COMPLIANCE CORNER

Election 2016: "Pay-to-Play" Considerations for Investment Advisers

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The 2016 elections are on pace to be the most expensive in American history. As a result of a series of Supreme Court decisions and legislative developments, politicians and their supporters have an unprecedented array of tools for raising and spending campaign cash. Political donors have responded with a surge in campaign contributions—ranging from the average of $27 contributed to Senator Bernie Sanders' Presidential campaign to contributions in the tens of millions to the independent political committees known as "Super PACs."

This state of affairs poses special challenges for investment advisers. In particular, advisers are subject to a broad range of "pay-to-play" regimes that can be implicated by their employees' political contributions and that can result in the adviser being banned from doing business with certain government entities for a period of years. These include the Securities and Exchange Commission ("SEC") pay-to-play rule for investment advisers, known as SEC Rule 206(4)-5, as well as a range of state, local, and even entity-specific regimes. The increasing volume of political giving—and the corresponding likelihood that advisers' employees and executives will make contributions that implicate pay-to-play regimes—raises the compliance stakes for investment advisers. This concern is exacerbated by the profusion of new political vehicles, each of which can pose unique pay-to-play compliance risks.

In this article, we address the key pay-to-play compliance issues for the 2016 election. We begin with a brief overview of relevant pay-to-play laws, including the key prohibitions imposed by SEC Rule 206(4)-5. We then identify the most relevant campaign finance trends, and describe the range of political financing vehicles. Lastly, we suggest potential compliance approaches for covered advisers to deal with established and emerging pay-to-play risks.

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SEC Rule 206(4)-5

The most significant pay-to-play rule for investment advisers is SEC Rule 206(4)-5, which applies to SEC-registered investment advisers, foreign private advisers, and exempt reporting advisers (together, "Covered Advisers"). The Rule is intended to prevent Covered Advisers from influencing the award of advisory business by making political contributions to officials with direct or indirect authority over investment decisions. SEC Rule 206(4)-5 imposes two key election-related restrictions as well as a broad anti-circumvention provision, each of which is described below.

1. The Two-Year Ban

The first restriction is known as the "Two-Year Ban." Essentially, the ban provides that when a Covered Adviser or certain of their key employees makes a political contribution to certain candidates, the Adviser will be prohibited from doing business with certain public sector entities for a period of two years. For the ban to be triggered, each of the following three elements must be met:

- **There must be a qualifying "contribution."** The term "contribution" is broadly defined to include any payment, gift, or loan that is intended to influence an election for federal, state, or local office. The term also includes paying debt incurred

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in connection with any such election, as well as paying the transition or inaugural expenses of a successful candidate for state or local office. This aspect of the rule is not limited to monetary contributions—providing goods or services to a candidate, which is known as an "in-kind" contribution, can also trigger the Two-Year Ban. Examples of "in-kind" contributions include allowing a candidate to use a corporate jet to travel to campaign events, or paying for a candidate's fundraising costs.

- **The contribution must be made by a covered donor.** Covered donors include the Adviser itself, as well as any person who qualifies as a "Covered Associate." Covered Associates include employees who solicit government investors for the Adviser and such employees' supervisors, up through the chain of supervision. The term also includes senior executives of the Adviser (*e.g.,* the President, General Partners, and Vice Presidents in charge of a business unit), anyone who performs policy-making functions for the Adviser (including non-employees), and political action committees or "PACs" controlled by other "Covered Associates" or the Adviser itself.

- **The contribution must be made to an "official" of a "government entity," also known as a "Covered Official."** The Rule defines a covered official as a person "who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (i) [i]s directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) [h]as authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity." The term "government entity," in turn, is defined under Rule 206(4)-5 to encompass agencies or instrumentalities of a State or political subdivision, including many public pension funds. Thus, whether a particular candidate is a covered official for purposes of the Rule turns on the authority of any state or local office he or she holds or seeks and specifically whether such office possesses the requisite direct or indirect authority to influence the selection of investment advisers by a government entity. Because indirect influence is covered, an official who appoints members of a retirement board who can influence the award of investment advisory business will qualify as a Covered Official for purposes of the Rule. Notably, while federal officials running for re-election do not qualify as Covered Officials, a state or local official running for federal office may qualify, depending on the authority of his or her state or local position.

If all three conditions described above are met, the Covered Adviser will be banned from receiving compensation for providing investment advisory services to any government entity for which the Covered Official has the requisite authority to influence the award of advisory business. This ban lasts for a period of two years following the date of the contribution.

The Two-Year Ban is subject to a limited set of exceptions. The most important of these is the *de minimis* exception, under which an individual who qualifies as a Covered Associate can make a contribution of up to $350 per election to candidates for whom the individual is entitled to vote and $150 per election to candidates for whom the individual is not entitled to vote.

2. The Solicitation Ban

The second key election-related restriction imposed by SEC Rule 206(4)-5 is the Solicitation Ban. While the Two-Year Ban restricts contributions to candidates, the Solicitation Ban prohibits certain fundraising or "bundling" activity undertaken on behalf of a Covered Official or certain political parties. Specifically, the Solicitation Ban prohibits a Covered Adviser and any of the Adviser's Covered Associates from soliciting or coordinating contributions from a third party to a Covered Official of a government entity to which the Adviser is providing or seeking to provide investment advisory services. The Ban also prohibits soliciting or coordinating contributions to a political party of a state or locality where the Covered Adviser is providing or seeking to provide investment advisory services to a government entity.

3. The Anti-Circumvention Rule

In addition, SEC Rule 206(4)-5 also includes a broad anti-circumvention provision, which prohibits Covered Advisers and their Covered Associates from doing "anything indirectly which, if done directly, would result in a violation" of Rule 206(4)-5. The Anti-Circumvention Rule prohibits contributions to recipients that are not otherwise covered by the Rule—such as a PAC, national political party, or other political entity—when made with the specific intent to circumvent the Rule by funneling contributions through such third parties to a Covered Official. Moreover, the SEC has historically required Covered Advisers to account for the possibility of such circumvention when developing a pay-to-play compliance program. Covered Advisers are thus required to take reasonable steps to ensure that contributions made by Covered Associates to entities not directly covered by the Rule are not used as a means to "funnel" contributions to Covered Officials. These steps can include performing diligence on contributions to such entities, as well as obtaining assurances from the Covered Associate and the recipient of the contribution that the funds are not being earmarked or otherwise steered to a Covered Official. Finally, such diligence can

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help make a case for exemptive relief in the event of a contribution that inadvertently triggers the Two-Year Ban.

State and Local Pay-to-Play Issues

While SEC Rule 206(4)-5 is the most significant pay-to-play rule for Covered Advisers, it bears noting that Advisers can also be subject to a range of state, local, and even entity-specific pay-to-play regimes. For example, a contribution to a candidate for Governor of New Jersey potentially implicates three distinct New Jersey pay-to-play regimes, in addition to Rule 206(4)-5. These regimes can vary significantly from jurisdiction to jurisdiction and from entity to entity; for example, some cover spouses of covered employees and others do not have any exception for *de minimis* contributions. In some cases, contributions that would not trigger SEC Rule 206(4)-5 have the potential to violate a state or local pay-to-play regime. As a result, compliance with Rule 206(4)-5 is not always sufficient, and Covered Advisers should ensure they are taking other pay-to-play regimes into account.

2016 Elections: Key Compliance Risks

Complying with SEC Rule 206(4)-5 is always difficult. But a number of trends associated with the 2016 election cycle—some of which are new, and others of which build upon prior developments— re making pay-to-play compliance even more of a challenge. First, the volume of political contributions is at historic levels, increasing the likelihood that Covered Associates will make or be asked to make a contribution. Second, the 2016 election involves a broad range of political financing vehicles, many of which pose unique compliance risks. Third, the 2016 election includes a significant number of "covered officials" running for federal office. Building on these trends, the SEC is highly focused on pay-to-play compliance, and is clearly on the lookout not only for violations of the Rule but also for defective procedures or practices that are not up to market standard. To avoid potential foot faults and examination risks, therefore, it is important that compliance professionals keep abreast of the latest trends in election financing. Compliance staff should also ensure that they have appropriate procedures and know-how in place to deal with the specific entities and fundraising mechanisms discussed below.

One of the most notable developments in the current election cycle is the sheer quantity of money being spent by candidates, political parties, and other political actors. With around $6 billion in estimated total spending in 2016 alone, the 2016 election cycle could well be the most expensive to date. In order to raise the vast sums required, candidates have been compelled to build massive fundraising operations, complete with digital outreach, hired fundraising consultants, and a dizzying schedule of fundraising events. The important issues at stake in the election have also brought new contributors to the table, many of whom may be unfamiliar with the world of political giving and the associated legal restrictions.

For Advisers, the principal risk associated with this groundswell of political giving is that a Covered Associate will make a contribution that inadvertently triggers a pay-to-play rule. Such a contribution could be the product of a new giver's unfamiliarity with SEC Rule 206(4)-5, or the pressure put on more frequent givers to make a contribution. As we enter the high point of the election season after the July political conventions, Advisers should remind Covered Associates of applicable pay-to-play restrictions and the potential consequences of even a relatively small contribution. A combination of e-mail blasts, newsletters, and targeted trainings can avoid serious issues down the road.

The 2016 election cycle features a number of "Covered Officials" running for federal office. This can frequently present pay-to-play compliance risks, as Covered Associates may mistakenly believe that SEC Rule 206(4)-5 does not cover federal contributions. To take one example, Ohio Governor John Kasich is a Covered Official with respect to the Ohio state public pension funds, including the Ohio Public Employees Retirement System and the State Teachers Retirement System. Other Covered Officials running for U.S. Senate include John Kennedy (current Louisiana State Treasurer), Maggie Hassan (current Governor of New Hampshire), and Jim Gray (current Mayor of Lexington, Kentucky). A number of sitting Governors and other Covered Officials have been mentioned as possible Vice Presidential candidates—if any of them is selected, then contributions to the presidential ticket could trigger the Two-Year Ban or other pay-to-play restrictions.

Another important trend in the current election cycle is the increasing importance of novel fundraising vehicles. The complexity of the increasingly diverse world of campaign fundraising can confuse potential givers, who may contribute to a Covered Official or political party without realizing it. Moreover, many of these vehicles pose unique risks under SEC Rule 206(4)-5's broad Anti-Circumvention Rule. Where a Covered Associate makes a contribution to an entity that, in turn, may make a direct or in-kind contribution to a Covered Official, the SEC expects that Advisers will perform appropriate diligence, up to and including obtaining a "representation" or "assurance" letter from the entity in question. Doing so requires that the Covered adviser have an understanding of the basic features of each vehicle. Key fundraising vehicles involved in the 2016 election include the following:

- *Candidate Committees:* A candidate committee is established by a candidate for office to support his or her own election campaign. The pay-to-play risks associated with a candidate committee turn entirely on whether or not the candidate in question is a Covered Official.

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IAA Webinar:

IAA to Present Pay-to-Play Compliance Webinar on June 17

Tuesday, June 17
2:00-3:00 pm ET

This month's Compliance Corner authors—**Charles Borden**, partner, and **Sam Brown**, associate, at Allen & Overy, along with IAA Assistant General Counsel **Sanjay Lamba**—will provide investment advisers with an overview of pay-to-play issues, with a focus on developments for the 2016 elections. The webinar will take place on Friday, June 17 from 2:00-3:00 pm Eastern time and will cover:

- Federal, state, and local pay-to-play laws, including SEC Rule 206(4)-5.
- New developments in the 2016 election cycle, with strategies for addressing compliance risks.
- A review the SEC's exemptive relief docket, with lessons learned for advisers and compliance professionals.

The webinar is free for IAA members and associate members; non-members are able to register for a fee. Advance registration is required for the live June 17 presentation—go to: **www.investmentadviser.org >> Events >> Webinars**.

- *Traditional PACs:* A Traditional PAC is an entity established to collect contributions and then direct them to a range of different candidates. Traditional PACs include corporate PACs and trade association PACs as well as independent PACs that have a policy or industry agenda. Because Traditional PACs may contribute to state or local candidates, or to state or local officials running for federal office, they present a relatively high degree of circumvention risk. To address these risks, Advisers should perform appropriate diligence on Traditional PACs before approving a Covered Associate's request to make a contribution.

- *Leadership PACs:* Leadership PACs are multicandidate committees that are affiliated with incumbent officeholders. A sitting Congressman or Senator may establish a Leadership PAC to raise money for his or her colleagues or political party. Leadership PACs may contribute to state or local candidates and officials, and thus such PACs pose many of the same risks as Traditional PACs. In addition, Leadership PACs may appear to be the candidate committee of the officeholder associated with the PAC. This can cause confusion on the part of potential donors, who may not realize the nature of the PAC in question and the associated circumvention risks.

- *Super PACs:* Super PACs are committees that are legally required to operate independently of the candidates they support. In exchange for this restriction, Super PACs can accept unlimited corporate and individual contributions. These funds are generally used for television advertisements or other independent expenditures. So long as the PAC faithfully observes the requirement to operate independently of candidates, a contribution to a Super PAC will not trigger the Two-Year Ban, even if the Super PAC supports a Covered Official. However, the potential for coordination with a candidate—which would result in an "in-kind" contribution to the candidate in question—means that Advisers should still perform diligence and potentially obtain a representation letter before approving a contribution to a Super PAC. In the 2016 election cycle, Super PACs are increasingly being used in novel ways, and it remains to be seen whether these changes will result in increased circumvention risks.

- *527 and 501(c)(4) Organizations:* These entities are charitable organizations that engage in political activities, such as running television advertisements or sending direct mail supporting particular candidates. These organizations register with the IRS, but they may take the position that they are not required to register as a "political committee" because of the nature and extent of their political activities. 527 and 501(c)(4) organizations vary widely in terms of circumvention risk, and as a result it is important that Advisers conduct appropriate diligence on such groups before approving a contribution by a Covered Associate.

- *Joint Fundraising Committees:* A joint fundraising committee or "JFC" is the product of an agreement between several other political actors to raise funds on a common basis. Contributions to JFCs are allocated among the participants, typically based on a set formula agreed upon by the participating parties. JFCs can include Covered Officials, state or local political parties, and PACs. As a result, and because a contribution to

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a JFC may be automatically allocated to the participants, contributions to JFCs pose significant compliance and circumvention risks. For example, it is quite common for incumbent federal officials to establish JFCs that consist of, *inter alia,* that candidate's campaign, one or more federal or state political party committees, and a Leadership PAC. Making matters worse, the JFC may carry the name of the incumbent federal official, leading contributors to believe that contributions will be "safe" when in fact they will be attributed to political party participants, and potentially even to a Covered Official.

Potential Compliance Approaches

One approach to pay-to-play compliance is to implement a "pre-clearance" regime for employees' political contributions. Under this approach, a Covered Adviser can review the potential legal consequences of a proposed contribution before it is made, allowing the Adviser to ensure compliance with applicable regimes without banning all political contributions, which would potentially raise employment law issues.

A political law pre-clearance regime generally consists of four steps:

- ***First,*** the Covered Adviser should identify whose contributions will be subject to pre-clearance. At a minimum, this should include anyone who qualifies as a Covered Associate. Depending on what state and local regimes potentially apply, there may be other employees who should also be subject to pre-clearance. Because family member contributions can implicate state and local regimes as well as the SEC Anti-Circumvention Rule, Covered Advisers regularly require pre-clearance for contributions by spouses and dependent children.

- ***Second,*** when a pre-clearance request is made, it is important to identify the recipient of the proposed contribution. As described above, the nature of the pay-to-play risks associated with a contribution depend largely on the identity of the candidate or political vehicle receiving the contribution.

- ***Third,*** the Covered Adviser should identify which legal regimes apply. In this context it is important to remember that a single contribution can be subject to multiple regimes, and thus it is vital to account for all potentially applicable pay-to-play rules.

- ***Fourth,*** the Adviser should determine whether or not to approve the contribution, and whether to impose conditions on any approval. For example, the Covered Adviser may impose amount limits on a proposed contribution to ensure that it qualifies for the *de minimis* exception described above.

Conclusion

With roughly five months to go until the 2016 general election, Covered Advisers and their compliance teams need to be on guard for potential pay-to-play risks. We expect that political giving will only increase in the months to come, and the risk of inadvertently triggering SEC Rule 206(4)-5 or a state, local, or entity-specific pay-to-play rule will only increase. However, advisers that have taken the time to build a robust compliance program and to adapt that program to the increasingly complex world of political giving should find that they are well positioned to avoid foot faults, prevent violations of the Rule, and obtain discretionary exemptive relief in the event that a contribution slips through the cracks.

While we have focused on election-related issues in this article, it bears noting that the SEC is in the process of finalizing an additional "pay-to-play" restriction that will affect Covered Advisers. Known as the "regulated person requirement," this rule will provide that Covered Advisers and their Covered Associates may not pay any person to solicit a government entity unless that person is subject to a federal pay-to-play regime, or is an executive officer, general partner, managing member, or employee of the investment adviser. This requirement will not come into effect until the Financial Industry Regulatory Authority ("FINRA") finalizes its proposed pay-to-play rule for broker-dealer placement agents. The SEC announced on March 29, 2016 that it was extending the deadline for comments regarding the FINRA pay-to-play rule until April 25, 2016 with rebuttal comments due by May 19, 2016. Given the current progress on that rule, the SEC's regulated person rule is likely to become effective in the first quarter of 2017, or sometime shortly thereafter.

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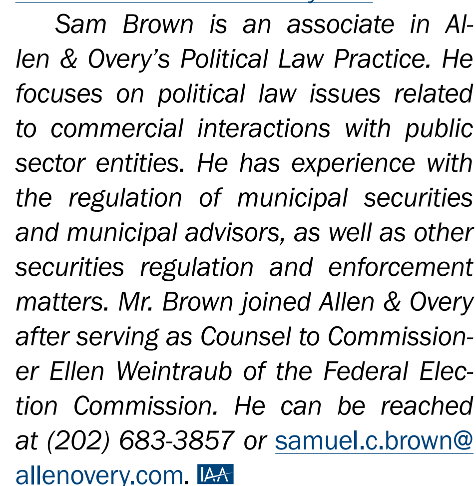

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