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Pay To Play Revisited: Political Contributions by Investment Advisers

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On July 10, 2018 the SEC brought three new cases against investment advisers for violating the Pay to Play Rule—Investment Advisers Act Rule 206(4)-5 (the "Rule"). Every investment manager employee must be extraordinarily vigilant not to run afoul of this Rule. A miniscule political campaign contribution of less than $200 (in cash or in kind) can prevent an investment manager from managing pension fund or endowment assets for up to two years following the contribution. Can you imagine the effect of losing a pension fund investment of several hundred million dollars because you gave (either directly or indirectly) $200 to a political candidate (that lost the election!)?

The Rule prohibits investment advisers from providing investment advisory services for compensation to a "government entity" within two years after a contribution to an "official" of a government entity made by the investment adviser or any covered associate of the investment adviser. Officials include officeholders or candidates for offices that are directly or indirectly responsible for or that have authority either to influence the hiring of investment advisers by the government entity or to appoint people who could influence the hiring of investment advisers by the government entity. This would include State or local officeholders running for a federal office. A "government entity" is broadly defined to include, among other things, any State or political subdivision (including local government entities) of a State. This definition captures public pension funds, public university endowments and other collective government funds. The Rule permits de minimis aggregate contributions of up to $350, per election, to a candidate for whom the covered associate is entitled to vote, and up to $150 for candidates for whom the covered associate is not entitled to vote.

Adopted in 2010, the SEC's first Pay to Play case was brought against TL Ventures Inc. in 2014 for a $2500 contribution to a Philadelphia mayoral candidate and a $2000 contribution to the Governor of Pennsylvania. Ten more cases were brought in January of 2017. The most recent cases were brought against Oaktree Capital Management, L.P. ("Oaktree"), Encap Investments L.P. ("Encap") and Sofinnova Ventures, Inc. ("Sofinnova"). Oaktree has approximately $110 billion under management.

The Oaktree case involves three campaign contributions in the amounts of (i) $500 (September 2014), (ii) $1000 (September 2014) and (iii) $1400 (April 2016) to (i) a candidate for California State Superintendent of Public Instruction (the "Superintendent"), (ii) the Treasurer of Rhode Island who was also a candidate for Governor of Rhode Island and (iii) a candidate for Mayor of Los Angeles. The candidates held or were seeking offices that had influence over selecting investment advisers for public pension plans in California and Rhode Island. Within two years after these contributions, Oaktree provided advisory services for compensation to the public pension plans in violation of the Rule.

In 2007, the California State Teachers' Retirement System ("CalSTRS"), a public pension plan, invested, $300 million in Oaktree Opportunities Fund VIIb, L.P. In 2011, the Employees' Retirement System of Rhode Island ("ERS"), through the Rhode Island Investment Commission, invested, $20 million in Oaktree European Principal Fund III, L.P. In 2009, the Water and Power Employees' Retirement Plan of the City of Los Angeles ("WPERP"), a public pension, invested $18.5 million in Oaktree Principal Fund V, L.P. Between 1999 and 2015, the Los Angeles City Employees' Retirement System ("LACERS"), a public pension plan, invested, $72 million in seven Oaktree funds. Between September 1999 and February 2015, the Los Angeles Fire and Police Pension System ("LAFPP"), a public pension plan, invested, $120 million in nine Oaktree funds. During all relevant times, CalSTRS, ERS, WPERP, LACERS and LAFPP remained invested in their respective funds (the "Funds"). The Funds were closed-end funds and investors were generally prohibited from withdrawing their money for the life of the funds.

The Superintendent (as an *ex officio* member of CalSTRS' board) had the ability to influence the selection of investment advisers for CalSTRS; the offices of Treasurer and Governor of Rhode Island had the ability to select advisers for ERS; and the Mayor of Los Angeles had the ability to appoint at least one member of the boards of WPERP, LACERS and LAFPP.

As a result of three campaign contributions totaling less than $3,000, Oaktree violated Section 206(4) of the Advisers Act and Rule 206(4)-5 thereunder and was not eligible to provide advisory services for compensation on investments totaling over $500 billion to five pension funds during a two year "time out" period following the contributions.

In addition to the Pay to Play Rule, there are also various State and local government laws governing campaign contributions which are beyond the scope of this brief article to discuss. These State and local rules, together with the Pay to Play Rule, collectively, are a trap for the unwary. All political contributions should be precleared by the Chief Compliance Officer if they are allowed at all. Many investment advisers prohibit political contributions to avoid any possibility of triggering this draconian Rule. The Rule also explicitly prohibits attempts at circumvention such as through indirect contributions through a spouse, lawyer or other entity.

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