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# Pay to Play

## How Can Hedge Fund Managers Participate in the Political Process without Violating Pay to Play Regulations at the Federal, State, Municipal or Fund Level?

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As the campaign season heats up, hedge fund managers who wish to engage in the political process are confronted with a conundrum. On one hand, the Securities and Exchange Commission (SEC) and individual states, municipalities and public pension funds have enacted a variety of pay-to-play regulations designed to limit political involvement by investment advisers who manage money on behalf of public pension funds. The penalties for even a minor violation of these rules can be severe.[1]

On the other hand, last year's Supreme Court decision in *Citizens United v. Federal Election Commission*[2] reaffirmed the right of corporations, unions and individuals to make independent expenditures in connection with federal elections as protected free speech under the First Amendment. The Court expressly rejected the argument that independent expenditures lead to government corruption or the appearance of government corruption,[3] while at the same time upholding reasonable restrictions on direct political contributions to candidates for office and rules requiring disclosure of donors.

The result is a confusing duality where political "contributions" may be regulated on pay-to-play grounds yet independent "expenditures" are permitted as free speech. Adding to the complexity is the variety of entities and organizations that now engage in the political process. There are candidate committees; national party committees; state and local political parties; separate segregated funds (also known as political action committees or PACs); 501(c)(3), 501(c)(4) and 527 outside organizations; 501(c)(6) trade associations; "Super PACs"; Joint Fundraising Committees (JFCs); inaugural and transitional committees; officeholder accounts; and a number of others.

These entities may allow donors to participate in the political process more efficiently and effectively. However, the variety of organizations creates challenges when combined with complex, broadly drafted statutes in overlapping jurisdictions. Moreover, several entities may contribute money to candidates and parties at multiple levels of government, increasing the risk of an inadvertent violation of pay-to-play statutes.

### *The New SEC Rule*

The most significant development in this area has been the enactment of SEC Rule 206(4)-5 ("Rule"), which went into effect earlier this year. The cornerstone of the Rule is a two-year ban on compensation if one of an adviser's "covered associates" makes a political contribution in excess of a *de minimis* amount identified in the Rule to an official or candidate who has the ability to influence the hiring of investment advisers of a government entity. With the elimination of the 203(b)(3) "private adviser" registration exemption under Dodd-Frank, the Rule applies to virtually all domestic fund managers seeking to manage money on behalf of public pension funds.

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The Rule is sweeping in scope. It covers all contributions to candidates who have or would have the ability to directly or indirectly influence the hiring of investment advisers. This includes officials who sit on a public pension fund board as well as those who have the authority to appoint individuals to such boards. The ban on compensation is an absolute prohibition on all compensation a fund manager would have otherwise been entitled to – including management fees and carried interest – and the exemptions are very limited, even for inadvertent violations.

The SEC Rule also includes a prohibition on indirect contributions through third parties, which creates certain complexity. For example, many Members of Congress have "Leadership PACs." Although Members of Congress serve at the federal level, their Leadership PACs may make significant contributions to state candidates and political parties, thereby triggering a pay-to-play violation. In addition, although the SEC Rule generally restricts contributions to state and local candidates for office, it also applies to state officeholders running for federal office.[4] Thus, contributions to Presidential candidate Gov. Rick Perry or even federal party committees (e.g. DCCC, NRSC) under certain circumstances might trigger the Rule.

Here are a few best practices that can help minimize the risk of a violation of the SEC Rule as well as state and local pay-to-play regulations:

### *Be Aware That Rules Are Everywhere*

Pay-to-play restrictions exist at the federal, state and municipal level, with jurisdictions around the country (particularly counties and cities) enacting new regulations seemingly every day. These regulations differ, sometimes significantly, from state to state and city to city and may be modified by self-interested lawmakers on a regular basis.

Many of these regulations may be violated by a range of activity that goes well beyond contributing money to a candidate. Violations may result from hedge fund manager employees soliciting contributions for a candidate or cause, hosting a non-fundraiser "meet and greet" for a candidate or incurring costs when volunteering their time. Contributions to non-candidate entities, even 501(c)(3) charitable organizations, can result in a violation.[5] These regulations generally apply to some (but not all) of a manager's employees and may or may not apply to a manager employee's spouse or relatives. Finally, many regulations impose recordkeeping requirements. See "Recent SEC No-Action Letter Outlines Alternative Recordkeeping Regime for Compliance with the Pay to Play Rule," The Hedge Fund Law Report, Vol. 4, No. 33 (Sep. 22, 2011).

For an investment adviser marketing its services to public pension funds across the country, this can create a complicated minefield of potential liability. Focusing on the SEC Rule is necessary, but alone is not sufficient to ensure compliance with the multiple layers of regulations one is likely to encounter, particularly when marketing in states that have had prior scandals such as California, Illinois, New York and New Jersey.

Hedge fund managers must ensure that all manager employees are aware that pay-to-play regulations exist at multiple levels of government, and that a violation may be triggered by a wide variety of activities.

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### *Know the Candidates and Organizations You Are Contributing To*

Each of entities identified above has different rules regarding the activities it is permitted to engage in, the candidates it may support and its requirements regarding donor disclosure. In order to minimize the risk of an inadvertent violation, before making any political contribution, a fund manager should know the type of entity he or she is contributing to because this will determine several key items, including: (1) where the organization can spend money; (2) whether the contribution will be disclosed; and (3) whether the contribution counts against contribution limits.

### *Know How and Where the Organization Spends Its Money*

Most pay-to-play statutes prohibit investment advisers from using third party entities (such as the ones described above) as a conduit to circumvent contribution restrictions.[6] Therefore, before making a contribution, fund managers should inquire how and where the entity spends its money, with a particular eye towards whether the entity supports state or local candidates or parties – thereby increasing the risk of implicating pay-to-play statutes. One cannot assume that just because a federal candidate or officeholder is making the solicitation, money contributed to the organization will be spent solely on federal activities. National party committees (e.g. RNC, DNC), Federal Leadership PACs and outside organizations have wide latitude to contribute to state parties and candidates for office.

- Ask for a Letter. If an entity can contribute to or make expenditures on behalf of state candidates or parties, the donor should ask the entity for a letter confirming that the donor's contribution is not being earmarked for a particular candidate, party or committee. Such letters carry significant weight with regulators and are very helpful in demonstrating that a donor is not attempting to circumvent regulations.
- Ask About a Separate Account. Several organizations have established separate operating accounts where the funds will not be spent on contributions or expenditures for state or local matters. Donors should ask if the organization has created such a separate account and, if so, request that the contribution be placed in such account. The donor should request a letter confirming the contribution has been placed in a separate non-state or local account.

### *Consider Donor Disclosure Requirements for Various Entities*

Certain entities have different disclosure requirements regarding the identity of donors. Contributions to 501(c)(3) and 501(c)(4) organizations, for example, are generally not disclosed while contributions to individual candidates, national committees, Leadership PACs and 527 organizations are disclosed. Importantly, independent expenditures often do need to be disclosed and the Supreme Court has upheld disclosure requirements.

If a donor wants to avoid public disclosure of his or her contribution, particularly if the contribution is sizeable, the donor should ensure that any contribution is made to an entity that does not disclose its donors. Donors should avoid establishing a corporate entity for the sole purpose of avoiding disclosure requirements.[7]

### *Be Mindful of Federal Contribution Limits*

Federal law limits the amount of money an individual can contribute to federal candidates, political action committees

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and party committees in any one year and election cycle. Donors should know which contributions count against these limits and which do not.

### *Educate Your Employees*

The best defense against an inadvertent pay-to-play violation is a well-educated team, combined with detailed procedures that are followed by all employees of the manager. Creating a culture of compliance is paramount, and all manager employees should be educated and trained regarding pay-to-play restrictions.

#### *Establish Policies and Procedures*

Every manager should have a document that sets forth the manager's policies with respect to political and charitable contributions and describes in detail the procedures that must be followed before an employee or his or her spouse can make a contribution. Each employee should sign a document certifying that he or she has read the policy and agrees to follow the identified procedures.

The compliance department should give periodic, at least annual, seminars that all officers and marketing personnel (if not all manager employees) should be required to attend. For managers with multiple offices, these seminars can be done by webinar and recorded, with tracking software enabled to ensure that the entire program has been viewed.

#### *Focus On the Employees Most Likely to be Subject to Restrictions*

Most pay-to-play statutes cover a subset of a manager's employees, which may vary from jurisdiction to jurisdiction. Some regulations also include an employees' spouse and other relatives. Generally, however, pay-to-play regulations focus on two categories of personnel: (1) executives or officers of the manager; and (2) people who market the manager's funds to public pension funds.[8] While it is advisable for a manager to educate, train and preclear contributions from all employees, particular focus should be placed on these two categories of employees because they are the riskiest categories of employees.

#### *Preclear Political and Charitable Contributions, Bundling Efforts and Solicitation Materials*

It is crucial that political and charitable contributions be reviewed by the compliance department or outside counsel before a check is sent or money is wired. Unless the number of employees makes it impracticable, it is advisable to preclear contributions for all manager employees. The compliance department should develop standard contribution preclearance and approval forms, and aim to have all contribution requests processed in a timely manner.

Due to new restrictions on soliciting contributions, manager employees should also receive preclearance before they solicit or bundle contributions or otherwise fundraise on behalf of a candidate or political entity. If employees are cleared to solicit contributions, they should preclear the invitation or contribution form they distribute in order to ensure it includes all disclaimers required under federal or applicable state law.

#### *Screen the Contribution History of New Hires*

Because the Rule has a two-year "lookback" period, the contribution history of potential new hires should be reviewed prior to an individual being hired. The SEC has made clear that the "lookback" period applies to all new hires, even in the

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case of a merger/acquisition, and a manager will ultimately be subject to a ban on compensation if a new hire has made prohibited contributions. See "How Will the SEC's New Pay to Play Rule Impact Mergers and Acquisitions of Hedge Fund Management Companies?," The Hedge Fund Law Report, Vol. 3, No. 31 (Aug. 6, 2010).

In addition to asking a potential hire about his or her contribution history, the personnel department should conduct an online search of the individual's contribution history as part of a general background check.

### *Transmittal Letter*

Where appropriate, a brief transmittal letter should accompany a check indicating that the donor is subject to pay-to-play restrictions and the contribution is being made with the understanding that the funds are being used solely to support the candidate's re-election, are not being earmarked for any particular candidate or party, and/or that the funds are to be deposited into a separate operating account (see above).[9] In other situations, a transmittal letter may accompany a check indicating which election the contribution is for – i.e., primary or general election – and whether the contribution is coming from personal or corporate resources.[10] Under no circumstances should the letter ever reference legislation or contain anything giving the appearance that the contribution is linked to a vote for or against legislation. Fund managers should avoid writing personal notes to the legislator or candidate receiving the contribution.

### *Distribute Quarterly Questionnaires*

In order to catch rogue contributions in a timely manner, compliance departments should distribute quarterly questionnaires to officers and those who market to public pension funds asking if they have made any contributions or engaged in other political activity during the prior quarter.

### *Be Mindful Of Coordination*

While independent "expenditures" are generally permissible under most pay-to-play statutes,[11] political "contributions" may trigger a pay-to-play violation. The difference between a "contribution" and "expenditure" is not always clear, and at the federal level depends on whether the expenditure was "coordinated" with a federal candidate. Certain actions or expenditures are treated as contributions to a candidate, and should be watched with care:

- Hosting Events. Money spent hosting an event – i.e. food and drinks, catering, parking, etc. – may be considered a contribution to the candidate or party, regardless of whether the event is at the employee's home or office.[12] This is true even for "meet and greet" events, where no contribution is required to attend and no direct solicitation for funds is made.
- Use of Corporate Resources. Corporations[13] are prohibited from making contributions or expenditures in connection with federal elections, so as a general rule, manager employees should avoid using corporate resources to fund or support their political activities (e.g., making phone call solicitations from an office phone)[14] without first clearing it with the compliance department. In certain circumstances, corporate facilities may be used for activities such as phone banking, creating or copying campaign materials, flying candidates on corporate aircraft, etc., but complex reimbursement rules are likely to apply.
- Volunteering. Volunteering for a candidate is generally

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permissible under pay-to-play statutes. However, expenditures made to support volunteer efforts, e.g., travel and food, may be considered in-kind contributions to the candidate subject to contribution limits and disclosure.

### *Avoid an Outright Prohibition*

While it might be tempting for a fund manager to institute a policy preventing all employees from making political contributions, many state labor laws prevent an employer from instituting an outright ban on political activity.[15]

## *Keep Optics in Mind*

### *Consider the Timing of Contributions*

Just because a political contribution does not run afoul of pay-to-play rules does not mean that it is advisable. Fund managers should consider the optics surrounding a political contribution, particularly its timing. The House Ethics Committee has launched numerous investigations of elected officials who solicited political contributions while legislation was about to be voted on, even where the official's position on the legislation is well known.[16] If an elected official is about to vote or has just voted on a major piece of legislation impacting the hedge fund industry, a fund manager should be cautious about making a contribution at that time.

### *Be Cautious With Solicitation Letters and E-mails*

New solicitation/fundraising restrictions placed on investment advisers by the Rule, together with disclaimer requirements and restrictions on the use of corporate resources, create numerous potential pitfalls for manager employees who solicit or bundle contributions. First, it is crucial that manager employees speak with the compliance officer or outside counsel before soliciting or bundling contributions on behalf of a candidate or political organization.

If the solicitation activity is approved, there are a few key points to keep in mind. Because federal law and many states prohibit the use of corporate resources to support candidates, solicitation letters should be written on personal rather than corporate stationary and the individual should pay all postage and mailing costs. The candidate or committee may then reimburse these costs or they can be treated as an in-kind contribution. When e-mailing solicitation letters, manager employees should e-mail solicitations from a personal rather than corporate e-mail account. While a fund manager is not likely to face prosecution because one of its employees solicited contributions from a corporate e-mail account, it could lead to negative publicity.[17] As noted above, federal and state election law frequently require invitations to contain certain disclaimers, and employees should ensure any invitation or form they send out include necessary disclaimers.

Fund managers should be careful not to put anything in e-mail, particularly a fundraising solicitation, that could prove to be embarrassing. A good rule of thumb is to assume that any e-mail you send out will be forwarded on to press outlets. See "Key Elements of Electronic Communications Policies and Procedures for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 3, No. 44 (Nov. 12, 2010).

### *Serving On a Host Committee*

Manager employees should confer with their compliance department prior to agreeing to serve on the Host Committee for a political fundraiser. Even if the employee does not actively bundle or solicit funds for the event, appearing on an invitation as a member of the Host Committee could be

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considered a "solicitation" under pay-to-play regulations and thereby trigger a violation.[18]

### *Gifts, Placement Agents and Lobbying*

In addition to pay-to-play rules, fund managers must keep in mind that there are also federal, state and local regulations involving gifts to elected officials, the use of placement agents and disclosure of lobbying activities. Although these issues are beyond the scope of this article, fund managers need to be extremely cautious about providing gifts to elected officials, including buying meals or paying for travel, and the use of outside placement agents. Funds that have hired lobbyists also need to ensure that all required disclosures are being made. See "How Much Are In-House Hedge Fund Marketers Paid, and How Will Recent Developments in New York City and California Lobbying Laws Impact the Compensation Levels and Structures of In-House Hedge Fund Marketers (Part Three of Three)," The Hedge Fund Law Report, Vol. 4, No. 20 (Jun. 17, 2011).

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[1] The penalty for a violation of the SEC Rule, discussed below, is a two-year ban on compensation, which can result in the fund manager forfeiting millions of dollars in fees.

[2] 558 U.S. 08-205 (2010).

[3] The Court concluded that "independent expenditures, including those made by corporations, do not give rise to corruption or the appearance of corruption. . . . In fact, there is only scant evidence that independent expenditures even ingratiate. . . . Ingratiation and access, in any event, are not corruption."

[4] For example, the State Treasurer of Nevada recently lost a special election for U.S. Congress and the State Treasurer of Ohio is currently running for the U.S. Senate.

[5] For example, most inaugural committees are set up as 501(c)(3) organizations and money contributed to a winning state or local candidate's inaugural committee counts as a "contribution" under the SEC Rule.

[6] The Rule expressly bars investment advisers from doing indirectly that which they are prohibited from doing directly, e.g., funneling contributions to prohibited officials via third party intermediaries.

[7] Recently, an individual created a Delaware limited liability company that made a $1 million contribution to a "Super PAC" supporting a particular Presidential candidate without being required under Delaware law to disclose the identity of the person making the contribution. The LLC was dissolved three months after the contribution was made. After facing significant negative press and causing his candidate a major headache, the donor ultimately ended up disclosing his name. This has also resulted in a formal complaint with the FEC.

[8] The Rule, for example, covers all of the manager's "covered associates," which generally includes executives and individuals who market the manager's funds to public pension funds.

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[9] The wording of the transmittal letter will vary depending on what entity the donor is contributing to.

[10] Corporations cannot make contributions to federal candidates or committees. Before a corporate contribution is made, the manager should make absolutely sure this is permitted for the jurisdiction in question.

[11] The Rule permits independent expenditures so long as they are not an attempt to do something indirectly that one is prohibited from doing directly.

[12] Under federal election law, individuals who host an event at their home can spend up to $1,000 ($2,000 per couple) on food and beverages without that counting as an in-kind contribution to a candidate or committee.

[13] Of course, most hedge fund managers are not corporations. For non-corporations, the Federal Election Commission generally looks to state law to determine the entity's corporate status. For LLCs, the determination is based on whether the LLC has elected to be treated as a corporation for tax purposes. 11 C.F.R. § 110.1(g). In order to avoid even the appearance of impropriety, fund managers should refrain from using their "corporate" resources even if their corporate structure includes LLCs, LLPs, LPs, etc. Moreover, the use of these resources may trigger an in-kind contribution subject to contribution limits and disclosure.

[14] Federal law permits the "occasional, isolated or incidental" use of corporate resources for volunteer activities. Anything more than the "occasional, isolated or incidental" use must be reimbursed at a "normal and usual" rate, otherwise it will be deemed to be an in-kind contribution.

[15] See, e.g., California Labor Code § 1101.

[16] In 2010, the House Ethics Committee investigated eight Members of Congress who held fundraisers around the time that Dodd-Frank was being voted on. Although all Members were ultimately exonerated, there was considerable negative publicity for both the officials and some of the donors.

[17] There have already been articles written about fund managers soliciting contributions for Presidential candidates from corporate e-mail accounts.

[18] The Rule defines "solicit" as "to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment."

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