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Pay-to-Play: Recent SEC Actions Highlight Importance of Compliance Controls

I. Overview

Two recent actions by the U.S. Securities and Exchange Commission ("SEC") and its staff highlight the importance of compliance controls with respect to political contributions and other political activities. In a settled enforcement action, the SEC alleged that a prominent municipal securities dealer ("Municipal Dealer") violated the Municipal Securities Rulemaking Board's ("MSRB") Rule G-37 ("Rule G-37" or "Rule") after an employee made certain, undisclosed, "in-kind" campaign contributions ("Settlement Order").[1] The "contributions" included using the firm's resources during work hours to engage in campaign activity in breach of the firm's policies. According to the SEC, the enforcement action is the first for pay-to-play violations involving "in-kind" campaign contributions. The Settlement Order also announces a heightened compliance obligation applicable to employees known to have been politically active.[2]

The SEC's Office of Compliance Inspections and Examinations ("OCIE") also issued a National Examination Risk Alert ("Risk Alert") relating to the policies and procedures employed by municipal underwriters to assure compliance with MSRB rules relating to political activities, including Rule G-37. The Risk Alert summarizes the observations of National Examination Program ("NEP") examiners regarding relevant compliance controls, and encourages compliance personnel to review and, if necessary, revise their policies and procedures.[3]

Although Rule G-37 applies only to municipal underwriters, the Rule has served as a model for other pay-to-play rules, including Rule 206(4)-5 under the Investment Advisers Act of 1940 ("Advisers Act"). Accordingly, the Settlement Order and Risk Alert also provide helpful insight for investment advisers and other regulated entities. This OnPoint examines both the Settlement Order and the Risk Alert.

II. Background

Rule G-37, approved by the SEC in 1994, was among the earliest pay-to-play rules. The Rule is designed to prevent firms from using political contributions to improperly influence the decisions of elected officials. The Rule generally prohibits firms from engaging in "municipal securities business" with an issuer for a period of two years after any non-*de minimis* political contributions have been made to certain officials of that issuer by the firm, a "municipal finance professional" ("MFP") associated with the firm, or a political action committee controlled by the firm or MFP.[4] In addition to this self-imposed "time out" from engaging in municipal securities business, firms that violate the Rule may be subject to monetary fines and penalties from enforcement actions, as well as possible reputational damage that could impact revenues from future business. Because of its success, the Rule has been used as a model for other federal and state pay-to-play laws, including Advisers Act Rule 206(4)-5 (which contains many of the same or substantially similar prohibitions as Rule G-37).[5]

III. Settlement Order

A. In-Kind Campaign Contributions

Rule G-37, as well as Advisers Act Rule 206(4)-5, defines "contributions" to include not only actual cash contributions, but also "anything of value."[6] While the Advisers Act rule is fairly new and has not been

interpreted extensively, the MSRB has issued several interpretations of Rule G-37 that emphasize that engaging in political activity during working hours, as well using an employer's resources (including administrative employees, phones, office space and other services), may be regarded as "in-kind" political contributions.[7] Under Rule G-37, "in-kind" political contributions must be valued and generally must be recorded and reported in the same fashion as cash contributions.[8]

The Settlement Order indicates that an MFP, who had previously occupied several positions of responsibility within the Massachusetts Treasurer's office, was hired by the Municipal Dealer to solicit municipal securities business from Massachusetts, among other jurisdictions. In the Settlement Order, the SEC alleged that the MFP had been actively involved in the gubernatorial and other political campaigns of the then-Treasurer of Massachusetts while the MFP was employed by the Municipal Dealer. According to the SEC, the MFP engaged in a variety of political activities on behalf of the official's campaign during work hours. These political activities included: (1) fundraising; (2) drafting speeches and fundraising solicitations; (3) reviewing, approving and writing campaign memoranda, contracts, letters, talking points, campaign position papers, and responses to campaign issues; and (4) approving campaign invoices and expenditures. The SEC further alleged that the MFP at times (and during ordinary work hours) used his firm e-mail account, telephone and other resources in connection with these activities. According to the SEC, these activities constituted "in-kind" campaign contributions by the MFP (and were attributable to the Municipal Dealer) because they occurred during work hours, while the MFP was being compensated, or involved the use of the firm's resources. Moreover, none of these activities were assigned a value as political contributions by the Municipal Dealer or recorded on its records and reported to the MSRB, in violation of MSRB rules.

Despite Rule G-37's prohibition against engaging in municipal securities business for two years after any political contributions have been made by a firm or its MFPs, the Municipal Dealer participated as senior manager, co-senior manager or co-manager for 30 negotiated underwritings by issuers, in violation of the Rule.

B. Solicitation Activities

The SEC also alleged that the MFP engaged in fundraising activities in violation of Rule G-37. The solicitation activities described in the Settlement Order, as well as in a separate cease-and-desist order brought against the MFP in his individual capacity,[9] include: (1) seeking contributions from others; (2) asking others to coordinate the collection of contributions; (3) sending e-mails containing information regarding fundraising events; and (4) providing tickets to fundraisers. As discussed above, both Rule G-37 and Advisers Act Rule 206(4)-5 prohibit the solicitation or coordination of certain contributions for political campaigns.

C. Compliance Failures Cited by the SEC

According to the SEC, the Municipal Dealer had adopted policies and procedures relating to, among other things, political contributions and Rule G-37. These policies and procedures, which were provided to the MFP, apparently contained a prohibition against using firm resources for political activities. Although the MFP certified to the Municipal Dealer that he had disclosed all of his political contributions and activities, the SEC alleged that the firm, among other things: (1) failed to supervise the conduct of the MFP to ensure compliance with the MSRB rules, including Rule G-37; and (2) failed to adopt, maintain, and enforce written supervisory procedures reasonably designed to ensure the employee's compliance with the MSRB rules.

In the Settlement Order, the SEC indicates that, in light of the employee's background in politics and his relationships with the then-Treasurer of Massachusetts and other state officials, the Municipal Dealer should have taken additional steps to ensure compliance with the MSRB rules. The SEC noted, for example, that the Municipal Dealer failed to detect, during an internal compliance review, the employee's use of e-mails for political activities, or to conduct any examination specific to compliance with Rule G-37.[10]

Both the MSRB, in the context of Rule G-37, and the SEC, in the context of Advisers Act Rule 206(4)-5, have emphasized that their respective rules were not designed to discourage political speech and volunteer political activities. The Settlement Order, however, is noteworthy because it illustrates that political activity that involves the resources of an employer (including e-mails or office space), or that occurs during "ordinary working hours," may result in pay-to-play violations. The Settlement Order also is noteworthy for suggesting

that heightened supervisory procedures, which could include specific e-mail reviews or additional training, may be necessary for persons who, because of their background or interests, are more likely to be politically active.

IV. The OCIE Risk Alert

Shortly before the Settlement Order, a Risk Alert involving compliance with MSRB rules relating to political activity, including Rule G-37, was issued by the SEC staff as part of the National Examination Program. According to the SEC staff, the Risk Alert reflects the observations and concerns that the staff has identified based on examinations of the compliance programs of brokers, dealers and municipal securities dealers engaged in municipal securities business. While the SEC staff is careful to note that their observations are limited to compliance with MSRB rules, the Risk Alert, for reasons discussed above, provides helpful insight for investment advisers and other regulated entities seeking to comply with other, similar pay-to-play restrictions, including Advisers Act Rule 206(4)-5.

A. Practices that Raised Concerns under MSRB Rules

In the Risk Alert, the SEC staff identifies the following practices as problematic and constituting violations of the MSRB rules:

- Doing business within the two-year time out after making a non-*de minimis* contribution.
- Failing to maintain accurate and complete records listing the names of a firm's MFPs, among others.[11]
- Failing to file accurate and complete reports on Form G-37 with the MSRB.
- Failing to develop or implement adequate supervisory procedures.

B. Pay-to-Play Compliance Programs

The Risk Alert identifies certain practices, described below, that firms have incorporated into their pay-to-play compliance programs. Many of these practices are followed by investment advisers and others that are subject to pay-to-play provisions.[12] While references in the Risk Alert are to "municipal finance professionals," or MFPs, an investment adviser should consider having similar requirements for its "covered associates" under Advisers Act Rule 206(4)-5.

Training. The Risk Alert notes that many firms regularly provide training for MFPs regarding the limits on political activity under MSRB rules. The Risk Alert also notes that many firms document this training.

During election cycles, employees may be encouraged by friends and civic appeals to make contributions that could subject a firm to a time out or other sanctions. Because of the harsh consequences that may apply to firms that violate pay-to-play restrictions, many firms implement regular training programs and encourage firm personnel to ask questions prior to making contributions or engaging in certain political activities. Documenting training may be important for purposes of monitoring attendance, as well as to avoid potential liability for the actions of individual employees and to support any request for an exemption from the two-year time out under Rule G-37 and Advisers Act Rule 206(4)-5.[13]

Self-certification. The Risk Alert notes that some firms also require MFPs, non-MFP executive officers and employees who could become MFPs, to certify on an annual or other periodic basis that they understand and are abiding with all policies regarding political contributions.

Depending on the context, quarterly employee surveys are employed by many firms to reinforce the importance of compliance with pay-to-play policies. In addition, these periodic employee surveys can reveal any contributions that were not previously reported and, if applicable, subjected to the firm's pre-clearance procedures. Prompt detection of an impermissible contribution may allow a firm to take action to mitigate its effects. Under both Rule G-37 and Advisers Act Rule 206(4)-5, for example, a firm is not subject to a time out if, among other things, the contribution is less than threshold amounts, the firm discovers the impermissible contribution within four months of the contribution and the employee obtains a return of the contribution with 60 days of the date of such discovery. Some firms may also use quarterly reviews as markers to examine any personnel changes or other developments that may affect their pay-to-play compliance programs.

Surveillance. The Risk Alert notes that some firms use various resources, such as the internet, to search for political contributions made by their MFPs, non-MFP executive officers and certain employees. The Risk Alert also notes that these firms may screen e-mails and other communications for unreported contributions.

Several national online databases collect information regarding political contributions. However, these databases largely are confined to candidates for federal office (although some may also include candidates for state and local offices). Most state and local election commissions also report contributions on websites. Some firms also review election databases that capture information regarding states and local jurisdictions in which they may have, or are seeking, significant business opportunities.

Two-Year Look-Back. The Risk Alert states that some firms identify non-MFP employees who may become MFPs in the future as a result of a promotion or change in responsibilities, and that these firms require these non-MFP employees to comply with the firm's pay-to-play policies and procedures. The purpose of this procedure is to mitigate the impact of the look-back provisions under Rule G-37. The Risk Alert also indicates that some firms prescreen potential employees for their prior political contributions to avoid similar consequences.

Screening new employees and conducting reviews prior to a promotion or change in responsibilities are practices widely used by investment advisers and municipal securities dealers to assure compliance with pay-to-play restrictions. Typically, firms use questionnaires to obtain information from any potential MFP or covered associate regarding his or her political activities. In the context of firm mergers or "lift outs," due diligence regarding political contributions of the target firm or its individual employees is essential to mitigate the impact of the look-back provisions under Rule G-37 or other applicable pay-to-play rules.

Pre-Clearance of, or Restrictions on, Political Contributions. The Risk Alert notes that many firms employ procedures that involve pre-clearing or restricting political contributions. According to the Risk Alert, the practices observed by the NEP examiners include the following: (1) requiring pre-clearance of political contributions only by MFPs; (2) requiring pre-clearance of political contributions by MFPs and certain non-MFP employees; and (3) prohibiting political contributions by any employee.

Some form of pre-clearance policy for political contributions is a common requirement of municipal underwriters and other organizations subject to pay-to-play restrictions. As the Risk Alert notes, there are a range of procedures used by firms, however, depending on their risk profiles. The Risk Alert states that many firms require the pre-clearance of all political contributions by MFPs, including contributions with respect to federal elections (for which state or local officials may be seeking office). Some of these firms may also require the pre-clearance of political contributions by certain non-MFP employees. The Risk Alert also notes that, while not required by MSRB rules, some firms prohibit non-*de minimis* political contributions, as a condition of employment. However, the Risk Alert states that such prohibitions may be in conflict with state or local laws.[14] Lastly, the Risk Alert indicates that some firms require the pre-clearance of political contributions by family members.

In addition to the examples noted in the Risk Alert, some firms may require pre-clearance of all contributions by their employees, whether or not the contributions would fall within the *de minimis* exceptions. By doing so, firms can avoid potential problems relating to errors in judgment or misunderstandings, detect potentially coordinated activity, assure that the MFP resides in the election district, and prevent contributions that cumulatively may exceed the permitted *de minimis* limits. The scope of restrictions often is based on a firm's risk profile. For example, municipal underwriters, which generally rely exclusively on business from government entities, are likely to have a greater awareness of limits on political activity under the MSRB rules and impose more detailed compliance policies and procedures on their staffs. In contrast, investment advisers, while subject to similar restrictions under Advisers Act Rule 206(4)-5, frequently manage assets for many different types of government and non-government clients and often have larger staffs, which include more administrative employees. For this reason, some investment advisers choose to employ a wider range of controls and may impose stricter compliance standards only on those individuals whose activities are clearly covered by the pay-to-play restrictions.

As noted in the Risk Alert, some firms that are subject to pay-to-play restrictions also require pre-clearance of political contributions by family members of employees or other associated persons. While not required under either Rule G-37 or Advisers Act Rule 206(4)-5, a contribution by a family member can present

attribution problems if made from a joint checking account or shared credit card. In addition, state and local procurement or lobbying laws can impose further limits on political contributions that extend to family members of certain officers, owners, and directors of a firm. Thus, depending on the nature of a firm's business, some personnel may be placed in a category that is subject to heightened pre-clearance restrictions, which includes family members.

Missing from the Risk Alert is a discussion of "in-kind" contributions similar to those discussed in the Settlement Order. Many general firm policies indicate that employees may express their political views to co-workers in a manner that is not offensive, and encourage community involvement and volunteer activity. However, such policies also state that the firm's resources are not to be used for political activities and employees may not solicit or coordinate contributions without approval. Some firms also require the pre-clearance of certain political activities, including hosting or attending fundraisers, serving on campaign committees, and providing testimonials in support of a candidate. Policies also often encourage all personnel to raise questions about their political activity with a firm's compliance department or other knowledgeable person, even after the fact.

Separation of Functions. Finally, the Risk Alert notes that some firms separate internal responsibility for certain compliance functions, including approving political contributions and surveillance of political contributions, from functions that could influence an employee's terms of employment, such as management and human resources. The Risk Alert notes that the segregation of information about political contributions and other activity is intended to protect an employee against any possibility that an adverse employment action could be taken based on the employee's political preferences.

Many employees are concerned that their political preferences will be shared with others within their firm, including their supervisors and co-workers. While the pre-clearance and reporting of contributions may be necessary to assure compliance with applicable pay-to-play restrictions, firms often recognize this concern of their employees and emphasize in their policies that the information provided by the employee will be used only for compliance purposes and will not be disclosed to others, except on a "need-to-know" basis. However, because political contributions may affect a firm's business decisions, including decisions to promote employees or to solicit new clients, this information may need to be shared with persons residing outside of the compliance department, as well as supervisors and other employees.[15]

V. Conclusion

Because of the harsh consequences for not complying with the law, firms and their employees should be keenly aware of political activity that may cause violations of applicable pay-to-play restrictions. The Settlement Order and Risk Alert provide an important reminder for investment advisers and municipal underwriters that are subject to pay-to-play restrictions. The Settlement Order, in particular, highlights issues relating to "in-kind" contributions and solicitation activities, as well as the heightened supervisory standards for politically active employees, that may be of interest to investment advisers who have less guidance from the SEC on the application of Advisers Act Rule 206(4)-5.

Footnotes

1. *See* Goldman, Sachs & Co., SEC Rel. No. 34-67934 (Sept. 27, 2012).

2. *See* SEC News Release No. 2012-199 (Sept. 27, 2012).

3. *See* Office of Compliance Inspections and Examinations, SEC, "Pay-to-Play" Prohibitions for Brokers, Dealers and Municipal Securities Dealers under MSRB Rules, National Examination Risk Alert, Volume II, Issue 4 (Aug. 31, 2012).

4. The Rule also generally prohibits firms and their MFPs from soliciting or coordinating any contributions or payments to an official of an issuer with which the firm

8. The Rule generally requires firms to file a "Form G-37" with the MSRB by the last day of the month following the end of each calendar quarter. Among other things, Form G-37 requires a firm to disclose the issuers with which the firm has engaged in municipal securities business, as well as certain non-*de minimis* political contributions by the firm and its MFPs, among others. Advisers Act Rule 206(4)-5 does not require this type of reporting, but has similar internal recordkeeping requirements. *See* Advisers Act Rule 204-2(a)(18)(i)(A),(B) and (C).

9. *See* In re NeilM.M.Morrison case, SEC Rel. No. 34-67935 (Sept. 27, 2012). This enforcement action has not

is engaging or seeking to engage in municipal securities business, or to a political party of a state or locality where the firm is engaging or seeking to engage in municipal securities business.

5. Advisers Act Rule 206(4)-5 prohibits an investment adviser from providing investment advisory services *for compensation* after certain political contributions by the adviser and its "covered associates." Accordingly, subject to applicable procurement or similar laws, an adviser could, for example, waive fees or compensation and continue to provide advisory services to a government entity without violating Rule 206(4)-5. Under Rule G-37, however, a time out is not cured by waiving fees or compensation.

6. *See* Political Contributions by Certain Investment Advisors, SEC Rel. No. IA-3043 (July 1, 2010) ("SEC Adopting Release") (The SEC notes that "[t]he definition [of contribution] is the same as … the one used in MSRB Rule G-37").

7. *See, e.g.,* MSRB Rule G-37 Q&A, Question II.18 ("[I]f the municipal finance professional uses the dealer's resources (*e.g.*, a political position paper prepared by dealer personnel) or incurs expenses in the conduct of such volunteer work (*e.g.*, hosting a reception), then the value of such resources or expenses would constitute a contribution."); and Question II.19 ("An employee of a dealer generally can donate his or her time to an issuer official's campaign without this being viewed as a contribution by the dealer to the official, as long as the employee is volunteering his or her time during non-work hours, or is using previously accrued vacation time or the dealer is not otherwise paying the employee's salary (*e.g.*, an unpaid leave of absence)."). The SEC has expressed a similar interpretation with respect to Advisers Act Rule 206(4)-5.

been settled.

10. The employee's e-mail was subject to general compliance screening.

11. MSRB Rule G-8 requires firms to maintain accurate and complete lists of their MFPs, among others. Advisers Act Rule 204-2(a)(18)(i)(A) contains a similar recordkeeping requirement with respect to an adviser's "covered associates."

12. See Edward L. Pittman & Brenden P. Carroll, "Pay-to-Play" in the Financial Services Industry, 42 Sec. Reg. & L. Rep (BNA) No. 19, at 921 (May 10, 2010); Edward L. Pittman, "Pay to Play" Laws Present Significant Compliance Challenges, Investment Adviser Association Newsletter, Issue 203 (Nov. 2009).

13. Under both Rule G-37 and Advisers Act Rule 206(4)-5, an applicant may request an exemption from the two-year time out. An exemption is subject to certain findings and considerations, including whether the exemption is consistent with the public interest and whether the applicant had developed and implemented policies and procedures reasonably designed to prevent violations of the applicable rule.

14. Local labor laws may prohibit overly broad restrictions that are not necessary to comply with the pay-to-play rules.

15. As noted above, information about political contributions is widely available on the internet, at the websites of local election commissions, or through the MSRB.

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