Exemptive Relief Granted Under the Political Contributions Rule After Clearing Significant Procedural Hurdles

In a positive sign for investment advisers, the Securities and Exchange Commission ("SEC") recently approved an application for exemptive relief pursuant to rule 206(4)-5 ("Political Contributions Rule") under the Investment Advisers Act of 1940 ("Advisers Act") allowing an investment adviser to retain the full $37 million of fees at issue following a Political Contribution Rule violation by a covered employee, indicating the SEC's willingness to consider exemptive relief even in cases involving potentially large disgorgements.[1]

The Political Contributions Rule prohibits an investment adviser from receiving compensation for providing advisory services to a government pension plan or other government entity for two years following certain political contributions. The rule also prohibits coordination or solicitation of certain political contributions. Without exemptive relief, investment advisers who violate this rule can be forced to disgorge compensation received from such government entities, and may also be subject to other potential fines or penalties.[2] This positive sign is tempered by the significant conditions and mitigating factors cited by the SEC in granting this relief (described below), which is consistent with the SEC's prior grants of exemptive relief for violations of the Political Contributions Rule. The difficulty of obtaining exemptive relief, coupled with the ease with which violations can occur[3] and the SEC Enforcement Division's active efforts to monitor political contributions through public database searches, all create a high degree of risk for investment advisers relating to political contributions and political fundraising activity by their personnel.

In applying for relief, the adviser noted that:

- the political candidate in question was running for federal and not state office;
- the adviser executive in question had extremely limited or no interaction with the candidate;
- the adviser executive had limited or no interactions with the government entities doing business with the adviser;
- the value of the contribution was within federal limits;
- the adviser was unaware of the executive's intention to make the contribution; and

Attorney Advertising

- the government entities had made the decision to engage the advisory services of the adviser prior to the contribution and had not uncharacteristically increased the amount of their investment following the contribution.
- In granting relief, the SEC also noted the following factors, among others, which it appeared to view as mitigating factors:
- the consequences of the violation would appear disproportionate in comparison to the violation (the adviser would forego fees 13,700 times greater than the value of the contribution);
- the adviser had placed the full $37 million in compensation in an escrow account pending the outcome of the exemptive application;
- the adviser had significant policies and procedures in place to prevent such breaches, including education programs and multiple reminders, some of which policies (a) actually went further than required under the Political Contributions Rule, and (b) were in the process of being made even more stringent as a result of the contribution;
- the adviser executive had sought and received a full refund of the contribution after discovering its prohibited nature; and
- the nature of the contribution was not intended to influence the selection of the adviser as a provider of advisory services to any government entity and the selection of the adviser significantly predated the contribution.

---

1 See SEC Order granting exemption (June 6, 2018). See also SEC Notice of Application (May 11, 2018) and applicant's second Amended Application for exemptive relief (March 28, 2018), describing the facts and the basis for relief. See also applicant's first Amended Application (November 21, 2017) and initial Application (May 26, 2017) for earlier versions of the applicant's descriptions of the facts and basis for exemptive relief.

2 In January 2017, the SEC brought enforcement actions against ten investment advisers for violating the Political Contributions Rule by accepting compensation from public pension fund investors following campaign contributions that triggered the rule. See SEC Press Release, which also contains links to the relevant SEC Consent Orders, and our prior *KirklandAIM* (January 19, 2017).

3 The Political Contributions Rule is drafted in strict liability fashion, allowing a violation to be triggered by a single political contribution or by any amount of political fundraising coordination efforts.

SEC Issues Relief from "Inadvertent Custody" Status in New FAQ Guidance for Separate Accounts

In two new FAQs appearing in the SEC's FAQ guidance on rule 206(4)-2 under the Advisers Act (the "Custody Rule"), the SEC staff provided no-action relief with respect to situations involving what it has termed "inadvertent custody" occurring in the context of certain separately managed accounts.[1] Prior SEC staff guidance[2] had indicated that, where an advisory client has established its own account with a qualified custodian, advisers should exercise caution because the client's custodial agreement with the custodian "may grant an adviser broader access to client funds or securities than the adviser's own agreement with the client contemplates," which might occur, for example, "where the custodial agreement enables the adviser to withdraw, or transfer, client funds or securities upon instruction to the custodian." This might even be the case where the adviser was unaware that the custodial agreement contained such provisions. Under such circumstances the adviser would be deemed to have custody under the Custody Rule although, from the adviser's perspective, only inadvertently.

The SEC staff's more recent FAQ guidance now provides relief in cases of "inadvertent custody" where the following conditions are met:

- the adviser does not have a copy of the client's custodial agreement;
- the adviser does not know, or have reason to know, whether the custodial agreement would give the adviser "inadvertent custody";
- "inadvertent custody" is the sole basis for custody, and there is no other basis for the adviser to be deemed to have custody over the assets in the relevant account;[3] and
- the adviser has not recommended, requested, or required the client's use of the custodian.

---

1 See Questions II.11 and II.12 in the SEC's Staff Responses to Questions About the Custody Rule (posted June 5, 2018).

2 See IM Guidance Update (February 2017).

3 An adviser generally would be deemed to have custody over the assets in a client's account where, for example, the adviser's advisory contract with the client permits the adviser to transfer assets to or from the account (other than in certain narrow cases where the adviser's authority to transfer assets is limited to "delivery versus payment").

If you have any questions about the matters addressed in this *Kirkland AIM*, please contact the following Kirkland attorneys or your regular Kirkland contact.

INVESTMENT FUNDS

Norm Champ, P.C.
norm.champ@kirkland.com
+1 212 446 4966

Kevin R. Bettsteller
kevin.bettsteller@kirkland.com
+1 415 439 1427

Michael Chu
michael.chu@kirkland.com
+1 312 862 2101

Marian Fowler
marian.fowler@kirkland.com
+1 202 879 5171

Elizabeth L. Richards
elizabeth.richards@kirkland.com
+1 212 446 5971

Aaron Schlaphoff
aaron.schlaphoff@kirkland.com
+1 212 446 4996

Jamie Lynn Walter
jamie.walter@kirkland.com
+1 202 879 5069

Corey Zarse
corey.zarse@kirkland.com
+1 312 862 2033

Scott A. Moehrke, P.C.
scott.moehrke@kirkland.com
+1 312 862 2199

Lisa Cawley
lisa.cawley@kirkland.com
+44 20 7469 2140

Matthew Cohen
matthew.cohen@kirkland.com
+1 415 439 4706

Alpa Patel
alpa.patel@kirkland.com
+1 202 879 5141

Jaime D. Schechter
jaime.schechter@kirkland.com
+1 212 446 4979

Robert H. Sutton
robert.sutton@kirkland.com
+1 212 446 4897

Josh Westerholm
joshua.westerholm@kirkland.com
+1 312 862 2007

Tier 1 Investment Fund Formation and Management: Private Equity Funds

The Legal 500 US, 2017

SEC ENFORCEMENT

Kenneth R. Lench
kenneth.lench@kirkland.com
+1 202 879 5270

Erica Williams
erica.williams@kirkland.com
+1 202 879 5044

Robert W. Pommer III
robert.pommer@kirkland.com
+1 212 446 4996

This communication is distributed with the understanding that the author, publisher and distributor of this communication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this communication may constitute Attorney Advertising.

© 2018 KIRKLAND & ELLIS LLP. All rights reserved.

www.kirkland.com