COVINGTON

The Top Three Political Law Risks for Hedge Funds, Private Equity Funds, and Investment Firms

September 20, 2017

Election and Political Law

Perhaps no industry faces more scrutiny and regulation of its political activities than the financial industry. Even though these rules are often not intuitive, failure to comply with them can result in big penalties, loss of business, and debilitating reputational consequences. This primer describes three sometimes overlooked risk areas for investment firms: (i) ensuring that covered employees and others affiliated with the investment firm do not make political contributions that result in "pay-to-play" problems for the firm; (ii) identifying when investor relations activities trigger state or local lobbying registration requirements; and (iii) conducting political law due diligence on prospective investments and portfolio companies. For each risk area, this advisory outlines steps and policies firms can adopt to avoid these common compliance traps.

Protecting Against a Potentially Crippling Pay-to-Play Violation

Most investment firms by now are aware of the complex and, in some cases draconian, pay-to-play regulations that restrict the ability of the firms and certain of their employees to make political contributions. But even firms well-versed in these restrictions might overlook some of the nuances and risks presented by this complicated patchwork of laws and regulations.

Part of the difficulty is that investment firm policies must address multiple overlapping and sometimes inconsistent pay-to-play regimes. These include the Securities & Exchange Commission's pay-to-play rule for investment advisers and separate rules for swap dealers, security-based swap dealers, FINRA member firms, municipal securities dealers, and municipal advisors. On top of these pay-to-play rules, many states and localities have adopted their own pay-to-play laws and ordinances that apply to government contractors, including investment firms that manage state or local investments. And some public investment funds have adopted their own fund-specific policies.

The most prominent and far-reaching pay-to-play rule was promulgated by the SEC in 2010. The rule's centerpiece is a two-year "timeout" provision that makes it unlawful for investment advisers to provide paid investment advisory services "to a government entity within two years" after a political contribution is made to "an official of the government entity" by the investment advisor itself or by one of its "covered associates."

An inadvertent violation of the SEC rule or other pay-to-play rules can result in forfeiture of millions of dollars and loss of future business. Assume, for example, a hedge fund manages the investments of the California State Teachers' Retirement System ("CalSTRS") and a vice president at the fund contributes $400 to a candidate for California Governor because she favors the candidate's education policies. Because the California Governor appoints individuals who sit on the Teachers' Retirement Board, the Governor is considered a covered "official" with respect to CalSTRS. Consequently, that small contribution by a single covered employee would trigger a two-year timeout on the investment firm itself receiving compensation from CalSTRS.

To protect against inadvertent violations of these rules, investment advisory firms should adopt policies and procedures that ensure that the firms, their employees, and others affiliated with them do not make political contributions that expose the firms to crippling sanctions and lost business. Often, these policies involve pre-clearance procedures that require employees to obtain written authorization from the firm's compliance or legal department before making political contributions. These pre-approval policies should be reviewed from time-to-time to confirm they are followed in practice and that they adequately protect against pay-to-play risks. When reviewing these policies, compliance officers should consider the following commonly overlooked issues:

- <u>Do the policies cover soliciting or coordinating contributions?</u> Under the SEC and other pay-to-play rules, it can be a violation not just to make a political contribution, but to ask others to make a contribution (such as by co-hosting an event, allowing one's name to appear on an invitation, or even making a casual suggestion to a friend or family member).
- <u>Do the policies apply to new hires?</u> Under the SEC pay-to-play rule, a political contribution made by a new hire in the six months, or in some cases two years, prior to his or her joining the investment firm can trigger the same timeouts that are triggered when a sitting executive makes a contribution. For this reason, during the new employee intake process, investment firm pay-to-play policies should require prospective new employees to disclose prior political contributions.
- <u>Do the policies apply to family member contributions?</u> The SEC pay-to-play rule does not explicitly prohibit political contributions made by spouses and family members of "covered associates." However, the SEC has stated that family member contributions can violate the rule if they are made "as a means to circumvent the rule." Moreover, some state-level pay-to-play rules, such as those in Connecticut and New Jersey, explicitly prohibit family member contributions. New Mexico's pay-to-play law even extends, in some cases, to parents-in-law and children-in-law.
- <u>Do the policies address potential "indirect" violations by requiring pre-approval for contributions to groups that themselves make political contributions? And does the investment firm receive "assurance letters" prior to approving these contributions?</u> The SEC pay-to-play rule and many other pay-to-play laws include vague catch-all language that makes it a violation "to do anything indirectly which, if done directly, would result in a violation." This catch-all language could effectively prohibit some contributions to a 501(c)(4) social welfare organization, 501(c)(6) trade association, 527 political organization, PAC, or another group if the recipient, in turn, makes contributions to candidates. The SEC has stated, for example, that the catch-all provision would effectively prohibit contributions that were "directed or funded through a third party with an expectation that, as a result of the contributions, another contribution is likely to be made by a third party" to the covered official. Similarly, the SEC and MSRB have stated that a contribution to a PAC or state or local political party could result in a violation of

the rule if the PAC or party was "soliciting funds for the purpose of supporting a limited number of" government officials. The SEC and MSRB have therefore counseled advisers and dealers to "inquire" of the PAC or political party "how any funds received" would be used. For this reason, it is often prudent to require pre-clearance for contributions to politically active groups, not just for contributions to candidates and political parties. Prior to approving a contribution to such a group, compliance officers might require that the donor obtain an "assurance letter" that makes clear that the recipient will not engage in activities that trigger pay-to-play concerns for the donor. These assurance letters help establish that the investment firm undertook due diligence prior to approving the contribution and made the "inquiry" of the recipient organization recommended by the SEC and others.

- <u>What process is in place to train employees on these restrictions and to routinely remind them of the policy?</u> To reduce the risk that employees forget to seek pre-approval prior to making a problematic contribution, investment firms should provide routine training to covered employees regarding the firm's pay-to-play compliance policies.
- <u>Does the investment firm review state campaign finance databases for potential unapproved contributions by employees?</u> Because it is easy for employees and family members to overlook pre-approval requirements, some investment firms periodically review certain state or local campaign finance databases to determine whether covered employees or family members made unapproved contributions that present a pay-to-play issue. When a prohibited contribution is identified early, corrective action (such as requesting a refund) can be taken promptly, increasing the chances that the SEC may grant an exemption. In addition, the SEC allows for automatic exemptions when refunded contributions are discovered within four months of the date of the contribution and other narrow criteria are satisfied.

To assist compliance officers with the case-by-case review of contributions, several resources are available. Covington, for example, annually publishes a manual of over 250 pages detailing pay-to-play rules that apply, if any, in all 50 states, as well as specialty pay-to-play provisions adopted by specific state or local pension funds. For further information regarding the Covington pay-to-play survey, please feel free to contact any of the authors listed below.

When Investor Relations Becomes "Procurement Lobbying"

Employees in the investor relations departments of hedge funds and private equity firms do not typically think of themselves as "lobbyists." But state laws sometimes say otherwise. In many states, attempting to influence the contracting decisions of government officials—including decisions about where to invest state pension funds and public university endowments—counts as "lobbying" and thereby triggers lobbying registration requirements for the employee or the investment firm. Each of the activities below, for example, could trigger lobbying registration requirements:

- An investment firm employee receives more than $1,000 in compensation related to efforts to secure an Indiana Public Retirement System investment outside the formal RFP process;
- An investment firm employee has just one meeting or phone call with a member of the Illinois State Board of Investments;

- An investment firm pays its employees more than $5,000 for their time devoted to attempting to secure New York City Employees' Retirement System investments.

Triggering registration sometimes just means a little more paperwork. But in some jurisdictions, the administrative burdens can be significant. California, for example, requires investor relations employees who qualify as "placement agents" to travel to Sacramento or other locations in the state to receive in-person state ethics law training.

As a result of these restrictions, investment firms should adopt lobbying compliance policies and routinely train investor relations staff on these lobbying registration requirements. These policies might, for example, require investor relations staff to first consult with the firm's compliance department before communicating with public officials about potential investments. The failure to comply with these lobbying registration rules can result in civil fines, long enforcement proceedings, and lost business opportunities as public investors pull back from considering investing with funds that have violated state ethics laws.

Political Law Due Diligence for Investments and Portfolio Company Acquisitions

It is not just the investment firm's own employees who can create political law headaches. When a private equity fund or other investment firm acquires a company, political law should be a part of the diligence process because an undiscovered political law violation by the target company could result in financial and reputational problems for both the target and the investment firm, post-acquisition. When those problems are discovered on the front-end, the fund can require the target to take corrective action and adjust the purchase terms to account for these risks. But if these issues are not uncovered until after the acquisition, the investment firm can inherit a target with unexpected liabilities.

While the scope of the diligence will depend on the nature of the target's business and the extent of its dealings with public officials, common diligence questions might include:

- Does the target have policies or procedures governing compliance with state, local, or other applicable pay-to-play laws?
- Has the target company or its executives or others affiliated with it made political contributions that violate any applicable pay-to-play laws?
- Does the company administer any political action committees and, if so, what are the policies, training programs, and safeguards those PACs have in place to ensure compliance with applicable law?
- Has the target company adopted policies addressing corporate political activity and personal political activity to ensure, for example, that executives do not use corporate resources in a manner that would violate the law when raising funds for candidates?
- What steps does the company have in place to ensure compliance with federal, state, and local lobbying laws? In which jurisdictions is the company registered as a lobbyist principal or client and in which jurisdictions does it retain or employ lobbyists?
- Do the company's contracts with outside lobbying firms carry any compliance risks?
- Does the company have a policy in place to ensure that it does not provide prohibited gifts to federal, state, or local government officials?

- Has the target company ever been subject to a political law enforcement proceeding or complaint involving alleged campaign finance, foreign agents registration, lobbying, government ethics, gift, or pay-to-play violations?
- When did the company last provide political law compliance training and what topics did it cover?

In assessing these issues, investment firms should be particularly careful when acquiring targets that do business with state and local governments. As described above, many states and localities have their own pay-to-play rules that apply to virtually all government contractors, not just investment firms. If a target company does business with state and local governments and has been inattentive to pay-to-play rules, the acquiring company should weigh the risk that, at some point, a target company employee may have made a political contribution that could jeopardize a major state or local contract.

In rare situations, the investment firm itself can face pay-to-play consequences that stem from the political contributions of the acquired company. In some states, a contribution made by a subsidiary that is directly or indirectly controlled by an investment adviser can prohibit the investment firm itself from managing state investments. The due diligence process can be used to ensure that the target company locks in pay-to-play and political law compliance policies before the investment firm itself is exposed to these risks.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Election and Political Law practice:

Robert Kelner	+1 202 662 5503	rkelner@cov.com
Bob Lenhard	+1 202 662 5940	rlenhard@cov.com
Zack Parks	+1 202 662 5208	zparks@cov.com
Derek Lawlor	+1 202 662 5091	dlawlor@cov.com