It's Election Season: Investment Advisers Beware of the SEC Pay-to-Play Rule

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With highly contested midterm elections less than three months away, investment advisers must be aware of, and pay close attention to, the Securities and Exchange Commission's (SEC) pay-to-play rule governing their business, SEC Rule 206(4)-5. The rule provides that when investment advisory firms and their covered associates make political contributions to certain candidates, the firms are prohibited from providing services for compensation to the governmental entities that the candidates can control or exert influence over. The rule also prohibits solicitations of contributions to these candidates and political parties, the violation of which is subject to substantial penalties. This article focuses on the key aspects of SEC Rule 206(4)-5, whose application to the rough and tumble world of political fundraising is notoriously complex.

Those who work in the financial industry should also be aware of the following additional four pay-to-play rules, which are similar to SEC Rule 206(4)-5:

- Municipal Securities Rulemaking Board Rule G-37, which applies to brokers, dealers, municipal securities dealers, and municipal advisers.
- Financial Industry Regulatory Authority Rule 2030, which applies to covered members of FINRA that are broker-dealers acting as placement agents for an investment adviser.
- Commodity Futures Trading Commission Rule 23.451, which applies to non-security-based swap dealers.
- SEC Rule 240.15Fh-6, which applies to security-based swap dealers.

Which Firms and Covered Associates Trigger the Rule Based on Their Political Contributions and Solicitations?

SEC Rule 206(4)-5 applies to investment advisers registered or required to be registered with the SEC, exempt foreign private advisers, and exempt reporting advisers. The rule also applies to covered associates of these advisers who are: (1) any general partner, managing member, or executive officer; (2) any employee who solicits a government entity for investment advisory business, and any person who supervises that employee; and (3) any PAC controlled by the investment adviser or any of its covered associates.

When a government entity invests or is solicited to invest in a covered investment pool, the adviser to the pool is treated as if it provides or seeks to provide advisory services directly to any government entity that invests or is solicited to invest in the pool. Examples of covered investment pools are collective investment trusts, hedge funds, private equity funds, and venture capital funds. Mutual funds are covered investment pools if they are an investment option of a government entity's plan or program, such as a Section 529 college savings plan, a Section 403(b) retirement plan, or a Section 457 retirement plan.

Which Candidates That Receive Contributions and For Whom Solicitations Are Made Trigger the Rule?

SEC Rule 206(4)-5 applies to contributions to, and solicitations for, an official of a government entity. It also applies to solicitations for a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

An official of a government entity means any person, including any election committee for that person, who was, at the time of the contribution, an incumbent, candidate, or successful candidate for elective office of a government entity, if the office: (1) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (2) 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 by a government entity. The focus is on the authority of the official's particular office, rather than the influence actually used by the official.

A government entity means any state or political subdivision of a state, and a plan or program of a government entity. This definition covers a pool of assets sponsored or established by a state or political subdivision, such as a Section 529 college savings plan, Section 414(j) defined benefit plan, Section 403(b) retirement plan, Section 457 retirement plan, and a general fund.

The definition of an official of a government entity covers persons who serve as an ex officio member of the governing body of a government entity. It also covers persons who hold an office that has the statutory authority to appoint a member of the governing body of a government entity.

An official of a government entity includes persons who hold state or local office and who are also candidates for federal office. It also includes federal officeholders who are candidates for state or local office. It does not include federal candidates who do not hold state or local office, nor does it include state, county, and municipal candidates for an office that does not have any responsibility or authority for the hiring of investment advisers.

A contribution to a political party, PAC, or other committee is not subject to SEC Rule 206(4)-5 unless it is a means to do indirectly what the rule prohibits if done directly. For example, a contribution is earmarked or known to be provided to benefit a particular government official. A contribution to an independent expenditure committee, otherwise known as a Super PAC, is not subject to the rule.

What Are the Contributions and Solicitations That Trigger the Rule?

SEC Rule 206(4)-5 applies to a contribution to an official of a government entity made within the prior two years. For a newly hired covered associate, and a person who has been transferred or promoted to a covered associate, a two-year look-back generally applies to that person's contributions. A six-month look-back

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applies to covered associates who are natural persons unless they solicit clients after becoming covered associates; in this case, the two-year look-back applies.

For example, a covered associate becomes employed and engages in solicitation of clients one year and six months after making a contribution. The adviser would be subject to the rule's prohibition on compensation for the remaining six months of the two-year look-back period. In this situation, the investment adviser would have to delay the start of employment, rescind the employment offer, or forgo the receipt of compensation associated with the government entity's investment.

The termination of employment of a covered associate, or ceasing to qualify as a covered associate, does not prevent his or her contributions made while a covered associate from being attributed to the investment adviser and does not end the two-year prohibition on the receipt of compensation. Accordingly, an investment adviser cannot circumvent SEC Rule 206(4)-5 by funneling contributions through departing covered associates.

The rule also prohibits an investment adviser and its covered associates from coordinating or soliciting any other person or PAC to make: (1) a contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services; or (2) a payment to a political party of a state or locality in which the adviser is providing or seeking to provide investment advisory services to a government entity.

For example, SEC Rule 206(4)-5 prohibits the bundling of a large number of small contributions by employees, or soliciting contributions from vendors. As another example, the rule prohibits a covered associate from acting as an intermediary who collects and distributes, or directs, contributions to candidates. In this manner, the covered associate can ensure that advisers not making the recommended level of contributions are not included among the finalists for advisory contracts.

What Are the Consequences of Violating the Rule?

If the investment adviser or its covered associates make a prohibited contribution, neither the adviser nor its covered associates can receive compensation from the government entity associated with the contribution for two years after making the contribution. Compensation includes both profit and recouping of costs. Since the prohibition is on accepting compensation, an adviser can avoid a violation by refraining from doing business or receiving compensation for that business. In addition, the adviser must continue to provide uncompensated services for a reasonable period to allow the government entity to replace the adviser.

A violation of the anticoordination and antisolicitation provisions does not trigger the two-year ban on the provision of investment advisory services for compensation. Rather, violations of the prohibition on the receipt of compensation and the anticoordination and antisolicitation provisions are subject to civil penalties under Section 203(i)(1)(B) and (2) of the Investment Advisers Act of 1940, as amended.

What Are the Exemptions to the Rule?

SEC Rule 206(4)-5 provides an exemption for contributions made by a covered associate who is a natural person to officials for whom the associate is entitled to vote at the time of the contribution and that in the aggregate do not exceed $350 to any one official per election. The rule also provides an exemption for contributions to officials for whom the covered associate is not entitled to vote at the time of the contribution and that in the aggregate do not exceed $150 to any one official per election.

For example, if a government official is a state governor running for reelection, any covered associate who resides in the state may make an exempt contribution of $350 to the official. If the government official is running for president, any covered associate in the United States may make an exempt contribution of $350 to the official's presidential campaign.

What Forms of Remedial Relief Are Available for Violations of the Rule?

SEC Rule 206(4)-5 provides for two forms of remedial relief for violations. First, the SEC, upon application, may conditionally or unconditionally exempt an investment adviser from the two-year prohibition on the receipt of compensation. In determining whether to grant an exemption, the SEC considers:

- Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Advisers Act; and
- Whether the investment adviser: (a) before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations; and (b) prior to or at the time the contribution that resulted in the prohibition was made, had no actual knowledge of the contribution; and (c) after learning of the contribution:
    - has taken all available steps to cause the contributor involved in making the contribution that resulted in the prohibition to obtain a return of the contribution; or
    - has taken such other remedial or preventive measures as may be appropriate under the circumstances;
- Whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment;
- The timing and amount of the contribution that resulted in the prohibition;
- The nature of the election (e.g., federal, state, or local); and
- The contributor's apparent intent or motive in making the contribution that resulted in the prohibition, as evidenced by the facts and circumstances surrounding the contribution.

Second, an investment adviser subject to the two-year prohibition on the receipt of compensation due to a contribution made by a covered associate receives an automatic exemption upon satisfying the following requirements:

- The investment adviser discovered the contribution within four months of the date of the contribution;
- The contribution must not have exceeded $350; and
- The contributor must obtain a return of the contribution within sixty calendar days of the date of discovery of the contribution by the investment adviser.

In any calendar year, an investment adviser that has reported on its annual updating amendment to Form ADV that it has more than 50 employees is entitled to no more than three automatic exemptions. An investment adviser that has reported on its annual updating amendment to Form ADV that it has 50 or fewer employees is entitled to no more than two automatic exemptions. Regardless of these annual limits, an investment adviser may not rely on the automatic exemption more than once with respect to contributions by the same covered associate, without regard to the time period between the contributions.

What Are Best Practices for Investment Advisers to Comply with the Rule?

The most important step an investment adviser should take to comply with Rule 206(4)-5 is to adopt a preclearance contribution policy that requires all its covered associates, prospective covered associates, and managerial employees above a certain level to obtain permission to make or solicit any contribution. The policy should require the requestor to submit copies of all candidate and party solicitation materials so that the adviser can determine the contribution's purpose and where the funds will be going.

For contributions to joint fundraising committees, the adviser should review the solicitation materials to determine whether there is an allocation of contributions to a covered official, and if there is, instruct the joint committee how to allocate the contribution to ensure that it does not go to that official. Most presidential campaigns have established alternate joint fundraising committees that support national party committees and candidates for whom contributions do not trigger the Rule.

An investment adviser should also require its covered associates and prospective covered associates to periodically certify that all their political contributions have been disclosed and approved in accordance with the contribution policy. Since the automatic exemption applies to contributions discovered within four months, the adviser should obtain certifications frequently enough to timely discover a disqualifying contribution.

Since a preclearance policy and certification requirement protect an investment adviser against the loss of government contracts and the imposition of penalties, they should not be unenforceable as a violation of public policy. Under the Restatement of Employment Law §7.08, an employee has a protected interest in personal autonomy outside of the employment relationship for adhering to or expressing political beliefs in a manner that does not refer to or otherwise involve the employer or its business. An employer is not subject to liability for termination of employment if the employer had a reasonable and good faith belief that the employee's actions interfered with the employer's legitimate business interests.

For the government entities that an investment adviser is currently providing or seeking to provide investment advisory services, or anticipates doing so in the foreseeable future (which can range from one month to five years), the adviser should maintain a list of the following offices: (1) the offices whose holders serve as an ex officio member of the governing body of a government entity; and (2) the offices whose holders have the statutory authority to appoint a member of the governing body of a government entity. The adviser should then maintain a list of the current holders and candidates for these offices and match any request to preclear a contribution against this list.

Investment advisers should maintain a list of their covered associates and employees likely to be promoted to covered associates in the next two years. Advisers should regularly review and update the list. When investment advisers hire a new covered associate, or transfer or promote a person to a covered associate, the adviser should conduct the appropriate due diligence on that person's prior contributions to determine whether his or her new position will trigger the two-year prohibition on the receipt of compensation.

Finally, investment advisers should perform periodic internal audits by searching state election agency databases for contributions by their covered associates and prospective covered associates. The advisers should compare the results of the searches against the certifications made by these persons of their contributions.

Will the SEC Ease the Rule's Restrictions and Reduce Its Complexity?

According to a post on the website of the Office of Management and Budget, the SEC sent proposed changes to Rule 206(4)-5 to the White House for review on August 12, 2026, stating that the changes are intended to address "identified compliance burdens." As investment advisers await the SEC's new guidance, they should sing the lyrics of Thelma Houston's Grammy Award winning song, *Don't Leave Me This Way*, with the fervor of a gospel choir on a Sunday morning: "Don't leave me this way. Don't you understand that I'm at your command. Oh baby, please, don't leave me this way."

Investment advisers with questions about SEC Rule 206(4)-5, political contribution preclearance policies, or related compliance obligations should contact the author or any member of the firm's Fund Formation & Management team for guidance on how the pay-to-play rule may apply to their business and covered associates.