



Financial Services Professionals: Check Your Political Contributions for Compliance to Avoid Pay-To-Play Fines

09.22.2022 | By **William A. Powers, Frederick T. Dombo III**

During these last weeks of the 2022 election season, campaigns are ramping up urgent, last-minute fundraising efforts. Financial services professionals should not let their guard down amid this flurry. Recently published Securities Exchange Commission (SEC) fines are a reminder that a contribution by such individuals could have consequences for their employer and for them, according to the SEC's Rule 206(4)-5, the so-called federal "pay-to-play rule."^[1] As seen in the SEC's recently unveiled settlements with four investment advisers, the most common source of a pay-to-play violation stems from an associate contributing to a governor or other chief executive, such as a mayor. With 36 states and three territories electing governors in 2022 (not to mention countless municipal elections), the SEC is holding up the proverbial yield sign with its announcement of these settlements so close to the election. These cases are a reminder that financial services firms should remind their professionals of compliance checks before making political contributions.

The SEC's Pay-to-Play Rule

SEC Rule 206(4)-5 places limits on political contributions made by certain "covered associates" of an investment adviser that has a contract with a government client. However, only contributions to candidates for an office that has the authority to influence the government's award of an investment advisory contract will trigger the pay-to-play rule. If a "covered associate" makes such a contribution, the investment adviser is prohibited from providing investment advisory services for compensation to a government client for two years from the time of that contribution, and if it does engage in those services, it is subject to penalty. It may also need to disgorge previously earned fees.

There are limited ways by which a “covered associate” can make contributions. SEC Rule 206(4)-5 permits certain *de minimis* contributions by a “covered associate” of up to \$350 to a candidate for whom the associate is entitled to vote and contributions of up to \$150 for other candidates.

Recent Settlements

With less than 60 days before the November election, the SEC’s settlement of pay-to-play allegations with four investment advisers neither admitted nor denied the violation and contain a total of \$300,000 in penalties, ranging from \$45,000 to \$90,000. Although these violations and fines appear in line with other SEC settlements, there are three key takeaways from a compliance perspective.

1. *Statewide and Citywide Offices Pose the Greatest Compliance Risk.*

Notably, three out of the four settlements involved \$1,000 contributions to three different 2018 candidates for governor, with the other being contributions to a candidate for Mayor of New York City for the 2021 election.

1. *The SEC Rule is one of Strict Liability.*

As Commissioner Hester Pearce points out in her statement critiquing the settlements, the pay-to-play rule is a “blunt” instrument. As a matter of law, there is strict liability under the rule – the intent of the donor does not matter, only the fact that the contribution was made to a certain official above the *de minimis* threshold.

1. *There is Limited Opportunity for Remediation.*

The contributor in the case of the \$1,000 contribution to the Massachusetts candidate sought and obtained a refund of the contribution, but to no avail. A refund of the contribution will only negate the violation if (1) the contribution does not exceed \$350; (2) the adviser discovered the contribution within four months of the date of the contribution; and (3) the contributor obtains a refund within 60 days after learning of the contribution.

Although the SEC’s pay-to-play rule applies throughout the year, the months heading into an election present a heightened risk of inadvertent violations, given the push from campaigns and the desire of donors to support the candidates and causes about which they care. As these settlements show, even a contribution as much as \$50 over the *de minimis* limit can trigger a significant penalty, a reminder of the importance of proactive compliance and vetting.

[1] The SEC pay-to-play rule covers investment advisers, but other financial service providers may be covered by similar rules issued by the Municipal Securities Rulemaking Board (MSRB), the Financial Industry Regulatory Authority (FINRA), and the Commodities Futures Trading Commission (CFTC).