

Pay-to-Play Compliance in Municipal Contracts

Avoiding Violations of MSRB Amended Rule G-37, SEC Rule 206 (4)-5, FINRA Rule 2030, CFTC Reg 23.451

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Template of Federal Pay-to-Play Rules

Examples of Federal Pay-to-Play Rules

- SEC Investment Advisers Rule 206(4)-5 (Investment Advisers)
- MSRB Rule G-37 (Municipal Securities Dealers and Municipal Advisors)
- CFTC Rule 23.451 (Swap Dealers)
- FINRA Rules 203 and 458 (Capital Acquisition Brokers)
- FINRA Rules 2030 and 4580 (Broker-Dealers)

Template of Federal Pay-to-Play Rules

The federal pay-to-play rules follow a similar pattern

- The regulated entity is prohibited from receiving compensation for its services to a government client if, within the prior two years, the regulated entity or certain of its personnel or affiliated entities made any political contributions to public officials involved in (or having the ability to influence) the selection of that regulated entity or to candidates for any such office.
 - **Two-Year Time-Out:** Once a contribution is made, the rules limit compensation for two years from the date of contribution (going forward). There are shorter compliance windows for new hires (e.g. six months).
 - **Personnel and Affiliates:** The rules apply to contributions of senior management of the regulated entity, as well as personnel involved in marketing to or managing the government client relationship. The rules also apply to certain affiliated entities, including PACs affiliated with the regulated entity.
 - **Contributions:** Includes monetary and in-kind contributions, as well as transition and inauguration contributions to a successful candidate.
 - **Public Officials and Candidates:** The rules apply to public officials involved in the selection of the regulated entity . . . *or having the ability to “influence” the selection.* This is the most difficult aspect of compliance, as it requires an analysis under state and local law.

Example: The first SEC rule enforcement case (2014) involved a contribution to a Philadelphia mayoral candidate. The regulated entity provided investment advisory services to the Philadelphia Board of Pensions and Retirement. The mayor appoints only 3 of 9 trustees (not even a majority).

Template of Federal Pay-to-Play Rules

The federal pay-to-play rules follow a similar pattern (continued)

- The rules also prohibit the regulated entity (and its personnel and affiliated entities) from coordinating or soliciting political contributions that they could not make to officials or candidates or to political parties of that state or locality, as well as broadly from circumventing the rules through indirect contributions.
- Each rule also has some form of prohibition or restriction on what types of entities may receive compensation for soliciting covered business (3rd-party and affiliated placement agent restriction)—has to be a regulated entity subject to pay-to-play rules
- The rules have limited exceptions, such as allowing *de minimis* contributions to candidates (e.g. \$150-350 under the SEC investment adviser rule, depending on the rule and whether the donor is eligible to vote for the candidate).
- The rules have recordkeeping, and in some cases reporting, requirements.
- In the event of a potential violation, the rules provide for automatic exemptions in limited circumstances, as well as discretionary exemptions.

Template of Federal Pay-to-Play Rules

There are notable differences among the federal pay-to-play rules:

- Recordkeeping
 - SEC Rule 206(4)-5, MSRB G-37 and FINRA 4580 have specific requirements
 - CFTC rule does not
 - Best practices
- Differing amount of *de minimis* exemptions
 - MSRB G-37: If not entitled to vote for the candidate, may not contribute at all
- Time periods for automatic exemptions
 - Example: 2 per 12-month period under CFTC and MSRB rules; per calendar year under FINRA and SEC rules
- Covered donors: G-37 v. the other rules
 - G-37 has broader coverage and also has a reporting-only coverage (Non-MFP and Non-MAP EOs)
- Placement agent rules

Common Issues Arising from Federal Pay-to-Play Rules

- Covered Officials
 - Federal candidates who are state or local officials at the time are covered—e.g. Pence was governor of Indiana when running for Vice President in 2016
 - MSRB guidance at <http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-56.aspx?n=1>
- Covered Personnel (Associates/MFPs/MAPs/Non-MFP/MAP EOs):
 - How to determine who is covered?
 - When are employees of affiliates covered? SEC guidance: FAQ II.3 at <https://www.sec.gov/divisions/investment/pay-to-play-faq.htm>
- Does limit on “indirect” contributions apply to contributions to political parties, PACs, and other political committees?
 - MSRB G-37 guidance: May be indirect contribution to candidate (MSRB FAQs III.7 and III. 8 at <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx>)
 - Supervisory procedures and best practices
 - MSRB guidance at <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx?tab=3>, Interpretive letters dated September 25, 2007 and December 21, 2006
 - Standard industry approach to outside PACs, party committees

Common Issues Arising from Federal Pay-to-Play Rules

- Affiliated PACS:
 - “Control” analysis: When does a covered associate or MFP “control” a PAC such that the PAC becomes a covered associate or MFP?
 - MSRB guidance on dealer affiliated PACs at <http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2010/2010-57.aspx?n=1>
 - 2-PAC structure
- Lookback for New Personnel: How to Vet?
 - Questionnaire and “scrubdown”
- Placement Agent Compliance
 - Due diligence
 - Representations
- What to do if a covered donor makes a contribution that triggers a ban (or new hire has made such contribution)?
 - Automatic or discretionary waivers: how to decide whether to “use” an automatic exemption, or apply for a waiver
 - Where to find precedent?

Constitutional Framework and Legal Challenges

First Amendment

- The U.S. Supreme Court analyzes campaign finance as “political speech” under the First Amendment. In recent years, the Court has invalidated numerous restrictions that are not intended to target political corruption.

“In a series of cases over the past 40 years, we have spelled out how to draw the constitutional line between the permissible goal of avoiding corruption in the political process and the impermissible desire simply to limit political speech. . . . Any regulation must instead target what we have called ‘quid pro quo’ corruption or its appearance. That Latin phrase captures the notion of a direct exchange of an official act for money.” - *McCutcheon v. Fed. Election Comm’n*, 572 U.S. ____ (2014)

- The federal pay-to-play rules are purported to target political corruption.

“We believe that payments to state officials as a quid pro quo for obtaining advisory business as well as other forms of ‘pay to play’ violate the antifraud provisions of section 206 of the Advisers Act.” – SEC Release No. IA 3043 (2010).

Constitutional Framework and Legal Challenges

Legal Challenges

- The first federal pay-to-play rule, MSRB Rule G-37, was challenged and upheld in 1995 as an appropriate restriction of political speech, narrowly tailored to serve a compelling government interest. *Blount v. SEC*, 61 F. 3d 938 (D.C. Cir. 1995), cert. denied, 517 U.S. 1119 (1996).
- More recent federal rules, including the SEC's rule applicable to investment advisers, were challenged and upheld on the same grounds. *New York Republican State Committee v. SEC*, No. 14-1194 (D.C. Cir. Aug. 25, 2015).
- State and local governments – as we will discuss – have also adopted pay-to-play rules. For example, in 2018, incumbent Cook County (Ill.) Assessor Joe Berrios challenged the county's limit on contributions by property tax appeals attorneys to his political committees. The Cook County Circuit Court denied his First Amendment claim on the basis that the ordinance was narrowly tailored to address the county's interest in preventing quid pro quo corruption. *Berrios v. Cook County Bd. of Comm'rs*, No. 18 CH 1103 (Cook Co. Ill. Cir. Ct., Mar. 13, 2018).

Super PACs and 501(c)4 Organizations

Source of Ambiguity

- In its 2010 release of the pay-to-play rule applicable to investment advisers, the SEC stated: “We also note that ‘contributions’ are not intended to include independent expenditures Indeed, it is our intent that, under the rule, advisers and their covered associates are not in any way restricted from engaging in the vast majority of political activities, including making direct expenditures for the expression of their views, giving speeches, soliciting votes, writing books, or appearing at fundraising events.” – SEC Release No. IA 3043 (2010).
- But the rule also prohibits regulated entities and persons from doing “anything indirectly which, if done directly, would result in a violation of this [rule].”
- The FEC permits federal candidates to raise funds for Super PACs (independent expenditure committees), suggesting there would be a basis for application of the rule to Super PACs.

Super PACs and 501(c)4 Organizations

Recent Developments

- Under a different, statutory pay-to-play law (which prohibits federal contractors from contributing to federal political committees), the FEC fined one company \$34,000 in 2017 for making a contribution to a Super PAC.
- SEC sweeps
- NYC federal investigation involving a 501(c)(4) organization associated with the mayor
- Best practices to avoid issues

State and Local Restrictions

- Pay-to-play laws in the following jurisdictions:
 - California, Connecticut, Florida, Hawaii, Illinois, Kentucky, Michigan, Missouri, New Hampshire, New Jersey, New Mexico, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and West Virginia
 - Albuquerque, Allentown (PA), Chicago, Chicago Ridge (IL), Cook County (IL), Dallas, Detroit, Houston, Jefferson Parish (Louisiana), Lehigh County (PA), Miami Beach, Miami Gardens, New Orleans, New York City, Orange County (FL), Orange County (NY), Philadelphia, Providence, Salt Lake City (UT), Salt Lake County (UT), San Antonio, Seattle
 - In California: All California Counties, Culver City, Los Angeles City, L.A. County MTA, Oakland, Pasadena, San Francisco, Santa Ana, and CalSTRS
 - In New Jersey: numerous localities
- Reporting-only requirements in Connecticut, Illinois, Maryland, Missouri, New Jersey, New Mexico, Ohio, Pennsylvania, Rhode Island, Denver, Detroit, DuPage County (IL), Kane County (IL), Los Angeles City, Nassau County (NY), Providence, San Antonio, and for CalPERS and CalSTRS

State and Local Restrictions

Illustration: State of Illinois, Cook County, and City of Chicago

- All three governments have adopted pay-to-play restrictions, largely applicable to government vendors and lobbyists.
- There are key differences:

| | State of Illinois | Cook County | City of Chicago |
|------------------------------------|---|--|---|
| Donors Covered by the Limit | <ul style="list-style-type: none"> • Vendors, as well as their key personnel and affiliated entities | <ul style="list-style-type: none"> • Vendors (but not personnel or affiliates) • Registered Lobbyists • Bond and Underwriters Counsel and their partners • Bond Financial managers and their key personnel • Financial Auditors and their key personnel | <ul style="list-style-type: none"> • Vendors (but not personnel or affiliates) • Registered Lobbyists |
| Limitation | \$0 | \$750 per election cycle | \$1,500 per year <i>(The mayor has reduced this to \$0 by executive order.)</i> |

State and Local Restrictions

Further examples of variation among state and local restrictions:

- Covered donors vary depending on the law. Not necessarily the same as federal coverage:
 - Some cover spouses and/or children (*e.g.*, Connecticut, New Jersey, Denver, Illinois, Kentucky, Pennsylvania, and Philadelphia)
 - Some cover partners, officers, and/or directors (*e.g.*, Connecticut, Illinois, New Jersey, and New Mexico)
 - Some cover employees who are dealing with the agency on a contract (*e.g.*, Connecticut and California)
 - Some only cover corporate or PAC contributions (*e.g.*, Hawaii, South Carolina, L.A. County, and Oakland)
 - Some cover all employees (*e.g.*, L.A. MTA)
 - Some cover outside consultants who solicit state contracts (*e.g.*, New Jersey pension fund rule)
 - Some cover affiliates, employees and directors of affiliates, and shareholders

State and Local Restrictions

Further examples of variation among state and local restrictions(continued):

– Trend toward including gifts and entertainment in pay-to-play laws:

- New Jersey: debarment liability for violation of vendor ban EO
- Philadelphia Executive Order gift ban contains a penalty of disqualification and/or debarment
- Virginia: restriction on gifts during pendency of bid
- CalSTRS adopted a policy that it may not do business with a company for two years if the company violates the \$470 per year gift limit
- L.A. City limits gifts from an underwriting firm and its officers, public finance employees, and affiliates to \$49.99 combined during the year prior to and following selection for underwriting non-competitive bid revenue bonds
- New Mexico has several gift provisions in its various pay-to-play laws
- Pennsylvania has a gift restriction in its municipal pension system pay-to-play law
- Pasadena prohibits gifts exceeding \$50 from the period beginning when the covered recipient approves the contract and (i) 1 year after covered recipient's term or departure from office; or (ii) 5 years after the approval, whichever is first

Compliance and Enforcement

Government Perspective

- Governments may not always know who their “officials” are for purposes of the federal pay-to-play rules.
- Even if they have a view, that view is not controlling.

Candidate Perspective

- Candidates may be frustrated by overly-broad compliance protocols.
- But candidates should remember that – at least under the federal pay-to-play rules – the burden of compliance and consequences of a violation are on the donor’s company.

Compliance and Enforcement

Donor's Perspective:

- Who do you pre-clear?
- What do you pre-clear?
- Controlling contributions to 527-organizations (such as RGA/DGA)
- Importance of avoiding willful blindness
- Maintaining lists of covered associates/MFPs
- Avoiding inadvertent in-kind contributions by the company
 - Example: contribution caused by an employee performing volunteer work for a campaign during work hours and/or using company resources, without reimbursement

Thank You

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