

# VENABLE<sup>®</sup>LLP

## Best Practices for Investment Advisers to Avoid Violating Pay-to-Play Regulations

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# Introduction



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# Outline for Today's Presentation

- Background of Pay-to-Play Regulations
- SEC Rule 206(4)-5
  - Review of Rule/Areas of Confusion
  - Impact of Dodd-Frank
  - Ban on Third Party Marketers
  - CFTC, MSRB, FINRA
- State Pay-to-Play Regulations
- Overview of Corporate Political Law
  - *Citizens United* – Independent Expenditures
  - Types of Entities
- Best Practices
- Questions and Answers/Discussion



# Timeline of Activity

## Timeline

- August 2009 – SEC proposes Rule 206(4)-5
- January 2010 – *Citizens United* decision announced
- June 2010 – SEC approves Rule 206(4)-5
  - Incorporates *Citizens United*
- July 2010 – Dodd-Frank bill signed into law
  - Repeal Section 203(b)(3) exemption
- March 2011 – Pay-to-play restrictions take effect for most advisers
- June 2011 – SEC Amends Rule 206(4)-5
  - Applies to exempt and foreign private advisers
  - “Municipal advisers” are “regulated persons”
  - Third Party Marketer ban effective June 13, 2012



# Timeline of Activity

## Timeline

- September 2011 – Pay-to-play restrictions take effect for managers of “covered investment pools.”
- TBD – FINRA sets placement agent rules
- TBD – MSRB sets pay-to-play rules
  - August 2011 – Rule G-42 proposed
  - September 2011 – Proposed Rule G-42 withdrawn
- TBD – CFTC sets pay-to-play rules for swap businesses
- TBD – SEC sets pay-to-play rules for securities-based swap businesses
- June 13, 2012 – Third party solicitation ban takes effect
- November 2012 – Federal election



# SEC Rule 206(4)-5

## History of Pay-to-Play Regulations

- 1994 – MSRB adopts Rule G-37, designed to reduce pay-to-play in municipal securities underwriting
- 1995 – Constitutionality of Rule upheld in *Blount v. SEC* 61 F.3d 938 (1995)
- 1996 – MSRB adopts Rule G-38, requiring municipal dealers to disclose contracts with third party marketers and consultants
- 1999 – SEC proposes pay-to-play rules similar to Rule 206(4)-5, but they are not enacted.
- 2005 – MSRB Rule G-38 amended to prohibit municipal securities dealers from paying third parties to solicit municipal securities business





# SEC Rule 206(4)-5

## Modeled on MSRB Rules

- Because the SEC Rule is modeled on the MSRB Rules, there are a few key points to consider:
- Although the Rule's constitutionality has not been challenged, it is likely to be upheld under *Blount*.
- SEC has stated that in interpreting the Rule they will give strong consideration to MSRB interpretations.
- MSRB has a Q&A section that is very helpful:  
<http://msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx>



# SEC Rule 206(4)-5

## Three Prongs of the Rule

- Unlawful for adviser to receive **compensation** for providing advisory services to a **government entity** for a two-year period after adviser or a **covered associate** makes a political **contribution** to a **public official** of a government entity or candidate for such office who is or will be in a position to **influence** the award of advisory business;
- Ban on **soliciting** or **coordinating** contributions for **officials** of a government entity adviser seeks to provide advisory services for, or payments to a **political party** of a **state** or **locality** where adviser is providing or seeking to provide advisory services;
- Ban on paying **third parties** to **solicit** government clients unless they are registered broker-dealers or registered investment advisers, in each case themselves subject to pay-to-play restrictions.





# SEC Rule 206(4)-5

## Advisers Subject to the Rule – Pre-Dodd-Frank

Pre-Dodd-Frank, the Rule applied to:

- Any adviser **registered** or **required to be registered** with the Commission;
- Advisers who are unregistered based upon **Section 203(b)(3)** of the Advisers Act, which exempts an adviser **not holding itself out to the public** as an investment adviser and had **fewer than 15 clients during the last 12 months**;
- An adviser to a “**covered investment pool**” which is defined broadly.



# SEC Rule 206(4)-5

## Advisers Subject to the Rule – Post-Dodd-Frank

Post-Dodd-Frank the Rule applies to:

- Any adviser **registered** or **required to be registered** with the Commission
- Advisers to “private funds,” including “exempt reporting advisers” and “foreign private advisers”:
  - Section 203(b)(3)** – Foreign private advisers
  - Section 203(l)** – Venture capital funds
  - Section 203(m)** – Private funds w/ AUM \$150m
- An adviser to a “**covered investment pool**” which is defined broadly.



# SEC Rule 206(4)-5

## Covered Investment Pools

Covered investment pools generally include:

- Investments in private equity, hedge, real estate and venture capital funds;
- Pooled investment vehicle sponsored as a funding vehicle or investment option in government-sponsored plan – i.e., 529, 403 or 457 plans;

Covered investment pool **does not** include:

- Direct investments by a public pension fund;
- Purchase of publicly-offered securities of a registered investment company;
- Where adviser has not solicited government entity's business



# SEC Rule 206(4)-5

## Two Year Ban – “Covered Associates”

The Rule applies to “covered associates,” which includes:

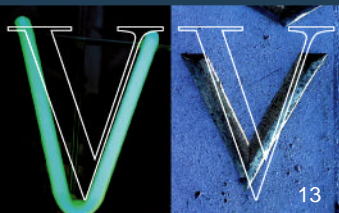
- **“General partners,” “managing members,” “executive officers”** or others with a similar status or function;
- **Any employee** who **solicits a government entity** for the investment adviser and any person who **directly or indirectly supervises** such employee;
- Any **PAC** controlled by the investment adviser or any of the adviser’s covered associates.
- “Executive officer” includes (i) the adviser’s President; (ii) any Vice President in charge of a principal business unit or division; (iii) any other officer who performs a **policy-making function**; or (iv) any other person who performs similar policy-making services for the adviser.



# SEC Rule 206(4)-5

## Two Year Ban – “Covered Associates”

- Look to a person’s function (not title) to see if they are an “executive officer.” Those who serve in a **policy-making capacity** will be subject to the Rule.
- The Rule does **not** apply to non-executive employees, except those who solicit government entity clients.
- Placing an executive who supervises a covered associate outside the corporate structure of the adviser does not prevent the Rule from applying. Thus, a supervisor of a covered associate may reside at a parent company but still be subject to the Rule.
- Advisers may not use non-executive employees to circumvent the rule – i.e., paying employee a bonus so it can be used by the employee to make a political contribution.



# SEC Rule 206(4)-5

## Two Year Ban – PACs and Spouses

- A PAC is **controlled** by the investment adviser or its covered associates if they have the ability to direct or cause the direction of the governance or operation of the PAC.
- The definition of a PAC is **not** limited to organizations registered as a political committee under federal, state or local law. The SEC will employ a “facts and circumstances test” to determine whether something is a political action committee.
- Definition of “covered associate” does not include **spouses**, **directors**, **consultants** or **attorneys**. Note, however, that you still cannot do indirectly that which you are prohibited from doing directly.





# SEC Rule 206(4)-5

## Two Year Ban – Definition of “Official”

- The Rule’s two-year timeout is triggered by a contribution to an “official” of a government entity.
- Includes **incumbent**, **candidate** or **successful candidate** for **elective office** of a government entity.
- Depends on whether the person was an official **at the time the contribution was made**. Thus, a candidate for federal office could be an “official” under the rule.
- The ban is triggered, for example, by a contribution to the **federal campaign** of a current municipal or state officeholder running for federal office.
- A contribution to a **inaugural or transition account** for a victorious candidate for state or local (but not federal) office counts as a contribution to that official.



# SEC Rule 206(4)-5

## Two Year Ban – Ability to Influence Investment Decisions

- Rule applies to officials of government entities who can “influence” the award of advisory business.
- Applies if the office is **directly** or **indirectly** responsible for, or can **influence** the outcome of, the selection of an investment adviser.
- Also applies if the office **has the authority to appoint any person** who is **directly or indirectly** responsible for or can influence the selection of an investment adviser.
- Look to the **scope of authority** for that particular office, not the influence actually exercised.
- Authority must relate to hiring investment adviser. Rule would **not** apply to a public official with audit authority only.



# SEC Rule 206(4)-5

## Two Year Ban – Political “Contribution”

- “Contribution” includes a **gift**, loan, advance, deposit of money, or **anything of value** made for the purpose of **influencing an election**.
- Includes **transition or inaugural expenses** of a successful candidate for state or local office, but **not for federal office**.
- Contributions to **political parties** are not covered unless they are an attempt to do indirectly something prohibited directly – i.e., earmarked for a candidate. They are, however, subject to the **recordkeeping requirements** and the **prohibition on solicitation** described below.
- **Volunteer** campaign activities by covered associates would **not** trigger the two-year ban, however, the use of **office space** or **phone lines** might be considered a contribution.



# SEC Rule 206(4)-5

## Two Year Ban – Two Year (Six Month) Lookback

- The “lookback” period is **generally two years** from the time that the contribution is made.
- **Six-month** period for a natural person who becomes a covered associate, unless that person solicits government clients **after** becoming a covered associate.
- The ban on compensation applies regardless of whether the adviser is aware of the contributions. Ban also applies in case of a merger or acquisition.
- The prohibition continues even if the person who made the contribution **leaves the firm**. It also applies to **any other adviser** that employs the person within the relevant period.
- Requires diligence on the part of fund advisers with respect to new hires.



# SEC Rule 206(4)-5

## Exception – *De Minimis* Contributions

Exception to the two-year timeout for *de minimis* contributions:

- Each covered associate who is an individual can make aggregate contributions of **up to \$350 per election** to an elected official or candidate for whom the individual is “**entitled to vote,**” and up to **\$150 per election** to a candidate the individual cannot vote for.
- Primary and general elections are considered separate elections.
- Person is “entitled to vote” for an official if the person’s **principal residence** is in the locality in which the official seeks election.
- Contributions must be limited to \$350 **before** the primary with an additional \$350 allowed **after** the primary for the general election.



# SEC Rule 206(4)-5

## Exception – Returned Contributions

There is a second exception where the contributions:

- Are made to officials **other than those for whom the covered associate was entitled to vote for** at the time of the contribution;
- In the aggregate **do not exceed \$350** to any one official per election;
- Are discovered **within four months** of being made; and
- Are returned **within sixty days** after discovery.
- This exception is **automatic** if the above criteria is met; however, no adviser can rely on this exception more than **two or three times in a twelve-month period** (depending on the size of the adviser) and an adviser cannot rely on the exception more than once for a particular covered associate.





# SEC Rule 206(4)-5

## Exemption – Factors to Consider

Adviser may apply for an order exempting it from the two-year compensation ban. SEC will consider:

- Whether an exemption would be in the public interest, and whether the adviser
  - **Before** the triggering contribution was made had adopted and implemented **policies and procedures**;
  - Had no actual knowledge of the triggering contribution;
  - After learning of the contribution has taken steps to get a **return** of the contribution and had taken **preventative** measures;
  - The **timing** and the **amount** of the contribution;
  - The **nature of the election** (federal, state or local);
  - The contributor's **apparent intent** or motive in making the contribution, as evidenced by the facts and circumstances surrounding the contribution.

**It is very difficult to get an exemption!!**



# SEC Rule 206(4)-5

## Soliciting Contributions and Payments

- A second prong of the Rule prohibits investment advisors and their covered associates from **coordinating or soliciting** any person or PAC to make a **contribution** to an **official** where the adviser **is providing or seeks to provide** investment advisory services.
- Also prohibits investment advisors and their covered associates from **coordinating or soliciting** any person or PAC to make a **payment** to a **political party of a state or locality** where the adviser is providing or **seeks to provide investment advisory services.**



# SEC Rule 206(4)-5

## “Soliciting” a Political Contribution

- “Soliciting” is defined with respect to a contribution or payment as communicating, **directly or indirectly**, for the purpose of **obtaining or arranging** a contribution or payment.
- An adviser that consents to the **use of its name on fundraising literature** for a candidate would be soliciting contributions for that candidate.
- An adviser that sponsors a meeting or conference that features a government official which involves fundraising would be soliciting contributions for that government official.
- **Facts and circumstances** test is used.



# SEC Rule 206(4)-5

## Recordkeeping Requirements

The Rule requires Advisers to keep record of:

- The name, titles and addresses of all covered associates;
- All govt. entities adviser provided services (past 5 years);
- All govt. entities that invested in a covered investment pool (past 5 years) or selected pool to be an option in a plan or program
- All direct or indirect contributions (or payments) made by the investment adviser or any of its covered associates to:
  - government officials (including candidates);
  - payments to state or local political parties; and
  - payments to PACs
- Information must be presented in a certain format;
- Each “regulated person” adviser has contracted with.



# SEC Rule 206(4)-5

## Ban on Third Party Marketers

- The final prong of the Rule prohibits advisers from paying third parties to solicit government entities for advisory business.
- The Rule makes it unlawful for any investment adviser subject to the Rule or any of its covered associates to provide “**payment**” to any **third party** to “**solicit**” a government entity for investment advisory services.
- The prohibition **only applies to third parties**; does not apply to **any** of the adviser’s employees, general partners or executive officers.



# SEC Rule 206(4)-5

## Ban on Third Party Marketers

- The term “**payment**” broadly includes any gift, subscription, loan, advance or deposit of money or anything of value.
- The term “**solicit**” is defined broadly to mean (i) with respect to investment advisory services, to **communicate, directly or indirectly**, for the purpose of **obtaining or retaining** a client; and (ii) with respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.
- Employ a **facts and circumstance test** to determine whether a particular communication constitutes a “solicitation.”





# SEC Rule 206(4)-5

## Ban on Third Party Marketers -“Regulated Persons” Exception

- There is an exception for payments made to certain **“regulated persons”** to solicit government clients.
- **“Regulated persons”** include **registered broker-dealers** and **registered investment advisers** that are **subject to pay-to-play rules** and, for broker-dealers, are subject to the oversight of a registered national securities association such as FINRA.
- For a **broker-dealer** to be a “regulated person” it must be (i) registered with the Commission and (ii) a member of a registered national securities association (FINRA) with stringent pay-to-play regulations. FINRA is currently considering new pay-to-play regulations for registered broker-dealers.



# SEC Rule 206(4)-5

## Ban on Third Party Marketers -“Regulated Persons” Exception

- An **investment adviser** may be considered a “regulated person” under the Rule if:
  - The adviser is **registered with the Commission** under the Advisers Act;
  - Within the past two years neither the adviser nor any of its covered associates have:
    - Made a contribution to an official of that government entity (other than a *de minimis* contribution)
    - Coordinated or solicited any person (including a PAC) to make a contribution to an official of the government entity or a political party of a state or locality where the adviser is trying to provide advisory services.



# SEC Rule 206(4)-5

## Ban on Indirect Activities to Circumvent Rule

- Rule 206(4)-5 also prohibits acts done **indirectly** which, if done directly, would result in a violation of the rule.
- Prohibits funneling payments through third parties, including, for example, **consultants, attorneys, family members, friends or companies affiliated with the adviser** as a means to circumvent the rule.
- Contributions made through “gatekeepers” would be considered to be made “indirectly” for purposes of the Rule.



# SEC Rule 206(4)-5

## MSRB, FINRA, CFTC and SEC Rulemaking

- MSRB
  - Proposed and withdrew MSRB Rule G-42 for Municipal Advisors
- FINRA
  - Working on developing pay-to-play rules
- CFTC
  - Proposed Rule 23.451 for non-security based swap dealers and major participants
- SEC
  - Proposed Rule 15Fh-6 for security-based swap dealers and major participants



# State Pay-to-Play Rules

Applies on top of SEC Rule

- 15 states have pay-to-play rules
- Many municipalities have their own
- Requirements:
  - Disclosure through either:
    - contracting process
    - lobbying process
  - Prohibitions on receiving contracts
  - Penalties



# Different Approaches

## Issues to Consider

- Which contracts are covered?
  - All
  - No-bid
  
- Which candidates are covered?
  
- Which individuals are covered?
  - Executives
  - Officers
  - Directors
  - Owners



# Corporate Contributions

## Permitted in Some States

- Some states allow direct corporate contributions
- Be mindful of pay-to-play even in states where corporate contributions are allowed
- Limits may apply
- Reporting obligations may apply to donors



# Corporate Contributions

## Federal Rules

- Direct corporate contributions to candidates, PACs, parties prohibited.
- Allowed to support independent expenditure committees (“Super PACs”)
- Allowed to give to nonprofits
- May create PACs
- May engage in fundraising, but must be very careful in use of corporate resources





# Independent Expenditures

## *Citizens United*—what it means and what it doesn't mean

- Distinction between contributions and expenditures
- Entities not affiliated or coordinated with candidate may accept contributions
  - Different types of entities
  - Different types of disclosure
- Important to understand when an entity is allowed to accept funds for independent expenditures
- Impact of SEC Pay-to-Play Rules



# Independent Expenditures

## Considerations for Giving

Entity	Disclosure	Limits on Activity	Tax Issues
501(c)(3)	No	No political	Charitable deduction
501(c)(4)	No	>50% non-political	No deduction
501(c)(6)	No	>50% non-political	Lobbying and political activity is non-deductible
527	Yes – IRS	Generally no express advocacy	No deduction
IE Committee	Yes – FEC	No	No deduction



# Best Practices for Investment Advisers

## Overview

- Recognize That Regulations Are Everywhere
- Know the Organization You Want to Contribute To
- Establish Policies and Procedures
  - Know who is subject to regulations
    - Employees who make policy decisions
    - Employees who market to governments
  - Pre-clear all contributions
  - Update records quarterly
- Consider Optics
- Non-Contribution Political Activities
  - Hosting “meet and greets”
  - Volunteering



# Best Practices for Investment Advisers

## Regulations Are Everywhere

- Consider federal, state and local regulations
  - Multiple layers of regulations
    - Federal
    - State
    - County
    - City/Municipal
    - Public pension fund
  - Regulations often differ
    - Employees covered under rule
    - Spouses
    - Restricted activities
    - Disclosure



# Best Practices for Investment Advisers

## Know the Entity You Are Contributing To

- As simple as it sounds, it is crucial to know the entity you would like to contribute to
  - Who Entity Is Affiliated With – candidate committee, political party or outside organization
  - Type of Entity – candidate committee, party committee, 501(c)(3), 501(c)(4), 527, Super PAC
- Ask who the entity makes contributions to:
  - Not always obvious. Watch out for:
    - Congressional Leadership PACs
    - National party committees
    - Outside organizations - 501(c)(4), 527



# Best Practices for Investment Advisers

## Know The Entity You Are Contributing To

- If there is a possibility the entity can contribute to state and local candidates consider asking:
  - If the Entity Has a Separate Account
  - For Letter Confirming No Earmark/Separate Account
- Applies to outside organizations and party committees
- Transmittal letter from the contributor stating contribution is not earmarked or is going to separate account
- Regulators look favorably upon this



# Best Practices for Investment Advisers

## Establish Policies and Procedures

- Educate Your Employees
  - Establish written policies
  - Annual seminar/training by compliance dept.
- Quarterly questionnaire to all employees
  - Include charitable and political contributions
- Focus on key employees
- Maintain accurate list of covered associates
- Maintain accurate list of government clients
- Screen new hires



# Best Practices for Investment Advisers

## Pre-clearing Contributions

- Crucial to pre-clear contributions
- Develop standard approval form
- Timely review
- If possible, pre-clear for all employees. If not focus on:
  - People who make policy decisions
  - People who market to public pension funds
- If possible, pre-clear:
  - Political and charitable contributions
  - Include covered associates and their spouses
- Avoid outright ban on contributions





# Best Practices for Investment Advisers

## Bundling/Soliciting Contributions

- Bundling/solicitation activities should be pre-cleared.
  - Serving on Host Committee
  - Meet and greets at firm offices
  - Review invitations
    - Wording of invitation/solicitation
    - No corporate stationery, logos
  - Use of corporate resources, email account
  - Make sure solicitation is a request, not demand
  - Requires coordination between marketing and compliance departments



# Best Practices for Investment Advisers

## Transmittal Letters for Contributions

- Generally, transmittal letters are not necessary
- Helpful where contribution is to an entity that itself can contribute to or support state or local candidates
  - Separate Account
  - No Earmark
- Should be short and to the point
  - Amount
  - Which Election
  - Disclaimer – “To best of my knowledge . . . .”
- Avoid linkage to legislation
- Consider optics



# Best Practices for Investment Advisers

## Hosting Fundraising Events

- Two Options
  - Volunteer
  - Restricted class
- Volunteer
  - No corporate resources should be used
  - Prepayment for staff time
- Restricted class
  - May solicit executive personnel
  - May not collect or touch checks
  - May host event using corporate resources



# Best Practices for Investment Advisers

## Other Considerations

- Consider Optics
  - Timing
  - Host Committee
  - Solicitations
- Volunteering
- Disclosure Requirements
  - Know the legal entity
- Contribution Limits
- Gift and Lobbying Restrictions



# Best Practices for Investment Advisers

## Non-Fundraising Events

- Meet and Greet
  - Sitting officeholders
  - Avoid candidates
- Make clear purpose of event
- Do not solicit contributions
- Do not treat as in-kind to candidate
- Make certain any food or drink complies with gift rules



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