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Political Contributions Cease Funding Rights

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By Michael Mascia
Partner | Fund Finance

A handful of state pensions and other municipal investors in the United States have been including side letter provisions that prohibit principals or persons employed by a fund sponsor from making campaign contributions to a candidate whose elected position can influence the selection of the fund sponsor for investments. Quite similar to the more widely seen placement agent disclosure provisions, the remedy for a breach is often structured to give the municipal investor the right to cease funding capital contributions without being declared a defaulting investor. Not surprisingly, for a subscription lender, this is problematic. First, a lender is looking to underwrite the credit wherewithal of the investor to meet its funding obligations. Underwriting a fund's ability to prevent prohibited campaign contributions is more tenuous. Second, the allocation of risk could result in a windfall for the investor at the expense of the lender: an investment gets acquired on the subscription line and credited ratably to the investor's capital account, but the investor then ceases to be obligated to fund a capital contribution for the previously acquired investment? Often these issues are solved in practice with a tweak to the side letter obligating the investor to fund future capital contributions only to the extent there are amounts outstanding on the subscription facility. However, side letters often get to the lender consummated, and amendments after execution can be challenging.

Investors with political contribution cease funding rights are often just excluded from the borrowing base. But at times, the investor is needed to make the borrowing base for the facility viable. Lenders have on occasion gotten comfortable accepting this risk, rationalizing that if the sponsor has a robust policy prohibiting offending campaign contributions, a violation of the provision is not likely to happen in practice. I mean, it would frankly be awesome if my firm had a prohibition on campaign contributions wholesale, so there would be a built in excuse every time a law school classmate called about their upcoming school board campaign fundraiser.

Perhaps, however, the issue is not as factually hypothetical as it might seem at first. On December 18, 2018, the U.S. Securities and Exchange Commission issued an order in an administrative proceeding against an investment advisor for its alleged violation of Rule 206(4)-5 of the Advisers Act (the rule prohibits campaign contributions by certain investment

advisor personnel to elected officials that can influence the selection of such advisor to manage the assets of government entities and public pension plans). According to the order, personnel at the advisor made campaign contributions to candidates for the offices of governor and treasurer of the State of Ohio. The governor and the treasurer of Ohio each appoint at least one member of the board of the State's public pension system, which makes investment selections. The advisor allegedly was managing investments for the pension system during this time period. Without admitting or denying the allegations, the advisor settled the matter and paid a civil penalty. The advisor was not a small shop; it reportedly had assets under management at the time on the order of $4.6 billion. Thus, it appears the exact facts that could trigger a cease funding right have allegedly occurred. There is no interplay with a subscription facility in the order, a copy of which is publicly available here.