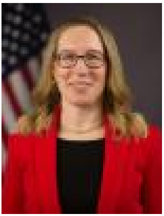
Statement

Laudable Ends, Poorly Pursued: Statement Regarding Recent Pay-to-Play Rule Settlements



Commissioner Hester M. Peirce

Sept. 15, 2022

Today the Commission instituted and settled administrative proceedings against four investment advisers for violating the Pay-to-Play Rule.[1] The Rule, adopted in 2010, came in response to instances where government entities, such as state and municipal pension plans, were choosing investment advisers based on their political contributions. When adopting the Rule, the Commission observed that "'pay-to-play' arrangements are inconsistent with an adviser's fiduciary obligations, distort the process by which investment advisers are selected, can harm advisers' public pension plan clients and the beneficiaries of those plans, and can have detrimental effects on the market for investment advisory services."[2] The Pay-to-Play Rule was intended to "ensure that adviser selection is based on merits, not on the amount of money given to a particular candidate for office."[3] The Commission characterized the Rule as being "closely drawn . . . to accomplish its goal of preventing quid pro quo arrangements while avoiding unnecessary burdens on the protected speech and associational rights of investment advisers and their covered employees."[4] Today's enforcement actions illustrate that the Rule is a poorly conceived means to pursue laudable ends. Accordingly, I dissent and urge the Commission to revisit the Pay-to-Play Rule to ensure that it does not hinder political engagement that is unconnected to an adviser's quest for government clients.

The four enforcement actions share similar facts. All involve one-time, small-dollar contributions by one or two people, and all the investment advisers had established advisory relationships with the relevant government entities before the contributions occurred. Three of the four actions involve closed-end funds investments where "investors were generally prohibited from withdrawing their money for the life of the Funds."[5] In the fourth, the contributor was not covered by the Rule at the time of the contribution in July 2018; the contributor became a covered associate when promoted in September 2018.[6] Nowhere do the Commission's orders find that any of the investment advisers solicited new or additional business from any governments at the time of or after the contributions. In sum, the conduct at issue in these cases is far afield from the conduct that gave rise to the Rule.

The Pay-to-Play Rule is sweeping in its reach. It only exempts up to $350 to one official per election,[7] and it defines "official" broadly to include both incumbents and candidates if the office held or sought "has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser."[8] Additionally, the Commission reads "influence" expansively—any person in a position to participate in the selection of an investment adviser can influence the hiring, regardless of whether the person has authority to make the hiring decision.[9] The Rule's look-back provision means that it also applies retroactively; a

contribution that was lawful when made becomes a “disallowed contribution” if the donor’s job duties change *after* she makes the contribution. The consequences of making a disallowed contribution are serious: the Rule prohibits “provid[ing] investment advisory services for compensation” within two years of a disallowed contribution.[10]

For these reasons, it is immaterial, under the Rule’s terms, that one of the contributions at issue in the recent cases was only $400,[11] that each of the advisers involved in the matters had a longstanding, existing advisory relationship with the government client when the contributions were made, and that the political candidates who received the contributions had attenuated influence over the government entities’ adviser selection. For example, the Governor of Hawai’i does not have unfettered control over appointments to the University of Hawai’i Board of Regents,[12] and the Governor of Massachusetts and Mayor of New York do not appoint a majority of the relevant pension boards.[13] Under the Rule’s broad reading of “influence,” the Governors and Mayor need only have the authority to appoint a single person who might indirectly influence the hiring of an investment adviser. Finally, it is immaterial that there is no finding that the advisers sought or obtained any *new* investments from government entities at the time of or after the contributions; rather, it is enough that the advisers simply continued to receive compensation from existing investments, the terms of which generally precluded early withdrawal.

In other words, the Pay-to-Play Rule is an exceedingly blunt instrument. It does not require any evidence of an actual *quid pro quo*, or even evidence that the adviser was seeking a *quid pro quo*. The Rule likewise does not require any assessment of whether the official receiving the contribution realistically could influence the decision to hire an investment adviser, or whether the contribution itself reasonably could be expected to influence the official. The Pay-to-Play Rule simply does not concern itself with whether the official would or could have prevented the adviser from playing without first paying or whether the adviser was paying to obtain a spot on the playing field.

The Pay-to-Play Rule, although well-intentioned, imposes unique, unquantifiable costs on individuals by impeding their ability to participate in the political process. An investment adviser, when seeking qualified candidates for a position meeting the Rule’s definition of “covered associate,” is in the uncomfortable position of having to seek a list of prior political contributions. The job candidate is in the equally uncomfortable position of having to provide that information to a prospective employer, and possibly being excluded from the competitive applicant pool because of lawful political activity. Rule 206(4)-5(e) authorizes the Commission to grant exemptions, but exemptions are rare, perhaps in part because among the various factors the Commission considers in the exemptive process is “the contributor’s intent or motive in making the contribution . . . as evidenced by the facts and circumstances surrounding such contribution.”[14] Because applications for exemptions are public documents, the unavoidable and altogether unfortunate consequence is that any entity seeking an exemption must publicly name the covered associate together with a description of the covered associate’s intent or motive in contributing.[15] A government agency’s probe into the motives of a person exercising her right to participate in the political process is not comfortable for anyone involved and can itself become political.

We did not need the Rule to bring pay-to-play cases. Before we adopted the Rule, the Commission brought such cases.[16] The Rule, agnostic to evidence of actual, harmful pay-to-play schemes, dissuades political contributions that have nothing to do with obtaining advisory business from government clients. The Commission and the public now have a dozen years of experience with the Rule, and it is past time to consider how it might be improved. In the meantime, investment advisers should have effective policies and procedures in place to prevent contributions made to win business, our examiners should examine for compliance with the Rule, and the Commission should exercise prudence in its enforcement efforts. Cases such as today’s, however, do more harm than good.

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[1] Investment Advisers Act Rule 206(4)-5 (the “Pay-to-Play Rule” or “the Rule”), 17 C.F.R. § 275.206(4)-5.

[2] Political Contributions by Certain Investment Advisers, Rel. No. IA-3043, 75 Fed. Reg. 41018, 41023 (July 14, 2010) (“Adopting Release”).

[3] *Id*.

[4] *Id.*

[5] *Asset Management Group of Bank of Hawaii*, Rel. No. IA-6127, 5-6 (Sept. 15, 2022); *Canaan Management,* LLC, Rel. No. IA-6126, 4-5 (Sept. 15, 2022); *Highland Capital Partners, LLC*, Rel. No. IA-6128, 4-5 (Sept. 15, 2022); *StarVest Asset Management, Inc*., Rel. No. IA-6129, 4-5 (Sept. 15, 2022).

[6] *See Asset Management Group*, 6 (noting the $1,000 July 2018 contribution and stating that the individual become a "covered associate" in September 2018). As applicable here, the "look-back" provision of Rule 206(4)-5(b)(2) brings contributions made by individuals who, although they were not covered associates at the time of the contribution, become covered associates within six months of the contribution.

[7] Rule 206(4)-5(b)(1).

[8] Rule 206(4)-5(f)(6)(ii).

[9] *See* Adopting Release, 75 Fed. Reg. 41029 & n.143.

[10] Rule 206(4)-5(a)(1).

[11] *StarVest*, 5.

[12] Regents for the University of Hawai'i are selected from a pool of qualified candidates nominated by the Regent Candidate Advisory Council and then appointed by the Governor, with the advice and consent of the Hawai'i Senate. *See* Hawai'i State Const., Art. X and Haw. Rev. Stat. § 304A-104.

[13] The Mayor appoints one of the eleven-member Board of Trustees of the New York City Employees' Retirement System and two of the seven-member Teachers' Retirement Board of the Teachers' Retirement System of the City of New York. *See* https://www.nycers.org/board-trustees and https://www.trsnyc.org/memberportal/About-Us/ourRetirementBoard. The Governor of Massachusetts, or his designee, serves as an ex officio member of the PRIM Board and the Governor appoints two of nine members. *See* https://www.mapension.com/about-prim/prim-board/.

[14] Rule 206(4)-5(e)(6)

[15] *See, e.g.*, D.B. Fitzpatrick & Co., Amendment No. 1 and Restatement of Application for an Order Pursuant to Section 206A of the Investment Advisers Act of 1940, at 6, 8 (March 23, 2020) (identifying the contributor by name and describing the contribution as "spontaneous and motivated by the Candidate's support of the environment and acknowledgement of the existence and impact of climate change and the threat it poses to the State of Idaho") (available at https://www.sec.gov/rules/ia/2020/803-00253-amended-application.pdf); D.B. Fitzpatrick & Co., Notice of Application for Exemptive Order, Rel. No. IA-5475, at 10 (April 9, 2020) (noting the applicant stated the contribution was motivated by "legitimate personal interest in supporting the Official because of the Official's support for the environment, position on climate change and focus on protecting Idaho's natural resources") (available at https://www.sec.gov/rules/ia/2020/ia-5475.pdf); Stephens Inc., Amendment No. 1 and Restatement of Application for an Order Pursuant to Section 206A of the Investment Advisers Act of 1940, at 6, (June 21, 2017) (identifying the contributor by name and describing the contribution as "spontaneous and motivated by his longstanding friendship with the Official" who he had "known for approximately thirty years," further noting that "Contributor and the Official's ex-husband also have a shared interest in competitive swimming" and that "Contributor lived with them for a time during college, worked at their restaurant and has maintained close relations") (available at https://www.sec.gov/rules/ia/2017/803-00238-application-amended.pdf); Stephens, Inc., Notice of Application for Exemptive Order, Rel. No. IA-4797, at 8-9 (Oct. 18, 2017) (noting that applicant represented that "Contributor and the Official have a long standing friendship as the Contributor worked at the Official's restaurant and lived with the Official and her ex-husband when he was in college" and contended that "it was because of that relationship, and not any desire to influence the award of investment advisory business that the Contributor made the Contributor made the Contribution to the Official's campaign") (available at https://www.sec.gov/rules/ia/2017/ia-4797.pdf).

[16] *See*, *e.g.*, *SEC v. Henry Morris, et al*., Litigation Release No. 20963 (Mar. 19, 2009) (alleging investment advisers paid sham "placement fees," portions of which were funneled to public officials, as a means of obtaining public pension fund investments in the funds those advisers managed) (available at https://www.sec.gov/litigation/litreleases/2009/lr20963.htm); *SEC v. Paul J. Silvester, et al*., Litigation Release No. 16759 (Oct. 10, 2000) (alleging a former Treasurer for the state of Connecticut participated in a scheme in which he awarded investments of hundreds of millions of dollars of state pension fund money in exchange for lucrative fees paid by the private equity firms to friends and political associates) (available at https://www.sec.gov/litigation/litreleases/lr16759.htm).