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What Investment Advisers Can Learn From TL Ventures Case

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Law360, New York (September 08, 2014, 10:31 AM ET) -- The U.S. Securities and Exchange Commission recently brought the first action against an investment adviser under Rule 206(4)-5 under the Investment Advisers Act of 1940 (Advisers Act), the so-called "pay-to-play rule." This rule prohibits an investment adviser from receiving compensation for advisory services provided to a government entity, such as a public pension plan, for two years (two-year timeout) following a campaign contribution by the advisory firm or any of its covered associates[1] to a politician, political candidate, or state or local official who is in a position to influence (either directly or indirectly) the selection of the investment adviser to provide advisory services to the public pension fund or other government entity.

Pay-to-Play Rule Background

The pay-to-play rule under the Advisers Act was adopted in 2010 (and became effective in 2011) to end the practice of investment advisers making campaign contributions to elected officials to influence the awarding of lucrative contracts for the management of pension plan assets. Investment advisers covered under the rule include those who are registered or required to be registered under the Advisers Act, those who are unregistered in reliance on an exemption and exempt reporting advisers.

This prophylactic rule is designed to ensure an even playing field for the selection of investment advisers for government entities, where selection is based on quality of the service provided by the investment adviser rather than political favors for contributions. Although its intent is to limit corruption, the pay-to-play rule requires no showing of intent to influence government officials or candidates for office or any quid pro quo arrangement.

TL Ventures Action

TL Ventures Inc., a Pennsylvania-based adviser to venture capital funds that invest in early-stage technology companies, was accused of accepting advisory fees from city and state pension funds after a covered associate made campaign contributions that triggered the two-year timeout.

In 2011, the co-founder of TL Ventures contributed $2,500 to the campaign of a Philadelphia mayoral candidate and $2,000 to the governor of Pennsylvania. Although neither elected position directly selects investment advisers for government clients, each office does have direct influence over those officials who make the hiring decisions for public pension funds.

The governor appoints six of the 11 members of the board of the Pennsylvania State Employees' Retirement System (state pension), while the mayor of Philadelphia appoints three of nine members of the City of Philadelphia Board of Pensions and Retirement (city pension).

Although TL Ventures does not provide advisory services directly to the state pension or city pension, it does manage pooled investment vehicles in which both pensions invest. The state pension has invested in two funds managed by TL Ventures since 1999 and 2000, with a total commitment of $75 million across the two funds. The city pension has invested in a TL Ventures fund since 2000, with a total commitment of $10 million. The pension investments are in the form of limited partnership interests in the TL Venture funds and generally are for the life of each fund, with limited ability to withdraw from the funds.

At the time the alleged improper advisory fees were accepted, each fund was in wind-down mode; however, the state pension and city pension remained limited partners through this process. Although TL Ventures did not provide advisory services directly to a government entity, under the pay-to-play rule, advisers to covered pooled investment vehicles in which a government entity invests or is solicited to invest are treated as though the investment adviser is providing services directly to the government entity.

Even though the SEC did not demonstrate corruption or an attempt to influence government officials, TL Ventures, without admitting or denying any wrongdoing, ultimately settled the action for $295,000 in sanctions, the majority of which was disgorgement of advisory fees.

Next Steps for Covered Advisers

In a statement released after the settlement announcement, SEC Enforcement Division Director Andrew Ceresney said, "We will use all available enforcement tools to ensure that public pension funds are protected from any potential corrupting influences .... As we have done with broker-dealers, we will hold investment advisers strictly liable for pay-to-play violations." Now that the SEC has brought its first action under the pay-to-play rule, and given Ceresney's statement, investment advisers should consider taking steps to strengthen their internal pay-to-play compliance programs.

Advisers who provide services to government clients or those who plan to solicit government clients should review existing policies and procedures to ensure compliance with the pay-to-play rule. Advisers who conduct business with governmental pension plans must closely monitor covered associates' political contributions and stress during training of new associates the need for attention to these policies. Investing in strong compliance policies and effective procedures can provide considerable cost savings when the alternative might be up to two years of lost advisory fees.

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[1] A covered associate includes (1) any general partner, managing member, or executive officer or other individual with a similar status or function; (2) any employee who solicits a government entity for the investment adviser and person who supervises, directly or indirectly, such employee; and (3) any political action committee controlled by the investment adviser or any person described in (1) or (2) above.