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REPORT

INVESTMENT ADVISERS

'Pay-to-Play' in the Financial Services Industry: Current Developments and Strategies to Reduce Risk

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I. Introduction

"Pay-to-play" concerns in the financial services industry were placed under a spotlight in 2009 as a result of scandals highlighted by an investigation of the New York State Common Retirement Fund ("NY Retirement Fund"), the third largest public fund in the United States. The investigation, led by the New York Attorney General ("NYAG"), revealed extensive kickbacks by investment advisers seeking business from the NY Retirement Fund. The investment advisers, who largely provided alternative investment products, were introduced to the NY Retirement Fund by place-

ment agents and other intermediaries. As a result of that investigation, the NYAG formed a nationwide task force and published a ''Public Pension Fund Reform Code of Conduct'' for advisers providing services to public funds.[1]

Throughout the United States, public pension funds and various state and local governments have called for, or adopted, reforms designed to prevent decisions of public funds from being improperly influenced. At the federal level, the U.S. Securities and Exchange Commission (''SEC'') voted in July of 2009 to adopt an antifraud rule that would effectively ban the use of third-parties to market investment advisory services to public funds, and significantly restrict the ability of advisers and their employees to make political contributions to elected officials who have the ability to influence investment decisions by a public fund.[2] In addition, the SEC has announced the creation of a specialized unit within its Division of Enforcement focused on, among other things, fraud involving public funds.[3]

This article provides a summary of current developments affecting investment advisers who seek business from public funds, and provides an overview of the practices employed by some organizations to mitigate the risk of any non-compliance with existing laws and policies.

II. Overview

Restrictions on the activities of government employees designed to preserve the integrity of the government procurement process have been in place for many years at all levels of federal, state, and local government. Traditionally, state and local governments have imposed ethical restrictions on the conduct of their own employees, often in the form of specific limits on gifts and entertainment as well as restrictions on post-employment activities. More broadly, however, graft, corruption, and bribery involving public officials has been prosecuted under ''honest services'' theories.[4]

In the 1980s, well-publicized scandals involving the defense industry lead to a series of reforms in federal contracting.[5] Among other things, these reforms resulted in a ban on the payment of contingent fees to persons acting as consultants in connection with government procurement lobbying, as well as clearly defined limits on gifts and entertainment for contractors interacting with government procurement personnel.[6] Although many states and municipalities enforce similar provisions, and require that persons engaged in ''procurement lobbying'' register as ''lobbyists'', the same standards generally have not been applied to firms providing financial services to public funds.

III. MSRB Rule G-37

In 1994, the Municipal Securities Rulemaking Board (''MSRB'') adopted a controversial new rule, MSRB rule G-37, that was intended to prevent ''pay-to-play'' practices in the municipal finance industry.[7] MSRB rule G-37 is directed at political contributions by municipal underwriters and generally prevents them from offering services to an issuer if the firm, a political action committee (''PAC'') controlled by the firm, or any ''municipal finance professional'' made political contributions to an elected official of the issuer within the prior two years. An exemption permits *de minimus* contributions to an elected official for whom an employee is entitled to vote, and also permits the Financial Industry Regulatory Authority (''FINRA'') to grant exemptions for inadvertent violations of rule G-37. A separate MSRB rule,

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[1] *See, e.g., Cuomo Secures Agreement with Leading Pension Fund Advisor Pacific Corporate Group Holdings to Adopt Code of Conduct and Eliminate Pay-to-Play in Pension Funds Nationwide*, Office of the Attorney General of the State of New York (July 1, 2009), *available at* http://www.oag.state.ny.us/media_center/2009/july/july1b_09.html; *Attorney General Cuomo's Fight Against Corruption in the State Pension Fund Nets Four More Companies and One Individual*, Office of the Attorney General of the State of New York (April 15, 2010), *available at* http://www.ag.ny.gov/media_center/2010/apr/apr15a_10.html. For a copy of the Public Pension Fund Reform Code of Conduct, please see *New York Attorney General Places Spotlight on Finders, Placement Agents, and ''Pay-to-Play Practices,''* Dechert OnPoint (June 2009; Issue 13), *available at* http://www.dechert.com/library/FS_13_6-09_New_York_Attorney_General_Places.pdf.

In addition, the NYAG has announced new legislation to reform the NY Retirement Fund and institutionalize the Code of Conduct. *See Cuomo Announces Legislation to Reform State Pension Fund*, Office of the Attorney General of the State of New York (Oct. 8, 2009), *available at* http://www.ag.ny.gov/media_center/2009/oct/oct8a_09.html.

[2] *See* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 2910 (Aug. 3, 2009).

[3] *See* Robert Khuzami, Director, SEC Division of Enforcement, My First 100 Days as Director of Enforcement (Aug. 5, 2009), *available at* http://www.sec.gov/news/speech/2009/spch080509rk.htm.

[4] This theory often is used by Federal prosecutors in cases involving public corruption. It is based on a provision of the U.S. Code that criminalizes activity that violates the public's ''intangible right to honest services.'' 18 U.S.C. § 1346. Because of its arguably ''vague'' language, the constitutionality of this provision currently is before the Supreme Court in the context of an appeal by Jeffrey Skilling, the former chief executive officer of Enron Corporation.

[5] Federal procurement standards date back to at least 1795. *See, e.g.*, Worthington and Goldman, *Contracting with the Federal Government*, Wiley & Sons (4th Ed. 1998). Scandals related to government contracting led President Reagan to appoint the ''The President's Blue Ribbon Commission on Defense Management'' (known as the ''Packard Commission''), which published a report entitled ''Quest for Excellence.'' Subsequently, the industry formed a group entitled the ''Defense Industry Initiative'' which includes the major government contracting firms and focuses on ethical issues in government contracting. *See* Defense Industry Initiative on Business Ethics and Conduct, http://www.dii.org/.

[6] *See* Department of Interior and Related Agencies Appropriations Act (Oct. 13, 1989); Pub. L. 101-102. Codified at 31 U.S.C. § 1352. The ban on contingent fees is found in the ''Byrd Amendment'', which prohibits the use of ''appropriated funds'' to lobby for the award of a federal contract. *See also*, Sussman and Martin, *Contingent Fee Lobbying: Inflaming Avarice or Facilitating Constitutional Rights?* Paper 1877, Berkley Electronic Press (2006) (discussing contingent fee lobbying for legislation).

[7] *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Political Contributions and Prohibitions on Municipal Securities Business and Notice of Filing and Order Approving on an Accelerated Basis Amendment No. 1 Relating to the Effective Date and Contribution Date of the Proposed Rule*, Exchange Act Release No. 33868 (Apr. 7, 1994).

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MSRB rule G-38, was amended in 2005[8] to prevent dealers from using third-party consultants acting as ''finders''.[9]

IV. Proposed Investment Advisers Act Rule 206(4)-5

In 1999, the SEC first published proposed rule 206(4)-5 under the Investment Advisers Act of 1940 (''Advisers Act''), patterned after MSRB rule G-37, which sought to prevent investment advisers and their employees from making political contributions that might improperly influence the decisions of public pension funds.[10] That proposal was opposed by many in the industry and never adopted by the SEC.

In the wake of the scandals involving the NY Retirement Fund, however, the SEC revised and re-proposed the rule, this time also proposing to ban the use of third-party intermediaries, including registered broker-dealers acting as placement agents. Published for comment in August 2009, the SEC's recently proposed rule 206(4)-5 under the Advisers Act (''Proposed Rule''), like the 1999 version, also contains language and concepts similar to MSRB rule G-37. The Proposed Rule generally would apply to all investment advisers seeking business from public entities, including state and local pension funds, 529 plans, and local government investment pools.[11]

The Proposed Rule would impose a two-year ban (euphemistically referred to as a ''time out'') on firms providing investment advisory services *for compensation* following an impermissible political contribution by the firm, firm-controlled PACs, and certain employees of the adviser (termed ''covered associates'') to elected ''officials'' that have the ability to influence the selection of an adviser.[12] Firms can avoid violating the Proposed Rule by not seeking advisory business from public funds if an impermissible contribution has been made. However, firms that learn of an impermissible contribution while currently providing advisory services to a public fund would be in violation of the Proposed Rule if they continue to accept fees from the public fund. Penalties for violating the Proposed Rule would likely include forfeiture of fees as well as fines and other sanctions.

A. Political Contributions. Almost all commenters agree with the goals of the Proposed Rule. However, commenters also have noted that the scandals prompting the SEC's actions have generally not involved political contributions. The Proposed Rule also has been criticized by some commenters because of the harsh consequences for inadvertent violations; the chilling effect on appropriate political contributions[13]; and the difficulty that firms may experience assuring compliance. As explained below, some of the more difficult issues that advisers will encounter in devising a compliance program if the Proposed Rule is adopted are determining which of their employees' political contributions are covered by the Proposed Rule, and what constitutes a political ''contribution'' or ''solicitation''.

1. ''Covered Associates'', ''Solicitations'', ''Contributions'' and ''Look Back Periods''.

The Proposed Rule would limit political contributions by the firm itself and any individuals that fall within its definition of a ''covered associate.'' According to the SEC, the individuals subject to limits on contributions are those that have an economic incentive to influence the selection of the firm by the public fund, such as a general partner or an employee of the adviser who solicits business from the public fund.[14] In this category, the SEC also has specifically included various types of ''executive officers'' of the adviser, including managers of research and sales within the adviser, as well as indi-

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[8] *See In the Matter of Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change Relating to Solicitation of Municipal Securities Business under MSRB Rule G-38*, Exchange Act Release No. 52278 (Aug. 17, 2005).

[9] ''Finder'' is a term used to describe persons who act as independent contractors to bring together buyers and sellers. Generally, they receive contingent compensation and often may be acting as unregistered broker-dealers if they are offering securities, such as interests in hedge funds or private equity funds. Advisers who use finders to solicit advisory services, rather than securities, are subject to the ''cash solicitation'' rule. *See* Advisers Act Rule 206(4)-3.

[10] *See* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 1812 (Aug. 4, 1999).

[11] A local government investment pool (''LGIP'') is a pooled investment vehicle that allows state or local governmental units to invest funds on a short-term basis. Many local government investment pools are managed by external investment management firms. A 529 plan is a tax-advantaged savings plan designed to encourage saving for college tuition and authorized by Section 529 of the Internal Revenue Code of 1986. Interests in 529 plans and LGIPs are considered municipal securities and distributors are subject to MSRB rule G-37. *See, e.g.,* MSRB Notice 2006-03 (Feb. 22, 2006).

[12] For purposes of the Proposed Rule, an elected official is one whose 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.'' For example, a contribution to a state governor who appoints board members or trustees of a public fund, may subject the adviser to the two-year ''time out'' on providing advisory services for compensation to the state's pension fund(s). *See In the Matter of Sisung Securities Corporation*, Exchange Act Release No. 56741 (Nov. 5, 2007) (SEC opinion discussing the term ''elected official'' in MSRB rule G-37 in the context of members of a public board).

[13] MSRB rule G-37 was challenged as an impermissible infringement on the First Amendment but eventually upheld by the U.S. Court of Appeals for the District of Columbia Circuit. *See Blount v. SEC*, 61 F.3d 938 (D.C.Cir. 1995), *cert. denied*, 517 U.S. 1119 (1996). The impact on the SEC's Proposed Rule of the Court's most recent First Amendment decision in this area, *Citizens United v. Federal Election Commission*, No. 08-205, __ U.S. __, 2010 WL 183856 (Jan. 21, 2010), remains unclear. However, the Supreme Court of Colorado recently rendered unconstitutional a very broad pay-to-play law that, among other things, prohibited contributions by public contractors, their employees, and family members. *See Dallman v. Ritter*, No. 09SA224 (Colo. Feb. 22, 2010), *available at* http://www.cobar.org/opinions/opinion.cfm?opinionid=7515&courtid=2.

[14] Determining, within a holding company, which employees' contributions are covered may be very challenging. For example, the MSRB has stated that for purposes of MSRB rule G-37, function and authority are more important than title. *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934*, Exchange Act Release No. 61734 (Mar. 18, 2010) (involving contributions made by the Vice Chairman of a holding company).

rect supervisors. In addition, the Proposed Rule would limit political contributions by a PAC controlled by the firm or its covered associates.

The Proposed Rule also would prohibit the ''solicitation'' of political contributions by the firm and its covered associates. Activities that are considered solicitations would include any fundraising attempts within the firm, or with friends, neighbors or vendors, as well as ''bundling'' contributions by placing multiple checks in a single envelope. While seemingly simple, in practice determining whether particular activity amounts to a ''solicitation'' may prove difficult.[15]

A more daunting task for compliance officials and the SEC may be determining whether or not a political contribution has been made. Volunteer activities specifically are not precluded. However, in addition to cash contributions, credit card payments, or checks, the definition of a political contribution includes ''anything of value''.[16] While this term is not defined well in the Proposed Rule, the term ''contribution'', and particularly the phrase ''anything of value'', has been interpreted extensively by the Federal Election Commission (''FEC''),[17] MSRB,[18] and attorneys general or ethics officers of many different states. Common activities that may fall within the term include providing facilities or secretarial support for campaign activities, allowing employees to volunteer on paid company time, or paying the expenses of employees who participate in campaign activities.

Finally, a ''look back'' provision in the Proposed Rule will prevent an adviser from doing business with a public fund if it or its covered associates have made an impermissible contribution in the prior two years. This provision will not only affect the ability of the adviser to do business with the fund until the period has lapsed, but also becomes a consideration in hiring new employees, engaging in mergers, or promoting current employees who have made impermissible political contributions in the two-year period prior to their new employment or promotion.[19]

2. Exceptions and Exemptions.

The Proposed Rule contains two exceptions from the two-year time out and a provision under which an adviser may apply to the SEC for an order exempting the adviser from the two-year time out.

- *De Minimis* – On an ongoing basis, the most important exception is a provision that would permit an individual employee to make contributions to an elected official, for whom he or she is entitled to vote, of up to $250 per election.[20]

- *Certain Returned Contributions* – A second automatic exception applies to instances in which a covered associate makes a contribution of less than $250 to an elected official for whom he or she is *not* entitled to vote, provided that the adviser learns of the transgression within four months after it was made and the con-

[15] For example, the term ''solicit'' in the Proposed Rule, which is based on the definition used by the MSRB, means ''to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment''. However, in campaign finance law, the Federal Election Commission has defined the term ''solicit'' to ''contain[] an objective test that takes into account all appropriate information and circumstance while avoiding subjective interpretations.'' *See* Definitions of ''Solicit'' and ''Direct,'' 71 Fed. Reg. 13926 (Mar. 20, 2006). *See also* 11 C.F.R. § 300.2(m) (''A solicitation is an oral or written communication that, construed as reasonably understood in the context in which it is made, contains a clear message asking, requesting, or recommending that another person make a contribution, donation, transfer of funds, or otherwise provide anything of value.'')

[16] Proposed Rule 206(4)-5(f)(1) generally defines ''contribution'' as anything of value, including any gift, loan or advance, for ''(i) [t]he purpose of influencing any election for federal, state or local office; (ii) [p]ayment of debt incurred in connection with any such election; or (iii) [t]ransition or inaugural expenses of the successful candidate for state or local office.'' An in-kind contribution generally is considered any good or service that is made available to the candidate or campaign for which it pays nothing or less than the commercial or normal price. The MSRB has interpreted many of the same terms found in the Proposed Rule in light of MSRB rule G-37. *See generally* MSRB Qs & As and MSRB Rule G-37 Interpretive Notices. Both the MSRB's Interpretations and Qs & As on MSRB rule G-37 are subject to the SRO rulemaking process and approved by the SEC.

[17] The definition of a contribution is generally the same as found in MSRB rule G-37 and similar to that used in the Federal Election Campaign Act (''FECA''), 2 U.S.C. § 431(8)(A), but without significant exclusions:

The term ''contribution'' includes (i) any gift, subscription, loan, advance, or deposit of money or anything of value made by any person for the purpose of influencing any election for Federal office; or (ii) the payment by any person of compensation for the personal services of another person which are rendered to a political committee without charge for any purpose.

The FECA definition has been interpreted extensively by the FEC in regulations and advisory opinions that are available on the FEC website.

[18] The MSRB has stated that ''[p]ersonal expenses incurred by the municipal finance professional in the conduct of such volunteer work, which expenses are purely incidental to such work and unreimbursed by the dealer (e.g., cab fares and personal meals), would not constitute a contribution.'' *See* MSRB Qs & As, Question II.18, *available at* http://www.msrb.org/msrb1/rules/QAG-372003.htm.

[19] Noticeably absent from the Proposed Rule is one of the most important exceptions contained in MSRB rule G-37. Under MSRB rule G-37, if certain municipal finance professionals contribute to an elected official prior to becoming a municipal finance professional, then the two-year ban only applies if such person subsequently solicits business from the same government entity that is associated with the elected official to whom the contribution was made. This allows the municipal securities dealer to continue to do business with the government entity, provided the particular municipal finance professional is not involved in solicitation efforts with that government entity. *See* MSRB rule G-37 (b)(ii).

[20] Under the Proposed Rule, primary and general elections are deemed separate elections. Timing questions may arise based on whether a contribution is made when a check is written, sent, approved or deposited by the campaign.

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tribution is returned by the campaign within 60 days of being discovered. An adviser is not entitled to rely on this exception more than twice in a 12-month period, and not more than once per covered associate, regardless of the time period.

■ *Exemptive Order* – A final provision of the Proposed Rule is similar to the current exemptive authority granted to FINRA under MSRB rule G-37, and would permit the SEC to provide exemptions on a case-by-case basis in instances in which the adviser is able to demonstrate, among other things, that despite the impermissible contribution, it had adequate compliance procedures in place.[21]

B. Recordkeeping. Registered advisers that provide services to public funds will be required under the Proposed Rule to keep records of direct or indirect political contributions made by the adviser, its covered associates, and controlled PACs, as well as the names of public funds to whom it provides services. Implicit in this requirement is that firms determine which employees are considered to be ''covered associates'' so that it can track their contributions. It is not clear, however, how this provision is intended to apply to advisers not presently seeking business from public funds.

C. Ban on Placement Agents and Finders. In addition to limiting political contributions, as published for comment the Proposed Rule would limit the ability of advisers to employ third-party placement agents or finders, other than affiliates, to solicit business from public funds. The NYAG's investigation revealed that a large number of advisers offering services to the public funds in New York State and New York City relied upon placement agents or well-connected finders,[22] many of whom may have been acting as unregistered broker-dealers.[23] The SEC's proposed ban on placement agents echoes similar bans that were announced as a matter of policy or law by several states and major public pension funds in response to the scandals.

Commenters on the Proposed Rule, including a number of public funds, have strongly objected to the proposed ban. Among other things, hedge funds and private equity funds have noted that they may be required by law to retain a third-party broker-dealer to offer their securities, or register as broker-dealers themselves. In addition, placement agents are necessary for smaller funds that cannot support internal sales staffs, and play an important role in introducing larger advisers to new markets. Some of the public funds themselves have suggested that placement agents perform an important role in screening potential investments.

As a result of the strong reaction by the industry, it now appears that the SEC may be considering measures other than a complete ban to address potential problems with placement agents. Andrew ''Buddy'' Donohue, Director of the SEC's Division of Investment Management, sent a letter to FINRA asking whether it would ''consider crafting and adopting'' rules that would prohibit pay-to-play activities for registered broker-dealers. According to the letter, the Division of Investment Management, which drafted the Proposed Rule, believes that an exception for registered broker-dealers serving as placement agents might be feasible if FINRA were to implement such rules.[24] In response, Richard Ketchum, Chairman and Chief Executive Officer of FINRA, has offered to propose FINRA rulemaking that would place limits on political contributions by placement agents registered as broker-dealers. That letter, dated March 15, 2010, states that such a rule would be a ''viable solution to a ban on certain private placement agents serving a legitimate function'' and that FINRA was ''delighted to state that [they] are in a position to promulgate such a rule.''[25] The letter also indicates that FINRA is moving forward with such a proposal.[26] It is not clear, however, what limits the SEC would seek to apply to third-party ''solicitors'' of investment advisory services, which are not required to become members of FINRA.

V. State and Local Laws and Public Fund Internal Policies

At the state, local and fund level, there also have been a number of reforms proposed or adopted. Traditionally, advisers seeking business from public funds have had to comply with state and local ethics laws addressing limits on gifts and entertainment of fund employees as well as revolving door limitations. Prior to the scandals and the Proposed Rule, some states also had adopted specific laws addressing the conduct of persons seeking business from public funds and prohibiting the use of placement agents.[27] Following the NYAG's investigation, however, several new states have proposed new legislation addressing placement agent

[21] The SEC will also consider: (1) whether the adviser has taken appropriate steps to obtain a return of the impermissible contribution, as well as appropriate remedial or preventive measures; (2) the timing and amount of the impermissible contribution; and (3) the apparent intent of the impermissible contribution. Examples of exemptive applications and responses under MSRB rule G-37 are found on the FINRA website.

[22] *See, e.g., Preliminary Inquiry Finds That 40 to 50 Percent of Placement Agents, Finders and Other Agents Seeking Investments from the NY State and City Pension Funds Were Unregistered*, Office of the Attorney General of the State of New York (May 1, 2009), *available at* http://www.ag.ny.gov/media_center/2009/may/may1a_09.html.

[23] Section 15(a) of the Securities Exchange Act of 1934 (''Exchange Act'') requires a ''broker'' to register with the SEC. A broker is defined as anyone ''engaged in the business of effecting transactions for the account of others.'' An exemption from the definition of ''broker'' in Rule 3a4-1 under the Exchange Act allows funds to self-distribute but may not be available to all funds that offer securities.

[24] *See* Letter from Andrew J. Donohue, Director, Division of Investment Management, SEC, to Richard G. Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority (Dec. 18, 2009), *available at* http://www.sec.gov/comments/s7-18-09/s71809-252.pdf.

[25] *See* Letter from Richard G. Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority, to Andrew J. Donohue, Director, Division of Investment Management, SEC (Mar. 15, 2010), *available at* http://www.sec.gov/comments/s7-18-09/s71809-260.pdf.

[26] While the Proposed Rule does not explicitly address political contributions by placement agents, a new FINRA rule patterned after MSRB rule G-37 could be much broader in scope, potentially capturing registered broker-dealers providing placement agent services as well as other business activities between brokers and public funds, including brokerage.

[27] *See, e.g.,* Illinois Pension Code, 40 ILCS 5/1-145 (prohibiting contingent and placement agent fees that influence the outcome of an investment decision or the procurement of investment advice or services by an Illinois state or local retirement system, pension fund or investment board).

activities, and many of the public funds themselves have revisited their guidelines regarding placement agents.[28]

Where placement agents or finders are not barred, new laws have been proposed, or some existing laws interpreted, to limit contingent compensation or require that advisers or placement agents register as procurement lobbyists.[29] Public funds also frequently request now that advisers supply information about placement agents, including whether or not they are registered as broker-dealers, the compensation they receive, backgrounds of principals of the placement agent, as well as annual compliance certifications.[30]

One of the most visible and controversial proposals in this area currently is before the State Assembly in California. In February of this year, legislation championed by CalPERS and CalSTRS was introduced in California that effectively would treat placement agents and certain internal sales staff as lobbyists under California law. If adopted as proposed, the legislation would prohibit the payment of contingent compensation to both placement agents and internal sales staff who solicit business from public funds within the State; limit political contributions; and require placement agents and certain employees of an adviser to register and comply with State lobbying laws.[31]

VI. Policies and Procedures

A. Political Contributions, Gifts, and Entertainment. If the Proposed Rule is adopted, it will present new challenges to the advisory industry, mandating compliance principles and procedures that are essentially the same as those currently used by organizations in many nonfinancial sectors that engage in government contracting. However, even if the Proposed Rule is not adopted, advisers who seek business from public funds or other government entities must be cautious of the patchwork of state and local laws and fund policies that may affect their business. For this reason, advisers should consider developing a compliance program that will take into account the potentially harsh consequences, including lost fees and other limitations on business, for those that do not adhere to limitations on political contributions and the use of third-party intermediaries. Below, we discuss general measures that advisers may consider in the context of their own business.

1. Seek Management Buy-In

A robust compliance program in this area requires management buy-in as an essential element; a strong statement of corporate values; policies and procedures to assure compliance; and training, monitoring, and audit. Because of the breadth of potential services and persons whose conduct may affect the adviser's ability to do business with public funds, a strong commitment from senior management will be necessary to assure compliance.[32] In larger organizations, for example, the conduct or responsibilities of personnel outside the adviser, such as individuals who sit on PAC committees, make referrals, engage in solicitations, and directly or indirectly supervise the personnel within the adviser, also could cause violations of applicable laws or other requirements. For this reason, many larger organizations place responsibility for enterprise-wide compliance with existing laws within a risk management group or legal department so that necessary resources and procedures can be marshaled at different levels within the organizational structure. In addition to members of senior management, other departments whose awareness and diligence may be necessary to assure compliance include human resources, accounting (to monitor expense reimbursements),[33] and audit.

2. Communicate Values

Policies concerning political contributions and ethical standards related to contracting with the government may be communicated in conjunction with core ethical values addressing integrity and honesty. Organizations that engage in government contracting often include broad admonitions stating that: ''it is never permissible to make or solicit a political contribution for the purpose of influencing the official conduct of an elected official.'' And, ''it is never permissible to use firm resources for political purposes without prior approval, or to seek reimbursement of political contributions or expenses made by yourself or another person.''[34]

3. Develop Internal and External Resources

In addition to these general statements, which are relevant at many different levels of an organization, more detailed procedures and policies may be neces-

[28] *See, e.g.,* Placement Agent Policy, New Jersey Department of Treasury, Division of Investment (Adopted July 9, 2009) (requiring placement agent registration with FINRA, among other things) (on file with authors).

[29] From the perspective of the public funds, laws or policies limiting the use of placement agents or finders may reflect twin concerns relating to (1) the potential for overreaching or corrupt action resulting from the ''salesman's stake'' evident in transaction-based commission compensation, and (2) the possibility that the public fund may indirectly pay for the placement agent's participation in the form of higher advisory fees. For this reason, some public funds emphasize that all fees must be paid by the adviser. In one case, the public fund requires that the adviser agree to reduce its fees by the amount of the placement fee, if requested. *See* Teacher Retirement System of Texas, Addendum to the Investment Policy Statement (July 2009) (''Each final investment agreement shall provide [the Teacher Retirement System of Texas] with the option to receive a reimbursement of management or advisory fees equal to the amount of Placement Fees to be paid to any and all Placement Agents . . . .''), *available at* http://www.trs.state.tx.us/investments/documents/investment_policy_statement_addendum.pdf.

[30] *See, e.g.,* PRIM Board Disclosure Statement, Commonwealth of Massachusetts, Pension Reserves Investment Management Board, *available at* http://www.mapension.com/Rfp/2009PERFP_ExhE.doc.

[31] *See, e.g., Assembly Committee Backs Bill Treating Placement Agents as Lobbyists,* California Public Employees' Retirement System (April 7, 2010), *available at http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2010/april/placement-agents-as-lobbyists.xml*.

[32] An appreciation by senior management of the potential effect on a firm's ability to generate business also may be necessary to support any sanctions against those within the firm that do not comply with its policies and procedures.

[33] *See In the Matter of CIBC World Markets*, Exchange Act Release No. 52942 (Dec. 12, 2005) (employee sought reimbursement of political contribution as a ''marketing expense'').

[34] Similar programs and procedures may be developed in conjunction with a public company's compliance with the Foreign Corrupt Practices Act, and also can serve as mitigating factors under the Federal Sentencing Guidelines as well as SEC enforcement actions. Advisers who solicit business from public funds outside the United States also may need to be aware of any local laws affecting their conduct.

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sary. Generally, an initial measure in formulating a more significant compliance policy program in this area is assigning specific responsibility to an individual or individuals who will serve as a point of contact and who will be responsible for being familiar with relevant laws and developing strategies to assure compliance.

In the context of the Proposed Rule, as well as the laws and policies of individual states and public funds, individuals responsible for compliance in this area should have an awareness of and sensitivity to issues that may be complex and whose boundaries are not clearly defined. Among other things, this would include awareness of whether certain political contributions or activities (including in-kind contributions) are likely to have an effect on the ability of the firm to do business with public funds. Some not uncommon questions regarding political contributions that may arise include: ''does volunteering my personal services to a campaign count as a contribution to the campaign?''; ''am I allowed to hold a campaign-related gathering at my house?''; ''can my husband (who does not work for the firm) host a fundraiser at our house?''; ''can I accept an invitation to attend a fundraiser if someone else paid for the table?''; ''can I be reimbursed for travel expenses to attend a political function?''; ''can this manager sit on our PAC committee?''; and ''can I serve on the finance or other committee of a candidate?''[35]

Equally important, is that a firm may learn of improper contributions or solicitations after the fact. For example, a compliance officer may learn the following: an intern spent the weekend in the firm's offices mailing campaign materials; an employee sent e-mails encouraging friends, neighbors, and fellow employees, to donate to the Governor or attend a fundraiser at his or her house; or, an individual who has previously made political contributions was just promoted to a position in which contributions are restricted. Because these instances are likely to arise if any of the new proposals are adopted, it will be necessary to have resources available to respond rapidly to address the issues.

4. Identify and Train Relevant Employees

An equally important aspect of the compliance function is identifying which employees are, or may be, subject to limits on their political activities, and then devising an appropriate education and training strategy. Among other things, this may include general policies delivered to all employees. While certain employees' activities will clearly be covered based on specific provisions, such as those found in the Proposed Rule, others who may have direct or indirect supervisory responsibility for their actions, advise PAC committees, or regularly solicit government entities to offer non-advisory services, including brokerage, custody, cash management, administration, and banking, also may need to receive additional training and be aware of the firm's policies to avoid potential problems. Particularly with respect to the Proposed Rule, it may not be clear which individual's contributions will be covered. For this reason, among others, it is important to provide regular training to a broader group of individuals who interact with government officials. Training relating to political contributions can be coupled with policies on ethics, gifts, entertainment, and charitable contributions.

5. Pre-Screen Contributions and New Hires

■ Political Contributions

Normally, a fundamental part of any compliance program in this area is to require pre-approval of political contributions by the firm and its officers and employees, including PAC contribution requests. Contribution requests may be submitted on written forms or electronically. Approval by the compliance department or the legal department generally is necessary.

Internal screens may include verification that the employee is entitled to vote for the elected official and that the maximum contribution for the election cycle has not been exceeded. In addition, the contribution request may include a certification that the employee has not been solicited by another member of the firm to make the contribution. While these forms generally focus on cash contributions, it is important to make employees aware that in-kind contributions may also have to be valued and may be subject to pre-approval.

■ New Hires and Mergers

If the Proposed Rule is adopted, because it has a ''look back'' provision, a political contribution made by an employee prior to his association with the firm could be a disqualifying factor that will affect the ability of the firm to provide advisory services for a fee. Advisory firms, however, often are not focused exclusively on providing services to public entities, and are likely to have a more difficult compliance problem if the Proposed Rule is adopted in its current form. In the context of a ''lift out'' or merger, the addition of new personnel who have made political contributions in the prior two years also could affect the ongoing business of the adviser, as well as new business opportunities. For this reason, awareness of firm policies and diligence by the human resources department may be particularly important in preventing potential problems as a result of hiring and mergers.[36]

6. Quarterly Surveys and Periodic Audits

Under the MSRB rules, which are referenced extensively by the SEC in the proposed rulemaking release, municipal dealers must file quarterly reports with the MSRB, disclosing any political contributions by persons who fall within the definition of a ''municipal finance professional.'' Similar records of contributions would need to be maintained by the adviser under the recordkeeping provisions of the Proposed Rule, but would not be publicly available. Typically, compliance officers obtain information for MSRB rule G-37 reports from political contribution request forms, as well as quarterly surveys of persons whose contributions are subject to limitations and disclosure or recordkeeping requirements. These surveys allow the firm to detect contributions that were not submitted for pre-approval, and also may require an affirmative statement that the individual has not made any non-disclosed contributions or solicited contributions from others. Quarterly surveys and reports of contributions and entertainment expenses also may be necessary to comply with state laws.

Audits may also be conducted to detect patterns which suggest that disclosed contributions were solic-

[35] For answers to some of these questions, see Volunteer Activity Brochure, Federal Election Commission (Oct. 2009), *available at* http://www.fec.gov/pages/brochures/volunteer_activity_brochure.pdf.

[36] Failure to appropriately screen employees' political contributions made prior to joining the firm has been a consistent source of problems for municipal underwriters in complying with MSRB rule G-37.

ited internally. In addition, public donor records (which are also available to the public funds, as well as the press, competitors, and regulators) may be sampled to check for non-compliance with firm policies. The quarterly cycle provides a convenient opportunity to reassess whether any significant changes have occurred in the laws, regulations or fund policies affecting political contributions or lobbyist registration requirements, as well as whether any organizational developments, such as mergers, new hires, or promotions, have occurred that may be relevant to the compliance program.

7. *Encourage Open Communication*

Open communication also is critical both to prevent potentially problematic political contributions before they are made, and to promptly address any problems that arise. The Proposed Rule, for example, contains exemptions for different types of inadvertent violations. Similar exemptions may be found under state laws. Often in these circumstances, the ability to promptly cure an inadvertent violation, by recovering the contribution within a narrow window after it has been made, is an important element in relying on an exemption.[37] For this reason, it is important to encourage employees to come forward if they believe a problematic contribution has been made.

B. Use of Consultants or Third Parties. Whether or not the SEC's ban on the use of intermediaries is adopted, any third-parties acting on behalf of the adviser can raise problems if they engage in activities that violate either state or federal laws, or conflict with the policies of the public fund. Apart from business considerations, factors that may be relevant to the adviser as part of its due diligence in working with an intermediary would include:

- Is the entity required to be registered as a broker-dealer, and if so, is it registered?
- Who are the principals that will be interacting with the public funds, and what is their background, including personal or professional relationships with public funds and their employees?
- What political contributions have the firm or its principals made that may affect the ability of the adviser to seek business from a public fund?

[37] Under state law, disqualifying contributions often must be recovered within 30 days.

Provisions found in traditional consulting arrangements involving government contracting increasingly may become relevant to advisers employing placement agents or third-party intermediaries seeking business from public funds. Among the more common provisions are the following:

- Express provisions prohibiting payments or gifts to public officials or their families for the purpose of improperly influencing their official actions;
- Representations that the intermediary is appropriately licensed;
- Limitations on sharing fees under the agreement with third-parties, or employing third-parties without the consent of the adviser;
- Prohibition on using confidential selection criteria to assist in obtaining business opportunities from the public fund;
- Agreement to disclose information concerning fees, principals, or political contributions if requested by a public fund; and
- Acknowledgement that the intermediary is not authorized to make political contributions on behalf of the adviser without written consent.

VII. Conclusion

The Proposed Rule is well-intended, but may present many complex compliance challenges for advisers if adopted in its current form. It is likely, however, that if it is adopted by the SEC, there will be an adequate transition period for advisers to develop compliance procedures, and that limits on political contributions under the Proposed Rule will only be applied on a prospective basis. Even if the Proposed Rule is not adopted, however, developments at the state and local levels, including new policies or requirements adopted by the public funds themselves, should encourage both advisers and brokers to examine whether they have adequate knowledge of the laws and policies affecting their business in this area. And, they should consider whether their compliance procedures are adequate to alert their employees to potential problems, so that they can make any necessary filings and avoid engaging in activities that may affect their current or future business relationships with public funds (and other government entities).

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