

## E-ALERT | Election and Political Law

November 22, 2010

### LOOKING BACK AND LOOKING FORWARD

The 2010 election cycle has ended and Washington is in full debate over whether to seek common-sense bi-partisan solutions to the nation's problems or relentlessly fight for the principles of our party (whichever political party that may be). While it seems hard to believe, a year ago, the Supreme Court had only recently heard reargument in *Citizens United* and President Obama's [approval rating](#) had just fallen below 50% for the first time during his administration. A year from today, the Republican presidential caucus in Iowa, and ensuing primaries in New Hampshire and South Carolina, will be approximately 60 days away. So with turkey dinners on everyone's mind, Covington's Election and Political Law group thought it was a good time to reassess some of the important changes in the law in the past year, as well as to consider some of the biggest issues that may occupy us in the two years ahead.

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### SEC Pay-to-Play Rule - Compliance Required Starting March 14, 2011

Beginning on March 14, 2011, investment advisers (including hedge funds and private equity funds) will be required to comply with the Securities and Exchange Commission's new "pay-to-play" rule governing political contributions. Although the SEC adopted the new rule this year, the agency chose to phase it in over time, and specifically chose to make sure that it would not apply to contributions made during the 2010 elections. It will, however, have a major impact on state elections in 2011 and the 2012 federal and state elections.

In general, the SEC's pay-to-play rule restricts the ability of certain employees and owners of firms that are registered investment advisers to make campaign contributions to state and local candidates and officeholders who are in a position to influence the awarding of state and municipal pension fund investment contracts. You can read our detailed summary of the new rule [here](#). Investment advisers will be barred from accepting compensation for investment advisory services from state and local pension funds if certain "covered associates" have made contributions to individuals who are, or if elected would be, in a position to award business. An investment adviser

generally will be barred from entering into an investment contract with a state or local pension fund if any covered associate has made a prohibited contribution during a six-month “look back” period (or two years in the case of an employee who solicits pension fund investments). Contributions made prior to March 14, 2011, will not, however, trigger the pay-to-play bar on business.

The SEC explained in announcing the new rule that “we have provided an extended transition period to provide advisers . . . with sufficient time to conform their business practices to the new rule, and to revise their compliance policies and procedures to prevent violation of the new rule.” All investment advisers, hedge funds, and private equity funds should consider adopting such a pay-to-play compliance policy tailored to their needs prior to March 14, 2011.

### The IRS - A Watch Dog with Real Teeth, But Will It Get off the Porch?

We are closely watching developments at the IRS, which has the potential to become the most important agency regulating political spending in the next cycle. Those involved in political spending decisions need to remember that the FEC and the IRS both have jurisdiction, and they do not always treat the same activity with the same level of regulatory zeal or laxness.

This becomes especially important since the IRS has instituted a formal procedure that allows interested individuals and organizations to “blow the whistle” on exempt organizations by submitting complaints to the IRS. The procedure has rapidly become quite popular. Indeed, some self-styled watch-dog groups do little more than prepare and submit complaints to the IRS, with the accompanying media blitz, of course.

While many donors favored the disclosure-light aspects of 501(c)(4)’s this cycle, some of those entities may be at risk if asked by the IRS to show that their primary purpose is to advance social welfare, as opposed to influencing the election or defeat of particular candidates for public office. Add to that the unsettled question of whether the gift tax applies to contributions to 501(c)(4) entities (and the fact that all those entities will attach to their IRS Form 990’s this spring confidential schedules of donors who gave over \$5,000) and you begin to see how a tax analysis can be as relevant to campaign spending decisions as the campaign finance laws.

A good example of this was *The New York Times* recent [story](#) detailing how retired and defeated members of Congress can take advantage of a “little-known loophole in campaign finance laws” that allows them to use their leadership PACs for lavish spending on meals, luxury hotels and similar forms of excess. The article concluded that former Members of Congress are “largely free to spend the money left over in their political action committees however they choose.”<sup>1</sup> But the *Times* story ignores the potentially unpleasant tax consequences that former members could face if they abuse this “loophole.”

Expenditures of funds controlled by former members of Congress after a campaign are generally treated as expended for his or her personal use and may therefore be taxable income unless the expenditure is for campaign related activity, or the funds are held in reasonable anticipation of future campaigns or given to charity or to the federal or a state government. In addition, any PAC – including a leadership PAC – is at risk of tax penalties whenever it spends funds for anything *other than* campaign-related activity, which generally includes activity to influence or attempt to influence the selection, nomination, election, or appointment of any individual to elected public office or office in a political organization. Luxury hotels in resort locations and the salaries of personal staff could fall outside the definition of “campaign related activity,” as could a quiet dinner at the Palm with your spouse. So this may not be such a big “loophole” after all.

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<sup>1</sup> “Political Funds Remain an Asset for Many Ex-Lawmakers,” by Eric Lipton, November 5, 2010.

## *Citizens United* - The Rulemaking

One of the bigger fights in campaign finance law in 2011 may be over the FEC's rulemaking, addressing the consequences of *Citizens United* on the FEC's regulations. The current Commissioners show little consensus on the permissible scope of regulation of political spending (or political speech if you prefer). This means two things are reasonably likely. First, the Notice of Proposed Rulemaking will likely include a broad range of proposals and questions, some that could be quite alarming, and most that will not make it into the final rule. Second, it will be a bumpy road on the way to finding the four votes necessary to adopt a final rule.

The stakes could be high, as was evident when fourteen Democratic Senators [wrote](#) the FEC Commissioners and urged them to use the rulemaking to roll back earlier FEC decisions that permit the domestic subsidiary of a foreign corporation to establish a federal PAC. FEC Commissioners tend to be good at reading these sorts of letters, and it was no surprise that the National Association of Business PACs weighed in quickly, and there may be comments from the Republican side of the Hill as well if this issue heats up in the rulemaking.

## Honest Services Fraud and the Alabama Legislature

The Supreme Court's decisions in the three honest services fraud cases (*Skilling v. United States*, *Black v. United States* and *Weyhrauch v. United States*) provided a welcome narrowing to the concept of "honest services fraud," which at times had seemed like a "we'll know it when we see it" standard. For a general description of the cases, see, Covington's June 24, 2010 E-Alert [here](#).

An example of the way the Justice Department may begin approaching charging decisions in political corruption cases appeared in the indictment in early October of four members of the Alabama Senate, three lobbyists, three businessmen and a staff attorney for the Alabama legislature, alleging a conspiracy to bribe legislators to vote in favor of a gaming bill. [United States v. McGregor, et al.](#)

Several things stand out in this case. First, it's old fashion bribery.<sup>2</sup> The charges all involve an exchange of something of value for votes or other official actions. Second, the "thing of value" offered and given to the legislators was mostly campaign contributions or in-kind support for their re-election campaigns. It is important to remember that the Department of Justice takes the position that otherwise lawful transactions, such as making a campaign contribution or hosting a fundraiser for a favorite politician at your home, could be a crime if done in exchange for their vote or other official action. Third, the case appears to have been built on intercepted phone calls and participants who wore a "wire" during meetings between lobbyists, legislators and businessmen. The FBI routinely uses the investigatory tools once associated with mob investigations to pursue public corruption cases. Finally, the state-level lobbyist involved used the PAC funds of clients in unrelated industries that were otherwise uninvolved and unaware of the scheme to make contributions needed to win votes on a gaming initiative. This is a reminder of the importance of overseeing state lobbyists and their activities.

So a narrower scope in the charging documents and broader investigatory tools seem to be the practice for now. This case also highlights the risks of mixing discussions with government officials of how they can assist you or your clients on policy matters, with conversations about how you can assist their campaign needs.

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<sup>2</sup> Specifically, the defendants were charged with federal program bribery, extortion, money laundering, conspiracy, false statements and obstruction of justice.

## Pay To Play - As Compliance Programs Are Implemented, So Are Sanctions

“Pay-to-play” provisions, aimed at limiting any connection between political contributions and government contracting decisions, remain popular in many states and localities. More than a dozen states have enacted some type of statewide pay-to-play law, and numerous local governments and individual government agencies have adopted their own policies.

For example, in July, a pay-to-play law went into effect in Virginia, prohibiting potential state contractors from making certain political contributions while a bid for a state contract worth more than \$5 million is pending. In September, the Comptroller of New York revised his [Interim Policy](#) on Political Contributions and eliminated an exemption for contributions of \$250 or less made by investment advisers to the State Common Retirement Fund and their “covered associates” who were eligible to vote for the candidate they contributed to. In California, any business entity “seeking a contract” with the Los Angeles Metropolitan Transit Authority (“MTA”), or any owner or employee of that business entity (including the owner’s or employee’s immediate family), is prohibited from giving any MTA employee or official or a member of his or her immediate family, any campaign contribution of more than \$10. MTA officials or employees who have accepted a campaign contribution of more than \$10 from a business entity, owner or employee, within the previous four years, may not participate in any contract decision involving that business entity.

Because pay-to-play laws are likely to continue to proliferate, many clients have begun the somewhat complicated process of developing policies that address these laws. These policies must take into account the variation in laws among the various states, localities, and agencies, as well as differences in approach: while some pay-to-play laws only require *disclosure* of the political contributions made by government contractors or potential government contractors, others *prohibit* certain contributions by those seeking government contracts. In many cases, a political contribution made months prior to a company seeking a government contract may disqualify that company from the process. Pay-to-play laws also differ in the scope of their coverage: while a few laws apply only to contributions made by a business entity itself, many more apply to contributions made by a company’s officers and senior employees, as well as the family members of these employees.

Companies have had to consider how best to collect and monitor the necessary information regarding employee political contributions. Many companies have implemented pre-clearance policies for certain employee’s political contributions. This can be a sensitive area: companies have had to educate their employees on the need for this information – as well as the consequences to the company for failure to comply with pay-to-play obligations.

The pay-to-play policies that clients have adopted have had real consequences in this recent election cycle. In some cases, employees who were considering making contributions to state or local candidates or political parties chose not to do so because the contribution would have been prohibited or interfered with the company’s ability to seek government contracts. We have also seen clients have to forego the pursuit of certain government business because of political contributions made in the past. Avoiding such severe consequences requires a good deal of planning and diligence by companies doing business with government entities.

## Money In Politics - Can We Grow The Restricted Class?

Many of our clients have asked how they can maximize fundraising for their corporate PAC. One of the ways is to increase the number of potential donors to the PAC by increasing the size of the PAC’s restricted class.

The Federal Election Commission permits a corporation to create a PAC, and solicit voluntary contributions from a limited class of individuals known as the PAC's "restricted class." The restricted class for a corporate PAC includes:

- The corporation's executive and administrative personnel;
- The corporation's stockholders; and
- The families of these two groups.

A company's "executive" and "administrative" employees are those who are employed by corporation on a salary, rather than hourly, basis and who have policymaking, managerial, professional, or supervisory responsibilities. Determining whether a particular employee has such responsibilities is not always a straightforward exercise. FEC regulations advise companies to look to the Fair Labor Standards Act ("FLSA") and its accompanying regulations for general guidance, and the FEC itself considered the issues involved in an Advisory Opinion issued earlier this year. See FEC Advisory Opinion 2010-04, *Wawa, Inc.* (April 30, 2010).

Generally, executive and administrative employees include those who devote the majority of their work week to duties involved in running the company's business -- such as plant, division and section managers, officers and executives. The exercise of discretion and independent judgment on matters of significance in performing work duties is also a factor weighing in favor of a determination that the individual is an executive or administrative employee. On the other hand, salaried foreman or other lower-level supervisors who directly supervise hourly employees are generally not considered executive or administrative employees.

One of the relevant factors to consider when determining whether an employee has managerial responsibilities include whether the employee has responsibility for the following types of activities:

- interviewing, selecting, and training of employees;
- setting and adjusting rates of pay and hours of work;
- planning and directing the work of employees;
- appraising employees' productivity and efficiency for the purpose of recommending promotions or other changes in status;
- handling employee complaints and grievances;
- disciplining employees;
- apportioning the work among the employees;
- controlling the flow and distribution of materials or merchandise and supplies;
- planning and controlling the budget; and
- monitoring or implementing legal compliance measures.

In addition, employees who work in functional areas such as payroll, accounting, auditing, purchasing, human resources, government relations, legal and regulatory compliance, or similar area may be considered to have managerial responsibilities.

Finally, members of the recognized professions – including physicians, registered nurses, lawyers, and engineers – are generally considered within the restricted class by virtue of their professional training and responsibilities.

Remember that your restricted class is not just for soliciting contributions for the corporate PAC. A corporation may also use corporate funds to communicate with its restricted class on political matters, including candidate endorsements. Corporate funds may be used to pay for events, including candidate fundraisers, to events for restricted class members. If a corporation spends \$2,000 or more for a particular election on communications containing express advocacy to its restricted class, it must disclose these expenditures in a public filing with the FEC.

### Independent Ads - What Have We Learned From the 2010 Cycle?

Aside from the Tea Party, there was nothing the press paid more attention to this cycle than the independent spending by outside groups. Certainly, a great deal of money was raised and spent by a variety of groups unaffiliated with candidates and parties, and that is likely to occur again in 2012. So what are some of the lingering issues?

*What are the coordination rules and what impact will they have?*

Courts, agencies and legislatures continue to wrestle with the question of what, if any, communications can an outside group funding independent ads have with a candidate who is mentioned in those ads.

The most important near-change took place in September, when the U.S. Court of Appeals for the Fifth Circuit in an *en banc* decision came within a hair's breath of striking down the FEC's tattered coordination rules. [Cao v. FEC](#). While the rules survived, all of the judges expressed a willingness to create an exception for limited communications between the group and the campaign, such as informing the candidate as to the timing of the ads prior to their airing, so long as the candidate was not aware of the exact content of the ad. A minority of judges argued strenuously for a new test that would turn on whether the ad articulates the views of the outside group (in which case the level of interaction with the campaign was irrelevant), or the views of the candidate (in which case the ad was a coordinated in-kind contribution).

There was also an interesting and little noticed FEC enforcement matter that came to a close this summer involving allegations of coordination between Harry Mitchell (AZ-5), who was facing a challenge from J.D. Hayworth in 2006, and the Democratic Congressional Campaign Committee. FEC MUR 5879. The case could be a helpful guide in understanding how the FEC is evaluating the use of candidate material in independent expenditures.

Days after the *Arizona Republic* gave Congressman Mitchell a surprise endorsement in the race, both the Mitchell campaign and the Democratic party's congressional committee aired ads touting the endorsement, featuring identical footage of Mitchell. Hayworth alleged illegal coordination. The investigation revealed that party staff reached out to the campaign after the endorsement, asking for footage of Mitchell. The campaign obliged with recently shot footage that the campaign would shortly use in its own ad. There was no evidence of coordination aside from forwarding the footage.

The FEC addressed two issues. First, the FEC concluded that there was no "coordination" because the mere request for footage from the campaign did not meet the "conduct" prong of the agency's coordination test: the candidate was not materially involved in decisions about (1) the content of the communication, (2) the intended audience, (3) the means or mode of the communication, (4) the

specific media outlet used, (5) the timing or frequency of the communication, or (6) the duration of the ads. This was true even though the campaign only provided the party with one minute and eight seconds of video from which to select and use in their ad. The FEC's lawyers concluded that the key here was whether there was "specific information to suggest that the Mitchell Committee was involved in the process by which the DCCC selected that footage for inclusion in [the ad]."

Second, there is a statutory provision which states that the republication of a candidate's campaign material "in whole or in part" constitutes an in-kind contribution to the campaign. The FEC Commissioners split 3-3 on this question, and have not yet produced Statements of Reasons explaining their votes. It is worth noting that the respondents raised arguments that were similar to the ones advanced in *Cao*: that the test should turn on whether the independent expenditure constituted the outside group's own speech, or whether instead the ad amounted to no more than paying the bills for the candidate's speech.

Put simply, the coordination rules remain in flux and outside groups will need to watch the agencies and the courts closely to understand how much leeway there is in communicating with parties they cannot "coordinate" with.

*What effect does the government contractor ban have on independent expenditures?*

An unexplored question left over from this cycle is whether an independent expenditure PAC operating consistent with the FEC's advisory opinions in *Club for Growth* and *Commonsense Ten*, can accept contributions from companies that hold government contracts. While the Supreme Court struck down the prohibition on corporate independent expenditures, do the same interests apply equally if the corporation is also a government contractor? The federal campaign finance laws prohibit "any person...who enters into any contract with the United States or any department or agency thereof either for the rendition of personal services or furnishing any material, supplies, or equipment to the United States or any department or agency thereof...if payment for the performance of such contract...is to be made in whole or in part from funds appropriated by the Congress" from making a contribution or a promise to make a contribution to a political party or candidate for public office "or to any person for any political purpose or use." 2 U.S.C. 441c(a)(1). The FEC's regulations expanded the ban on contributions to cover "expenditures" as well.

For almost all government contractors, the longstanding prohibition on corporate contributions and expenditures proved the most easily identified barrier to their legal participation in campaign activity, and consequently, the separate restriction on government contractors has only occasionally been litigated or interpreted by the FEC. While the statute does not prohibit a government contractor from making an independent expenditure, it does appear to prohibit it from making a contribution to a political committee, even if that PAC only funds independent expenditures.

This analysis is open to challenge. The arguments that underlie the court's decision in *Citizens United* should apply equally to a statutory ban on government contractors making independent expenditures, either individually or collectively, as an independent expenditure PAC. While the government's interests in limiting corruption (or its appearance) would presumably be greater in the context of government contractors, it seems hard to imagine the majority of the Court that decided *Citizens United* reaching a different conclusion in the context of independent expenditures by government contractors. But time will tell.

## Who We Are

Covington's Election and Political Law practice is one of the oldest in the Nation. In addition to our high-profile election law litigation and FEC enforcement practice, we advise numerous Fortune 500 corporations, trade associations, financial institutions, political party committees, PACs, candidates, lobbying firms, and individuals concerning compliance with the increasingly complex array of laws governing the political process. These include federal and state campaign finance, lobbying disclosure, and government ethics laws.

For more information about Covington's Election and Political Law practice group and to access previous political law updates and client advisories, please click [here](#).

Our team includes the following attorneys:

<a href="#">Robert Kelner</a> , Partner and Practice Group Chair	<a href="mailto:rkelner@cov.com">rkelner@cov.com</a>
<a href="#">Robert Lenhard</a> , Of Counsel, Washington, D.C.	<a href="mailto:rlenhard@cov.com">rlenhard@cov.com</a>
<a href="#">Kevin Shortill</a> , Of Counsel, Washington, D.C.	<a href="mailto:kshortill@cov.com">kshortill@cov.com</a>
<a href="#">Gary Rubman</a> , Partner, Washington, D.C.	<a href="mailto:grubman@cov.com">grubman@cov.com</a>
<a href="#">Andrew Byrnes</a> , Partner, Silicon Valley, CA	<a href="mailto:abyrnes@cov.com">abyrnes@cov.com</a>
<a href="#">Demetrios Kouzoukas</a> , Of Counsel, Washington, D.C.	<a href="mailto:dkouzoukas@cov.com">dkouzoukas@cov.com</a>
<a href="#">Scott Gast</a> , Associate, Washington, D.C.	<a href="mailto:sgast@cov.com">sgast@cov.com</a>
<a href="#">Zachary Parks</a> , Associate, Washington, D.C.	<a href="mailto:zparks@cov.com">zparks@cov.com</a>
<a href="#">Melanie Reed</a> , Associate, Washington, D.C.	<a href="mailto:mreed@cov.com">mreed@cov.com</a>
<a href="#">Derek Lawlor</a> , Associate, Washington, D.C.	<a href="mailto:dlawlor@cov.com">dlawlor@cov.com</a>
<a href="#">Angelle Smith</a> , Associate, Washington, D.C.	<a href="mailto:asmith@cov.com">asmith@cov.com</a>
<a href="#">Andrew Bernie</a> , Associate, Washington, D.C.	<a href="mailto:abernie@cov.com">abernie@cov.com</a>
<a href="#">Ken Leonczyk</a> , Associate, Washington, D.C.	<a href="mailto:kleonczyk@cov.com">kleonczyk@cov.com</a>

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