

NSCP CURRENTS

A Publication of the NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS

The SEC's New IA Pay-to-Play Rule

by Tom Potter

A unanimous SEC adopted a new rule July 1, aimed at curbing rampant “pay-to-play” practices among investment advisers and the politicians who control contracts to manage public pension funds – which, at over \$2.6 trillion, account for over a third of all U.S. pension assets. Such cozy *quid-pro-quo* arrangements have led to a spate of recent criminal prosecutions, including the former treasurers of New Mexico, Connecticut and City of Chicago.¹

The Rule is modeled after the Municipal Securities Rulemaking Board’s Rule G-37, which prohibits similar activity by broker-dealers and municipal-finance professionals in negotiated municipal securities business. MSRB’s Rule G-37 has been in place since 1994 and survived several Constitutional and other challenges. The main court case, *Blount v. SEC*, 61 F. 3d 938 (DC Cir. 1995), cert. denied, 517 U.S. 1119 (1996), was brought by a Montgomery, Alabama investment banker, who just last year pleaded guilty in a classic pay-to-play scandal involving a sewer refinancing.² That scandal also led to the October

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2009 bribery conviction of Birmingham Mayor Larry Langford³ and brought Jefferson County to the brink of the nation’s largest municipal bankruptcy.

The Release.

SEC Release IA-3043, File No. S7-18-09 (June 30, 2010) adopts new Rule 206(4)-5 and amends Rules 204-2 and 206(4)-3 under the Investment Advisers Act of 1940, 15 U.S.C. §80b and its implementing Rules, 17 C.F.R. §275.

Prohibits Contributions to Government Officials Who Hire IAs.

The Rule applies only to SEC-registered advisers (generally those with more than \$25 million under management) and un-registered advisers to private investment companies exempt under Section 203(b)(3).

The Rule seeks to prohibit public-pension pay-to-play by:

- Imposing a ban on compensated advisory services for two-years after an IA or **covered associate’s** campaign contributions to an **official of a governmental entity**. R. 206(4)-5(a)(1).⁴ The Rule institutes a two-year “look back” for new hires and similar “look-forward” for departing employees, R. 206(4)-5(a)(1), except that contributions made by new hires over six months before their start date will not trigger the ban, unless their new role includes soliciting clients. R. 206(4)-5(b)(2).⁵

- A **“covered associate”** is defined as: (i) any general partner, managing member or executive officer, or other individual with a similar status or

function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any PAC controlled by the IA or any of its covered associates. R. 206(4)-5(f)(2).⁶

- A **government “official”** is anyone who, at the time of the contribution, is a candidate for or incumbent of an elective office that is directly or indirectly responsible for, or has authority to influence, the hiring of advisers – or who appoints those who do. R. 206(f)-5(f)(6). “Government entities” under the Rule include all state and local governments, agencies, instrumentalities, public pension plans and collective government funds (even if self-directed, like 529 Plans). R. 206(f)-5(f)(5).⁷

- Prohibiting third-party solicitors unless they are “regulated persons” like registered BDs or IAs who themselves are subject to pay-to-play prohibitions,⁸ under this or MSRB Rule G-37 or similar, as-yet un-proposed, FINRA rules.⁹ R. 206(4)-5(a)(2)(i). And flatly prohibiting cash payments to any solicitors. R. 206(4)-3.

- Prohibiting solicitation, coordination, bundling or controlled-PAC contributions to officials of governmental entities or state/local political parties in geographic areas where the IA is soliciting public-pension business. R. 206(4)-5(a)(2)(ii).¹⁰

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- Extending coverage to advisers of “covered investment pools” – like hedge funds – in which a governmental entity invests. *R. 206(4)-5(c)*.¹¹
- Prohibiting “indirect” violations, *R. 206(4)-5(d)*, including the requirement that it be with the intent to circumvent the Rule, as established for the identical provision in MSRB Rule G-37.¹²
- Requiring advisers to make and keep records of contributions, their governmental clients and “covered persons” subject to the Rule.¹³

The Rule creates exceptions for small contributions or mistakes: \$350 for candidates for whom the contributor can vote; \$150 to any official; and small contributions (maximum \$350) promptly discovered and returned. *R. 206(4)-5(b)*.¹⁴

Six-Month Phase-In.

Most of the Rule does not take effect until March 14, 2011 – six months after the September 13, 2010 Effective Date (60 days after publication in the Federal Register). The Rule’s provisions on third-party solicitors and covered investment pools first apply one year after the Effective Date, or September 13, 2011. In the meantime, the “prohibition on providing advisory services for compensation within two years of a contribution will not apply to, and the rule’s prohibition on soliciting or coordinating contributions will not be triggered by contributions made before” the Rule first applies, i.e. March 14, 2011. *Rel. IA-3043 §III.A. at p. 123*.¹⁵

Key Differences from MSRB Rule G-37.

Although the SEC expressly modeled its new IA pay-to-play rule after MSRB Rules G-37 and G-38,¹⁶ there are at least eight points of difference between them:

1. MSRB Rule G-37 typically applies to municipal securities dealers and episodic, transaction-oriented activity, like underwritings. The new IA Rule, however, applies to continuing, often long-term, relationships involving, for example, cooperative

(often discretionary) relationships to define, refine and implement investment objectives.¹⁷

2. The MSRB Rules expressly do not apply to competitively-bid municipal securities business,¹⁸ recognizing that negotiated business presents opportunities for pay-to-play, while more transparent competitive-bidding actually helps prevent pay-to-play. Though the SEC even noted that distinction in passing,¹⁹ neither the Proposing nor the Adopting Releases explain why the Commission chose to overlook this distinction for the IA Rule. By doing so, without explaining the basis for abandoning that more-tailored approach, the Commission unintentionally may have left open additional arguments against the Rule’s constitutionality (see below).

3. Neither Rule prohibits political contributions; instead, they impose consequences for them. MSRB Rule G-37 imposes a ban on business with a governmental issuer in the wake of an offending contribution. ***The new IA Rule does not prohibit the business; it just prohibits receiving payment for it.*** Thus, a disqualifying contribution places the IA in the awkward position of a “disabled” fiduciary and its governmental client in the position of being required to accept (at least until replaced) uncompensated services that may be prohibited under state or local law.²⁰

4. Under MSRB Rule G-37, an underwriter is barred from ***new business*** with the issuer for two years, but may complete its contractually-required duties from any securities-business awarded ***before*** the disqualifying political contribution.²¹ Under the new IA Rule, however, upon the disqualifying contribution, the IA immediately is precluded from receiving any further compensation for advisory services to that government entity for two years – whether for that or a separate engagement. That shift from a “no-more” to a “quit now” regime, raises the compliance table-stakes.²²

5. Rule G-37 does not “look through” municipal offerings to the

underlying funding beneficiaries: Because it is an issuer-centric Rule, MSRB guidance provides that political contributions to elected officials of conduit borrowers (when, for example, the securities are issued by a separate umbrella agency) do not trigger the Rule.²³ The IA Rule, however, does “look through” pooled investment vehicles to connect an IA with a government-entity investor in the pool to whom contributions were made. And that requires additional “due-diligence” and compliance efforts.²⁴

6. Though originally proposed with the same *de minimis* limitations as Rule G-37 (\$250 to candidates you can vote for and returned mistaken contributions), the SEC responded to arguments about the IA Proposal’s constitutionality by changing those provisions in Rule, as adopted, to: \$350 to candidates you can vote for; \$150 for any other candidates; \$350 for returned mistaken contributions.²⁵ While a number of commenters argued those changes alone were not sufficient to pass constitutional muster (see below), the change in and of itself casts greater doubt on Rule G-37 and may portend similar amendments by MSRB.

7. The MSRB recently extended Rule G-37 to include contributions to bond-ballot initiatives. While they do not trigger the Rule’s ban, they nevertheless are reportable.²⁶ The perceived risk of “pay-to-play” practices in connection with bond-ballot initiatives presumably is the same for the investment of their proceeds as for the underwriting raising them, but the new IA Rule does not encompass bond-ballot initiatives.²⁷

8. The new IA provisions are promulgated as implementing regulations of the Adviser Act’s anti-fraud provisions, even though the Commission recognizes that the proscribed activities are not necessarily “themselves fraudulent.”²⁸ By contrast, MSRB G-37 is not, *per se*, an anti-fraud rule and enforcement actions often are treated as “fair dealing” violations.

Potential Constitutional Challenges.

Some commentators and others have suggested that the Rule, and

MSRB G-37 on which it was modeled, may be subject to constitutional challenge, based on the Supreme Court's January 2010 decision in *Citizens United v. Federal Election Commission*, 130 S. Ct. 876 (US Jan. 21, 2010). Openly criticized by President Obama in his State of the Union address, that decision struck down restrictions on independent elective campaign contributions as unconstitutional limitations on freedom of political speech protected by the First Amendment.

The SEC relied upon the 16-year-old facial challenge to MSRB Rule G-37 as first promulgated,²⁹ and glibly dismissed other constitutional concerns by concluding that intervening (and arguably superseding) Supreme Court precedent simply would not apply to Rule G-37 as it now stands, or to the new IA Rule.³⁰ But Rule G-37 as it stands 16 years after that first challenge has been broadened, not narrowed, and the more substantive constitutional challenges are likely to arise from these Rules as applied through the Enforcement process.

Even prior to *Citizen's United*, more concrete bases for constitutional challenge to these pay-to-play rules may be found in *Randall v. Sorrell*, 548 U.S. 230 (2006), in which the Court struck down campaign-contribution restrictions, holding them not "narrowly-tailored" enough to withstand strict scrutiny, among them:

- Vermont's \$200 limitation was too low, *Id. at 249-53* (Are \$250 under G-37 or \$350 under the IA Rule constitutional "distinguishable?");
- A blanket limitation without consideration of, or correlation to, the relatively greater costs of campaigns in larger states, *Id. at 251-52* (one-size-fits-all in these Rules);
- Prohibiting meaningful association with political parties, *Id. at 256*.

Both Rules penalize solicitation or coordination of payments "to a political party of a state or locality" in which the IA or municipal dealer seeks any business – a penalty based not on conduct closely-related to an advisory client or issuer, but solely by (a perhaps

grossly overbroad) geographic area;

- Chilling meaningful volunteer participation by including non-cash contributions of any value, *Id. at 260* (as these Rules do); and,
- Having un-indexed contribution limits, *Id. at 261*.

Together with the discrepancies between the two rules noted above, these issues may leave these regulatory efforts to curtail "pay-to-play" subject to constitutional doubt.³¹

1. Adopting Release, IA-3043 at 9-11 & nn. 18-28.
2. *SEC v. Langford*, No. 08-0761-AKK (USDC NDAL July 14, 2010)(consent judgment against Blount et al). This past February, Blount was sentenced to over four years in prison and a \$1 million forfeiture. See *SEC Wins Final Consent Judgments in Alabama Municipal Bribery Case*, 42 Sec. Reg. & L. Rep. (BNA) 1417 (July 26, 2010). See also '34 Act Rel. No. 21595 (SEC July 20, 2010).
3. The SEC's Proposing Release, Rel. No. IA-2910, 74 FR 39840 at 39843 & 42 specifically cited the Birmingham scandal, it did not refer to Defendant Blount by name or recall his involvement in challenging the promulgation of MSRB Rule G-37 in 1994.
4. See Adopting Release, Rel. No. IA-3043, pp. 31-42.
5. See Adopting Release, Rel. No. IA-3043, pp. 58-62.
6. See Adopting Release, Rel. No. IA-3043, pp. 49-58.
7. See Adopting Release, Rel. No. IA-3043, pp. 43-46.
8. See Adopting Release, Rel. No. IA-3043, pp. 70-93. Some commentators suggested that the "look-through" covered pools and resulting regulatory consequences vis "customers' customers" is inconsistent with Rule 203(b)(3)-1 and existing law. 17 C.F.R. §275.203(b)(3)-1; see, e.g., *Phillip Goldstein v. SEC*, 371 U.S. App. DC 358, 366 (D.C. Cir. 2006).
9. In its Adopting Release, the SEC recounted FINRA's indication that it would be proposing a set of similar Rule regarding "pay-to-play." Rel. No. IA-3043, p. 84 n. 305.

10. See Adopting Release, Rel. No. IA-3043, pp. 93-96 (solicitation, bundling) & pp. 48-49 (PACs, political parties) & pp. 55-56 (PACs).

11. See Adopting Release, Rel. No. IA-3043, pp. 97-113. The exception allowing "regulated persons" such as broker-dealers, along with the impending FINRA pay-to-play regulations, were not a part of the Proposing Release (which prohibited all third-party placement agents). Some commentators suggested that the Rule as proposed would have constituted an impermissible attempt to regulate broker-dealers under the Advisers Act. See, e.g., *Goldstein v. SEC*, 451 F. 3d 873 (D.C. Cir. 2006).

12. Adopting Release, Rel. No. IA-3043, p. 97 n. 340. See *Blount v. SEC*, 61 F. 3d at 948; *In re Podesta*, Complaint No. C8A960040, NAC 0398-07 at 6-7, 1998 NSCP Discip. LEXIS 27 (Mar. 23, 1998)(dismissing individual respondent for lack of scienter). See generally *Adopting Rel.* at pp. 96-97.

13. See Adopting Release, Rel. No. IA-3043, pp. 116-21.

14. See Adopting Release, Rel. No. IA-3043 at pp. 62-70.

15. See Adopting Release, Rel. No. IA-3043 at pp. 122-27.

16. See Adopting Release, Rel. No. IA-3043 at 12.

17. The SEC noted that distinction, but did not find it sufficiently compelling to require changes to the rule as proposed. See Adopting Release, Rel. No. IA-3043 at pp. 33-34.

18. See *MSRB Rule G-37(g)(vii)* (A, C, D)(excluding competitively-bid transactions from the definition of "municipal securities business" to which the Rule applies).

19. See Adopting Release, Rel. No. IA-3043 at p. 33 (and, indeed, some commentators' assertion that IA business is awarded on a competitive-bid basis more frequently than municipal underwritings for dealers). In fact, in describing the governmental need compelling this restriction on IAs' electoral free speech and association, the SEC expressly cited "the absence of arm's length negotiations," *Id. at 18*; but that justification, of course, does not apply to competitively-bid IA

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contracts.

20. See Adopting Release, Rel. No. IA-3043 at pp. 38-43, esp. n. 125.

21. See MSRB Interpretation (Apr. 2, 2002) at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx?tab=2#_06F218C1-62E0-40D4-9F8D-8D2040A5796A (last accessed July 31, 2010).

22. That also raises the stakes somewhat on supervision, enforcement and compliance, with disgorgement and “willful violation” issues arising from the lag time between a good-faith but negligently non-compliant employee’s making of the contribution and the organization’s discovery and action upon it. Though not different in kind from the supervision and compliance issues under Rule G-37, the “discontinue immediately” effect of the IA Rule

presents greater challenges that the “check before you solicit” rubric of the MSRB Rule.

23. See MSRB Interpretation (Jan. 23, 1997)(“financial advisor to conduit borrower”) at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx?tab=3#_E30F3550-7AFE-4FCC-9BB8-F1195B0AAFDC (last accessed July 31, 2010).

24. See Adopting Release, Rel. No. IA-3043 at 97-113.

25. See Adopting Release, Rel. No. IA-3043 at 63-65.

26. MSRB Rule G-37(e)(i)(B). See MSRB Reg. Notice 2010-09 (Mar. 26, 2010).

27. In fact, the SEC twice cited MSRB bond-ballot releases in touting the success of Rule G-37. See Adopting Release at pp. 31-32 n. 101. The inclusion of bond-ballot initiatives in Rule G-37 but not the IA Rule may raise the anomaly that a municipal securities dealer must report

contributions to a special-purpose bond-ballot political campaign that might result in some underwriting business, but an IA would not have to report contributions to the same campaign that might increase its assets under management.

28. *Compare* Adviser Act §206(4), 15 U.S.C. §80b-6(4), *with* Adopting Release, Rel. No. IA-3043 at p. 16.29. *Blount v. SEC*, 61 F.3d 938, 945 (D.C. Cir. 1995), *cert. denied*, 517 U.S. 1119 (1996).

30. See Adopting Release, Rel. No. IA-3043 at 22 n. 68 (“We disagree. The cases cited by commenters are distinguishable.”).

31. These constitutional arguments were presented in large measure by the two comment letters submitted by W. Hardy Callcott: <http://www.sec.gov/comments/s7-18-09/s71809.shtml> (last visited July 31, 2010).

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