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Hot Issues Alerts – Law Firms

Putting Teeth Into "Pay-To-Play"

The Editor interviews ***David E. Frulla****, Partner in Kelley Drye & Warren LLP's Washington office.*

Editor: Please describe your practice in the area of campaign finance and political law, government relations and public policy.

Frulla: We at Kelley Drye work to help business and other entities address a wide range of laws governing their interactions with government at the federal, state and even local levels. These jurisdictions have varied campaign finance regimes some of which we will discuss today, as well as lobbying registration and reporting requirements, and also ethics rules governing gifts, entertainment and other interactions with public officials and employees. Each jurisdiction's rules are different, and Kelley Drye helps its clients to develop an integrated compliance structure and quickly respond to legal questions to enable them to operate with confidence.

Editor: The SEC in July proposed a rule restricting campaign contributions by investment advisers seeking contracts from public pension funds if that adviser had made campaign contributions to public officials within two years of his seeking to advise that public pension fund. Has there ever been a precedent for this rule in, say, the realm of municipal finance?

Frulla: Yes, there is a precedent. The SEC's proposed rule tracks an existing rule that has been regulating political contributions and payments in the municipal securities area for the last fifteen years – the Municipal Securities Rulemaking Board's ("MSRB") Rule G-37.

David E. Frulla

Editor: What are the implications of this rule for employee hiring by investment advisers and the role of HR departments in screening new hires? If an employee of such an adviser had made a contribution before his hiring? What if an employee is promoted to senior management of an adviser or transfers into an area handling public pension funds while at the same time his employer is advising that fund?

Frulla: Let me answer the question in two parts. The first is to briefly explain what the proposed SEC rule would require: The company providing or seeking to provide investment advisory services to states and localities would need to identify all current officers and employees who either work with or solicit the government funds; are in the supervisory chain for employees performing investment advisory business; or, are a part of the company's senior management, including the board of directors. The next step would be to obtain a detailed history of each covered individual's state and local political contributions over the preceding two full calendar years. The rule would prohibit compensation for current or future investment advisory business in a jurisdiction where political contributions or payments from these directors, officers and employees had been made to public officials or employees who play a decision-making role in awarding investment advisory business, with very narrow exceptions. Next, the company would need to continue to keep track of these employees and pre-clear their political contributions and payments even when they change departments or divisions for one year after the last activity falling within the definition of performing investment advisory services. What the rule would mean for the hiring process, in essence, is that HR is going to need to pre-screen all hires, and make sure there were no payments made or solicited by the potential hiree which could restrict the company from managing or advising pools of government retirement and pension-type funds.

At a minimum HR needs to understand where current and prospective covered officers and employees have made these contributions. This information may of necessity factor into the company's hiring and staffing decisions. HR would need to use this information in deciding whether to hire an individual, or else, conceivably, to isolate him or her from certain activity within the company if it relates to a state or local jurisdiction where the hiree has made or solicited a political contribution or payment. The other element that companies will need to be cognizant of is that even transfers within a company, whether an employee enters a different sales or regional team or possibly enters a supervisory or senior management role, may suddenly qualify that employee for application of these restrictions. Given the two-year look-back, employees and officers must be screened before they are transferred or promoted to such a position. Also, HR will need to keep track of officers and employees even after they change departments or divisions, including moving overseas, because the rule's restrictions can last for a year after the covered individual last worked in this area of finance. The municipal securities

Please email the interviewee at dfrulla@kelleydrye.com with questions about this interview.

industry has been dealing with these restrictions for years, but HR for investment advisory businesses and divisions will confront significant new requirements and complexities given the much larger employee universe in this area.

Editor: Is there any precedent for this kind of employee screening?

Frulla: As I explained before, the most direct precedent is MSRB Rule G-37. There is also increasing activity at the state level regarding what we colloquially call these "pay-to-play" restrictions. Approximately 15 states currently have such "pay-to-play" laws in existence, and quite a bit of state-level legislative activity is underway. In addition, many cities and counties have their own "pay-to-play" restrictions. New York City, for example, has its own regime, and although it is not as onerous as the SEC's proposed rule, it applies to companies who do business with the city, and the covered business is not limited to investment advisory services. These more general "pay-to-play" rules are something that companies – and not just investment advisers – are going to have to start dealing with more and more frequently.

Editor: The proposal to eliminate placement agents will be a handicap to many fund managers. We recently ran an interview discussing the use of placement agents by the former New York State Comptroller where many abuses came to light.

Frulla: Recently, New York's Comptroller DiNapoli essentially implemented the SEC rule in New York State with the caveat that if and when the SEC rule is promulgated, the New York State restrictions will cease to apply. New York's Attorney General Cuomo had been requiring companies who settled allegations of pension plan misconduct to agree to a Code of Conduct, similar to the proposed SEC rule, as a condition of settlement. As another example, similar regulatory restrictions are now in place in New Mexico because of the allegations that came to light when Governor Bill Richardson was being considered for Secretary of Commerce. You also have the situation in states like Illinois, which had just passed a "pay-to-play" law – actually, Governor Blagojevich implemented a "pay-to-play" regime by executive order, and the state legislature passed its own, different bill. In general, these rules tend to arise in jurisdictions and industries after some notorious incident occurs.

Editor: What are the exceptions to this rule?

Frulla: Under the proposed SEC rule there is a *de minimis* exception that would permit a covered officer or employee to make a contribution of $250 or less, per election per candidate, if the contributor is entitled to vote for the candidate. There is also a proposed second exemption intended to address situations in which an adviser triggers the ban inadvertently – a one-time exemption in a 12-month period if the firm discovers a covered contribution within 4 months and gets it refunded within 60 days. It will also be possible to file for a waiver, but these waivers have been sparingly granted, at least under MSRB Rule G-37, so a company really needs to count on its internal systems.

Editor: Please give our readers an illustration of how a fund manager might run amuck of this regulation if extreme care in hiring personnel is not taken.

Frulla: A New York City employee who lives in New Jersey attends a cocktail fundraiser in the City after work. Maybe the candidate is the employee's college friend, and the contribution is small, say $25. The candidate is running for an office the duties of which include decision making relating to procurement of investment advisory services, such as the New York State Comptroller himself. That $25 contribution would have to be reported to the SEC and would disallow the employee's entire firm from receiving compensation for handling any New York State pension plan moneys for two years going forward. The SEC is aware that when a company is providing investment advisory services, it cannot just be terminated mid-stream because there are often millions of dollars under management. The SEC rule thus includes an obligation of the original firm to keep managing the fund without compensation until the firm can be replaced. Thus, even a modest contribution by an employee or an officer can put a firm at a lot at risk.

Editor: Doesn't that fall within the $250 rule?

Frulla: The $250 exception applies only to a payment to a candidate for whom the covered individual can vote. The example that I just provided was an employee who works in New York City who lives in New Jersey and who went to a fundraiser in New York for a New York candidate. Had this been a New Jersey public official for whom that employee could vote, then the exception would apply.

Editor: Does this rule infringe on an employee's right to make contributions in support of the candidate of his choice?

Frulla: There is certainly a burden on employees' and officers' first amendment rights to undertake political speech and conduct political activity. The MSRB restrictions have been upheld, as have many state and local "pay-to-play" rules that have been subject to litigation. For example, in February 2009, a federal court upheld NYC's "pay-to–play" ordinance. *Ognibene v. Parkes*, 599 F. Supp.2d 434 (S.D.N.Y. 2009), is the citation. In court, the issue comes down to whether a jurisdiction can identify a specific harm the contested new rule is seeking to prevent. And then, the rule must be narrowly tailored to address that harm. For instance, the proposed SEC rule explains, "fairness can be undermined if an adviser seeking to do business with state and local governments makes political contributions to elected officials or candidates, hoping to influence the selection process." Given where we are in the financial world today, courts will, in general, give the financial regulators some fair amount of running room. I would note, though, that the U.S. Supreme Court may be looking more critically at some of these corporate-related campaign finance restrictions.

Editor: When is the comment period for this regulation over?

Frulla: The formal comment period for the SEC proposed rule has ended, but we understand that the SEC is taking comments as they come in.

Editor: If any of our readers are interested in sending a comment, they should do so.