BRACEWELL

INSIGHTS

Private Equity Fund Charged by SEC with Violation of the Pay-to-Play Rules for Investment Advisors

August 7, 2014

The Securities and Exchange Commission ("SEC") recently announced that it had charged TL Ventures, a Philadelphia-area private equity firm (the "Firm") with the first ever case involving a violation of the "pay-to-play rules," Rule 206 (4)-5. The Firm agreed to the disgorgement of almost $257,000 in fees it had earned from the Pennsylvania state retirement system, and Philadelphia's pension plan, as well as prejudgment interest and a penalty of $35,000. In addition the Firm was censured and agreed to cease and desist from committing or causing any future violations of the provisions of the SEC's order.

Rule 206 (4)-5, which was adopted in 2010, prohibits investment advisers from providing compensatory advisory services to a government client for a period of two years following a campaign contribution from the firm, or from defined investment advisors, to any government officials, or political candidates in a position to influence the selection or retention of advisers to manage public pension funds or other government client assets. Some de minimus contributions are permitted, topping out at $350 if the contributor is eligible to vote for the candidate, and the contribution is from the person's personal funds.

In the current case a covered investment advisor at the Firm had made a $2,500 campaign contribution to a candidate for Mayor of Philadelphia, in April of 2011, and a $2,000 contribution to a candidate for Governor of Pennsylvania in November of 2011. Such contributions triggered a mandatory 'time out", prohibiting the Firm from receiving compensation for investment advisor services for two years from the date of each contribution. Rule 206 (4)-5 was implicated because the Mayor of Philadelphia appoints three of the nine members of the Philadelphia Board of Pensions and Retirement, while the Governor appoints six of the eleven members of the Pennsylvania state retirement system. As such, each candidate, if successful, would be in a position to influence the hiring of investment advisors to each of the subject funds.

It should be noted that contributions are not only prohibited to candidates and officials for state or local office that could influence decisions to hire investment advisors for public funds, but also to state officials seeking federal office, which office does not include the authority to influence such decisions.

Moreover, in pursuing this matter the SEC discovered the Firm was not a registered Investment Advisor, having claimed it was exempt from registration, predicated on its work, which was limited to being an advisor to one or more venture capital funds. Moreover, the Firm acknowledged a related firm, Penn Mezzanine Partners Management, L.P., ("Penn") that had also claimed an exemption based on Rule 203 (m)-1, because it acted solely as an adviser to private funds with less than $150 million in regulatory assets under management. Having attracted the attention of the SEC, it quickly became evident the two firms were under common control with each other. The employees and managing directors of the Firm owned over 25% of Penn, they shared management employees, and had overlapping policies and procedures, as well as marketing materials describing the Firm and Penn as partners. Thus, they collectively managed over $150 million in assets, and managed venture funds containing government investments, thereby requiring registration and reporting. As a result the Firm was also found to have violated Sections 203 (a), 206 (4) and 208 (d) of the Investment Advisers Act of 1940.

This case should serve as a wakeup call to any firm providing investment advisory services to a fund to have an effective compliance program in place.