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  - September 2011 – Proposed Rule G-42 withdrawn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 securites-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
- **1996** – MSRB adopts Rule G-38, requiring municipal dealers to disclose contracts with third party marketers and consultants
- **1999** – SEC proposes play-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.
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.
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.
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.
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.
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.
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.
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!!**
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.
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.
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.”
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

<table>
<thead>
<tr>
<th>Entity</th>
<th>Disclosure</th>
<th>Limits on Activity</th>
<th>Tax Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>501(c)(3)</td>
<td>No</td>
<td>No political</td>
<td>Charitable deduction</td>
</tr>
<tr>
<td>501(c)(4)</td>
<td>No</td>
<td>&gt;50% non-political</td>
<td>No deduction</td>
</tr>
<tr>
<td>501(c)(6)</td>
<td>No</td>
<td>&gt;50% non-political</td>
<td>Lobbying and political activity is non-deductible</td>
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<tr>
<td>527</td>
<td>Yes – IRS</td>
<td>Generally no express advocacy</td>
<td>No deduction</td>
</tr>
<tr>
<td>IE Committee</td>
<td>Yes – FEC</td>
<td>No</td>
<td>No deduction</td>
</tr>
</tbody>
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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 Greets
  - 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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