayor of Philadelphia. In November of 2011 the covered associate contributed $2,000 to the Governor of Pennsylvania. The Governor appoints six members to SERS' board. And the Mayor has authority to appoint the City's Director of Finance, Managing Director and City Solicitor. Each of these officials serves as a member of the PRB. The Adviser continued to manage SERS' and PRB's investment in the Funds for compensation during the two year period following the covered associates' campaign contributions in violation of the Rule.

Conclusion: Registered investment advisers and exempt reporting adviser need to be vigilant with respect to the political contributions and fund raising efforts of their employees. This is especially true for advisers that either manage or are seeking to manage assets for state and local governments, their agencies and instrumentalities, or any public pension plan or other collective government fund. No employee of an adviser should give any money to a political candidate with first preclearing such contribution through the firm's chief compliance officer. Contributions over the *de minimis* thresholds are extremely dangerous. Once such a contribution is made, the damage is done. Requesting a return of the offending contribution is of no consequence and the two-year time out period will have to run its course. Donations to PACs and political parties are also of concern and should not be viewed as a safe harbor.

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