BNA

Securities Regulation
& Law Report™

Reproduced with permission from Securities Regulation & Law Report, 43 SRLR 2485, 12/12/2011. Copyright © 2011 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

REGULATORY REFORM

The Clash of the SEC's New 'Pay-to-Play' Rules And Employees' Rights to Participate in the Political Process

BY STEVEN D. FELDMAN AND RAIMUNDO GUERRA

Pension funds have recently been in the public eye due to major scandals in New York State and elsewhere in which investment advisers were accused of making payments to help themselves get government business.[1] As part of a three year investigation into New York State's $125 billion pension fund by former Attorney General Andrew Cuomo, eight individuals pleaded guilty in relation to the administration of these funds.[2] As a result, the U.S. Securities and Exchange Commission (''SEC'') approved new regulations to curtail these payments by limiting political contributions.

Although the new regulatory scheme promises to diminish the possibility of ''pay-to-play,'' it presents a new series of questions as to how it will impact statutorily protected employee lifestyle choices outside of the workplace, particularly employees' involvement in the political process. The SEC failed to consider these lifestyle statutes when creating the new rules. While the SEC may be able to regulate investment advisers, will employers be able to control, punish or fire employees who violate the rules?

Background

On June 30, 2010, the SEC approved new rule 206(4)-5, adopted under the Investment Advisers Act of 1940. The purpose of the rule is to curtail potential ''pay-to-play'' abuses resulting from investment advisers making political contributions to the same persons that select the managers for public pension funds. With over $2.6 trillion in assets, pension funds are among the largest institutional investors in the United States.[3]

In this context, ''pay-to-play'' is the practice of making campaign contributions and related payments to elected officials in order to influence the awarding of lucrative investment management contracts.[4] The practice is difficult to eliminate because it is so hard to identify and prove. In the public pension fund context, this concern is magnified because of the high stakes in-

Steven Feldman is a lead partner in Herrick's White Collar Defense practice. He represents companies and individuals accused of securities law violations, business crimes and fraudulent practices by the U.S. Attorney's Office, State Attorney General, District Attorney and U.S. Securities and Exchange Commission. Raimundo Guerra is an associate in Herrick's Litigation Department. *The authors wish to extend their appreciation to Steven K. Weiss, General Counsel at The Roosevelt Investment Group Inc., for suggesting the topic.*

[1] *See* Fawn Johnson, *SEC Bans ''Pay to Play'' for Advisers*, The Wall Street Journal, June 30, 2010, *available at* http://online.wsj.com/article/SB10001424052748703426004575338743893126572.html.

[2] *See* John Eligon, *Adviser Pleads Guilty in Pay-to-Play Pension Scheme*, N.Y. Times, Nov. 22, 2010, *available at* http://www.nytimes.com/2010/11/23/nyregion/23morris.html.

[3] *See* Securities and Exchange Commission, Release No. IA-3043, *Political Contributions by Certain Investment Advisers*, July 1, 2010, *available at* http://www.sec.gov/rules/final/2010/ia-3043.pdf.

[4] *See Id.* at 6.

volved. When a government official selects an investment adviser through a ''pay-to-play'' scheme, he or she violates the public trust and undermines the fairness of the process through which public contracts are awarded.[5] In theory, this practice can detrimentally affect the operation of the fund, potentially jeopardizing the retirement savings for retirees who depend on the pension payments, as well as the taxpayers who are ultimately held responsible for guaranteeing pension fund payouts.

The new rule, which went into effect on September 13, 2010, applies generally to registered investment advisers as well as certain unregistered advisers.[6] Despite the 2010 effective date, the Commission created a six month window to allow advisers to identify their ''covered associates'' and their government clients in order to address the new compliance obligations under the rule. The new rule does not apply to political contributions made before March 14, 2011.

In crafting the rule, while the SEC recognized certain negative ramifications from the new policies set forth in 206(4)-5 — including possible large compliance costs to the funds and burdens placed on covered individuals' participation in the political process through the giving of campaign donations — the SEC determined that these issues were outweighed by the ''pay-to-play'' concerns.

Main Elements

Rule 206(4)-5's main element is a two year ''time out'' for contributions. Under rule 206(4)-5(a)(1), if an investment adviser or a covered associate makes a contribution to a government official involved with fund manager selection, then the investment adviser is prohibited from receiving any payment for fund management for two years after making the contribution.[7] An official of a government entity is defined as any incumbent, candidate or successful candidate for elective office if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.[8]

For the two year time out to be triggered, the donation must be made by the investment adviser or a covered associate. The SEC defined a covered associate as: (1) any general partner, managing member or executive officer, or other individual with a similar status or function; (2) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (3) any political action committee controlled by the investment adviser or any of its covered associates.[9]

Rule 206(4)-5 does not prohibit all political contributions by covered associates to an official of a government entity. Instead, the SEC established an exception for what it considers *de minimis* contributions. Under this exception, the two year time out is not triggered if the individual donates no more than $350, per election, to a government official or candidate for whom he or she is entitled to vote.[10] If, on the other hand, the donation is to a government official or candidate for whom the individual is not entitled to vote, the maximum donation is $150.[11] The *de minimis* exception is only available to individual covered associates, not the adviser itself. Primaries and general elections are considered separate elections for the purposes of the *de minimis* exception.

The other main elements of the new rule include a ban on using third parties to solicit government business, and restrictions on soliciting and coordinating contributions.[12]

Analogous Legal Restrictions

The fact that 206(4)-5 limits political contributions does not by itself make this rule unique. For instance, states such as New Jersey have limited contributions by contractors to public officials. Under New Jersey's Campaign Contributions and Expenditure Reporting Act, a state agency is prohibited from awarding a contract with a value over $17,500 to a business entity that has contributed more than $300 during the preceding 18 months to the governor, a candidate for governor, or any state or county political party committee.[13] Similar to restrictions on investment advisers, enforcing this rule has proved extremely challenging, as evidenced by the myriad lawsuits brought by contractors who are now virtually enjoined from making political donations.[14]

In New York, the imposition of limits on campaign contributions has also been met with stiff resistance from many sectors. In *Ognibene v. Parkes*, citizens brought suit alleging that certain provisions of New York City's political campaign finance and lobby laws

[5] *See Id.*

[6] However, the new rule will not apply to most small advisers registered with state securities authorities instead of the SEC. *See* Securities and Exchange Commission, *supra* note 3, at 29.

[7] *See Id.* at 31.

[8] *See Id.* at 43.

[9] *See Id.* at 50.

[10] *See Id.* at 62.

[11] *See Id.* at 63.

[12] The second main element of 206(4)-5 makes it unlawful for any investment adviser subject to the rule or any of the adviser's covered associates to provide or agree to provide, directly or indirectly, payment to any third person to solicit government clients for investment advisory services on its behalf, unless such third parties are registered broker-dealers or registered investment advisers, in each case themselves subject to pay-to-play restrictions. The third main element of the new rule prohibits advisers and covered persons from coordinating or soliciting any person or PAC to make (1) any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services, or (2) any payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity. *Id.* at 70, 93.

[13] *See* James O. Castagnera, Patrick J. Cihon & Andrew M. Morriss, *New Jersey Supreme Court Wields Another Blow to Contractors' First Amendment Rights*, 25 No. 4 Term of Employment Bulletin 6, April 2009.

[14] *See In re Earle Asphalt Co.*, 198 N.J. 143 (N.J. 2009), where court upheld the Campaign Contributions and Expenditure Reporting Act, citing the state's strong governmental interest in limiting political contributions by businesses that contract with the state, against a contractor who won a public auction for construction of a section of Interstate 195 but was later disqualified for having exceeded the established donation thresholds under the Act.

 COPYRIGHT © 2011 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0037-0665

violated their constitutional rights.[15] Specifically, plaintiffs challenged amendments to the New York City Administrative Code, commonly known as the ''pay for play'' rules, which reduced to levels below the generally applicable campaign contribution limits the amount that persons engaged in certain business dealings with the City could contribute to political campaigns.[16] Citing defendants' argument that limits on political contributions serve a sufficiently important governmental interest, the district court granted their motion for summary judgment.[17]

Clash with Lifestyle Discrimination Statutes

One overlooked issue in the discussion of these restrictions is the interplay between the new SEC rule and what are known as lifestyle discrimination statutes. Specifically, the SEC has failed to address how investment advisers can comply with the obligations of the new rule while simultaneously avoiding liability under these varying state law statutes. Enacted by over 20 states across the country, lifestyle discrimination statutes are intended to limit an employer's ability to make employment decisions based on an employee's off duty, off premises conduct.[18]

Section 201-d of the New York State Labor Law, also known as New York's Lifestyle Discrimination Statute, prohibits an employer from discriminating against an employee for engaging in certain activities, particularly including participation in the political process. The statute provides in pertinent part that:

> It shall be unlawful for any employer. . .to refuse to hire, employ or license, or to discharge from employment or otherwise discriminate against an individual in compensation, promotion or terms, conditions or privileges of employment because of. . .an individual's political activities outside of working hours, off of the employer's premises and without use of the employer's equipment or other property, if such activities are legal. . .[19]

In discussing its new pay-to-play rules, the SEC acknowledged that the new rule will place burdens on advisers that provide or seek to provide advisory services to government entities, and that ''advisers may in turn choose to limit the ability of certain persons associated with the adviser to make contributions to candidates for certain offices and to solicit contributions for certain candidates and payments to political parties.''[20] However, none of the SEC's discussions addressed the possible conflict with state lifestyle discrimination statutes. Rather, the SEC's discussion was based on the premise that advisers could ''restrict'' their employees' political contributions or require employees to receive approval prior to making any political contributions.[21]

Therefore, the question remains. While the SEC opines that advisers may choose to limit the ability of certain persons to make or solicit political contributions, what actions may an adviser actually take against an individual who, despite the new SEC regulations and employer's policy, makes a political contribution surpassing the *de minimis* exception, therefore triggering the two year time out for the entire fund? If the adviser decides to take action against this particular individual — such as terminating his or her employment — will it face legal backlash under New York's Lifestyle Discrimination Statute or the laws of other states? Because 206(4)-5 was adopted only last year and the ''pay-to-play'' rules have only recently been implemented, no legal precedent exists to definitively answer these questions.

Although 201-d has been enforced in various cases involving, for instance, the termination of an employee based on political activity, there is no § 201-d case in New York dealing directly with political donations.[22] Despite this dearth of case law, it seems likely that political donations would fall within the purview of political activities and hence would be protected by § 201-d.[23]

In *Wehlage v. Quinlan*, a city employee sued under § 201-d, alleging that her position had been terminated based on her political affiliation.[24] In holding that the city did not discharge the employee for political activities outside the workplace where the employee did not run for public office, campaign for a candidate for public office, or participate in fund-raising activities for the benefit of a candidate, political party or political advocacy group, *Wehlage* implicitly held that political donations, such as those limited by rule 206(4)-5, are considered political activities and hence are protected by New York's Lifestyle Discrimination Statute.[25]

Court rulings in other states have held that an employer may not terminate an employee for making, or refusing to make, a political contribution. In South Carolina, for instance, the Supreme Court held that an employee terminated for refusing to contribute to a political action fund had a cause of action for wrongful discharge.[26] In *Culler*, an employee refused to join a political action fund and was fired.[27] Enrollment in the fund entailed automatic deductions from his paycheck, which would be deposited in the organization, which would in turn donate to political campaigns of politicians supporting cooperative utilities.[28] Although the judge determined that Culler was not terminated because of his failure to contribute to the political action fund in question, the court made clear that terminating an employee for failure to make a political contribution would give rise to a claim for wrongful termination. In

[15] *See Ognibene v. Parkes*, 599 F. Supp. 2d 434 (S.D.N.Y. 2009).

[16] *See Id.* at 438.

[17] *See Id.*

[18] *See* American Civil Liberties Union, *Legislative Briefing Kit: Lifestyle Discrimination in the Workplace*, *available at* http://www.aclu.org/racial-justice_womens-rights/legislative-briefing-kit-lifestyle-discrimination-workplace.

[19] *See* Discrimination Against the Engagement in Certain Activities, N.Y. Lab. Law § 201-d(2)(a) (2009).

[20] *See* Securities and Exchange Commission, *supra* note 3, at 127.

[21] *Id.* at 140.

[22] *See Richardson v. City of Saratoga Springs*, 246 A.D.2d 900 (N.Y. App. Div. 1998), where plaintiff, a city employee, brought action under 201-d alleging that the city and the commissioner of public works modified his job duties so as to deny him a promotion for his support of the commissioner's opponent during the upcoming election.

[23] *See Wehlage v. Quinlan*, 55 A.D.3d 1344 (N.Y. App. Div. 2008).

[24] *See Id.*

[25] *See Id.*

[26] *See Culler v. Blue Ridge Electric Coop., Inc.*, 309 S.C. 243 (S.C. 1992).

[27] *See Id.* at 245.

[28] *See Id.*

addition, under South Carolina law, termination of an employee for the exercise of political rights is a misdemeanor, punishable by a fine or imprisonment.[29]

Similarly, in California an employer may be unable to terminate an employee who were to exceed the thresholds established by 206(4)-5. Under Section 1102 of the California Labor Code, ''an employer may not influence or coerce . . . his employees through or by means of threat of discharge or loss of employment to adopt or follow or refrain from adopting or following any particular course or line of political action or political activity.''[30] As a result of this provision, an employer subject to California law may be unable to terminate an employee exceeding the political donation allowance under 206(4)-5 as doing so would constitute an infringement of the employee's political action or activity. Moreover, even the threat in a compliance manual policy to terminate an employee for exceeding the SEC *de minimis* contribution limit, thereby subjecting the investment adviser to the two-year time out, may violate the law.

This also appears to be the case in Louisiana, where statutory protection for employees who participate in politics and run for political office is considered the broadest in the nation.[31] Section 961 of the Louisiana Code states that employers with 20 or more employees

> [S]hall not adopt or enforce any rule . . . which will control . . . or direct the political activities or affiliations of his employees, nor coerce. . .any of his employees by means of threats . . . of loss of employment in case such employees should support or become affiliated with any particular political faction or organization, or participate in political activities. . .[32]

The Business Exception

What is particularly important about Louisiana's statute is that, contrary to some other states, Louisiana does not recognize a ''business exception.'' In *Davis v. Louisiana Computing Corp.*, the court held that an employer who fired an employee who was running for political office violated section 961.[33] In *Davis*, the plaintiff employee became a candidate for city council, opposing a candidate supported by Jefferson Parish officials, which accounted for 60 percent of employer's revenues.[34] Soon after announcing his candidacy, plaintiff was told that the corporation would benefit if he withdrew from the race. After refusing to do so, he was terminated.[35] Although the corporation argued that plaintiff had not been fired because of his candidacy but because of economic reasons, the court held that even though the business justification for firing plaintiff was valid, ''the policy of the statute is unmistakable,'' and there is ''no exemption from the legislative purpose because of the nature of the employer's business.''[36]

One state that does recognize a business exception to its lifestyle statute is New York. Section 201-d(3) states, ''[T]he provisions of [this law] shall not be deemed to protect activity which: (a) creates a material conflict of interest related to the employer's . . . business interest.''[37] Although no court has applied this exception, perhaps it could be applied to allow an adviser to compel its employees to abide by the limitations of 206(4)-5 by potentially discharging from employment those who make donations in excess of the *de minimis* limits and thereby detrimentally affect the adviser's business interests.

In New York, another alternative for an employer seeking to enforce 206(4)-5 without incurring liability under § 201-d seems to lie in § 201-d(4), which states that ''an employer shall not be in violation of this section where the employer takes action based on the belief that: (i) the employer's actions were required by statute, regulation, ordinance or other governmental mandate (. . .).''[38] Applying this language, and considering that 206(4)-5 limits the dollar amount that employees of advisers are able to donate to political campaigns, it seems that an adviser who decides to terminate an employee for violating a policy enforcing compliance with this regulation would be able to do so without violating § 201-d, as its actions would be based on the belief that they were required by the SEC's regulation. However, as the rule does not prohibit donations — it simply requires that the adviser work for two years without pay if its covered associate makes a donation — then a court may reject a claim that the adviser was literally ''required by statute . . . or other governmental mandate'' to discipline the employee.

Recommendations

The main purpose of 206(4)-5 is to eliminate ''pay-to-play'' schemes in the pension fund arena. Arguing that this kind of change requires drastic measures, the SEC enacted the time out provision in order to hit investment advisers where it hurts—in the bottom line. Therefore, the most effective way to curtail ''pay-to-play'' and hence achieve the objectives of 206(4)-5 is by avoiding political donations exceeding the thresholds in the first place, and as a result, terminating an employee who precludes his or her fund from complying with these regulations is perhaps an available recourse for an employer attempting to enforce this government mandate.

Precisely because of the competing legal principles involved, advisers must be very careful in implementing in-house policies and systems to comply with the new

[29] *See* Assault or intimidation on account of political opinions or exercise of civil rights, 16 S.C. Code Ann. § 16-17-560 (2009). Section 16-17-560 of the South Carolina Code of Law states, ''It is unlawful for a person to . . . discharge a citizen from employment or occupation . . . because of political opinions or the exercise of political rights and privileges guaranteed to every citizen by the Constitution and laws of the United States or by the Constitution and laws of this State.'' A person who violates this provision, if convicted, is guilty of a misdemeanor punishable by a fine or imprisonment.

[30] *See* Coercion of Political Activities of Employees, Cal. Lab. Code § 1102 (2003).

[31] *See* Frederick J. Lewis, *Can We Talk? A Guide to Political Expression In the Workplace*, Employment and Labor Update: November 2008, *available at http://www.lorman.com/newsletters/article.php?article_id=1098&newsletter_id=238&category_id=1.*

[32] *See* Political rights and freedom; restrictions forbidden; penalty; employees' right to recover damages, La. Rev. Stat. Ann. § 23:961 (2010).

[33] *See Davis v. Louisiana Computing Corp.* 394 So.2d 678 (La. Ct. App. 1981).

[34] *See Id.*

[35] *See Id.*

[36] *See Id.*

[37] *See supra* note 19, § 201-d(3)(a).

[38] *See supra* note 19, § 201-d(4).

 COPYRIGHT © 2011 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0037-0665

regulations. In order to achieve this, we recommend a clear policy on employee political contributions, including orientation on 206(4)-5 and the *de minimis* exception. This orientation should emphasize that political contributions in general are not prohibited, nor is a certain party or political position being favored institutionally.

In formulating its policy, a careful adviser will also take the time to ascertain the provisions of any state lifestyle statutes in the states where its covered associates are working. If possible, the adviser should implement a uniform policy applicable to all covered associates, and not a policy that varies state-by-state.

Advisers should also establish systems to track relevant political contributions to ensure compliance with the *de minimis* limits, and facilitate the return of a contribution if the limits are exceeded.[39] Nonetheless, this alternative is troublesome since an employee contributor may refuse to request the return of a donation, leaving the adviser with limited options. By tracking contributions, an adviser might be able to alert the SEC to inadvertent excessive contributions and thereby avoid punishment.[40]

Finally, fund managers should develop policies and procedures to scrutinize new hires, or personnel promoted into a restricted position, in order to confirm that he or she has not previously made any political contribution in violation of 206(4)-5 within the prior two years. Failure to do so may trigger the application of the two year time out under 206(4)-5(a)(1) and cause substantial losses to the adviser.

Even if these measures are successfully implemented to mitigate the risk of violations, the question remains: can a fund manager avoid liability under a state's lifestyle discrimination statute while taking disciplinary action against an employee who has made a donation exceeding the thresholds established under 206(4)-5? Although in New York § 201-d may provide some alternatives, the absence of a concrete answer to this question seems to indicate that this is just another example of a flaw in our federalist system, a case where a federal rule conflicts with the law in over 20 states. Further, even considering the limited alternatives available under state law, such as New York's business exception, issues remain as to how a fund with employees and offices throughout the country would be able to comply with the requisites of 206(4)-5.

Under the current legal scheme, a fund is left with two options: comply with lifestyle discrimination statutes and refrain from taking action against an employee who exceeds the contribution limits established by 206(4)-5—potentially losing millions of dollars when the time out provision is applied—or take action against the employee and face a lawsuit. Although taking the latter option could be more cost effective, the compliance issues raised by 206(4)-5 may well persist, as in theory the time out provision may apply to the fund regardless of the employee's termination. Because of the lack of adequate alternatives, it seems 206(4)-5 handcuffs employers, forcing them to pick the lesser of two evils.

[39] The SEC has recognized an exception for certain returned contributions, providing an adviser with the limited ability to cure the consequences of an excessive political contribution to an official for whom the covered associate making it is not entitled to vote. The exception is available to contributions not exceeding $350 to any one official, per election. *See* Securities and Exchange Commission, *supra* note 3, at 65.

[40] The SEC stated that an adviser can be exempt from the time out requirement where the adviser discovers contributions that trigger the compensation ban only after they have been made and when imposition of the prohibition is unnecessary to achieve the rule's intended purpose. *See Id*. at 114. This exemption in essence provides advisers with an additional avenue by which to cure the consequences of an inadvertent violation, such as when a disgruntled employee makes a greater than the *de minimis* contribution as he or she exits a firm. *See Id*. Among factors to be considered in deciding whether to grant an exemption are: (i) whether the investment adviser, (A) before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of rule 206(4)-5; (B) prior to or at the time the contribution which resulted in such prohibition was made, had no actual knowledge of the contribution, and (C) after learning of the contribution, (1) has taken all available steps to cause the contributor involved in making the contribution which resulted in such prohibition to obtain a return of the contribution; and (2) has taken such other remedial or preventive measures as may be appropriate under the circumstances; (ii) whether, at the time of the contribution, the contributor was a covered associate or otherwise an employee of the investment adviser, or was seeking such employment; (iii) the timing and amount of the contribution which resulted in the prohibition; and (iv) the contributor's apparent intent or motive in making the contribution which resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution. *See Id*. at 114-15.

Note to Readers

The editors of BNA's *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

Prospective authors should contact the Managing Editor, BNA's *Securities Regulation & Law Report*, 1801 S. Bell St. Arlington, Va. 22202-4501; telephone (703) 341-3889; or e-mail to sjenkins@bna.com.