



Political Law Alert

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SEC Pay-to-Play Rule for Security-Based Swap Dealers Set to Come Into Effect

In 2016, the Securities and Exchange Commission (SEC) adopted Rule 15Fh-6, the pay-to-play rule for security-based swap (SBS) dealers (SBS dealers) and companion to Commodity Futures Trading Commission (CFTC) pay-to-play Rule 23.451 for commodities-based swap dealers. At the time the rule was adopted, the SEC linked the rule's compliance date to the date on which SBS dealers would be required to register, a date that was in turn dependent on the adoption of several rules governing such SBS dealers. On February 4, 2020, the final SEC rule required to enact the SBS dealer registration regime was published in the Federal Register. Thus, the compliance date for Rule 15Fh-6 will be October 6, 2021. However, an SBS dealer only will need to comply with Rule 15Fh-6 once it is required to register, which likely will be the end of October 2021 for many dealers. Further, the SEC has advised that contributions made before the SBS dealers are required to register will not be subject to Rule 15Fh-6.

Below is a summary of Rule 15Fh-6.

What Type of Business is Covered?

The rule covers SBS dealers and security-based swaps that an SBS dealer offers or enters into with a municipal entity, which is defined as (1) a state, state agency, city, county, municipality, other political subdivision of a state, or any instrumentality, department, or a corporation of or established by a state or political subdivision of a state; (2) any plan, program or pool of assets sponsored or established by a state, subdivision or instrumentality; or (3) any other issuer of municipal securities.

Prohibitions on Political Contributions

Ban on Making Political Contributions: The rule prohibits an SBS dealer from offering or entering into a security-based swap, or a trading strategy involving a security-based swap, with a municipal entity for two years following the SBS dealer or one of its covered associates (defined below and including any PAC they control) having contributed to an official of that municipal entity. This includes not only political contributions to the official's election campaign, but also to his or her inaugural and transition committees.

Covered Officials: Under the rule, covered officials are any official of a municipal entity who is a candidate for, successful candidate for or incumbent of a state or local elective office:

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- is directly or indirectly responsible for, or can influence the outcome of, the selection of an SBS dealer by a municipal entity; or
- has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of an SBS dealer by a municipal entity.

Covered Associates: A covered associate includes:

- any employee who solicits security-based swap business from a municipal entity on behalf of an SBS dealer;
- any person who directly or indirectly supervises such solicitor;
- the general partner, managing member or executive officer (the president, vice president in charge of a principal business unit, division or function, or any other officer or person who performs policy-making functions); and
- any political action committee controlled by the SBS dealer or a person listed above.

Look-Back for New Covered Associates: For an employee who becomes a covered associate for the first time by soliciting security-based swap business, the contributions he or she made during the prior two years to an official of the municipal entity would trigger a ban for the SBS dealer. Other new covered associates have a shorter six-month look-back. Thus, when an employee becomes a covered associate for the first time, one must “scrub” that employee to make sure he or she has not made a covered contribution during the relevant look-back period. The look-back will not cover contributions made prior to the SBS dealer being required to register.

Exemptions:

- There is an exemption for any individual who contributes no more than \$350 per election to a candidate for whom he or she is entitled to vote, or \$150 per election to a candidate for whom he or she is not entitled to vote.
- If an individual contributes within the \$350 per election limit but is not entitled to vote for the candidate, there is an automatic exemption if (1) the SBS dealer discovers the contribution within 120 days and (2) a refund is obtained within 60 days of discovery. An SBS dealer may use this automatic exemption only twice during a 12-month period (three times if it has more than 50 covered associates) and only once in a lifetime for any single covered associate.

- A security-based swap that is executed on a registered national securities exchange or registered or exempt security-based swap execution facility (the regulated trading platforms for security-based swaps) is exempt if the SBS dealer does not know the identity of the counterparty for a reasonably sufficient time prior to the execution of the transaction to comply with the ban. This is a deviation from CFTC Rule 23.451, which made the exemption unavailable if a swap dealer learned the identity of the counterparty before execution.
- An SBS dealer may seek a discretionary exemption from the SEC, in which the agency will consider a variety of factors, including but not limited to the sufficiency of the SBS dealer’s compliance procedures, whether the SBS dealer had knowledge of the contribution before it was made, and the remedial steps, if any, the SBS dealer took after discovering the contribution.

Ban on Soliciting Political Contributions: The rule prohibits an SBS dealer and its covered associates from soliciting or coordinating political contributions on behalf of (1) an official of a municipal entity with which the SBS dealer is offering to enter into, or has entered into, a security-based swap or (2) a political party of the state or locality where the SBS dealer is offering to enter into, or has entered into, a security-based swap or trading strategy involving a security-based swap.

Prohibition on Paying Unregulated Third Parties to Solicit Municipal Entities: An SBS dealer is prohibited from providing or agreeing to provide, directly or indirectly, any payment to any person, including but not limited to an affiliate, to solicit a municipal entity to offer or enter into a security-based swap with that SBS dealer, unless the person also is subject to a pay-to-play rule imposed by the CFTC, SEC or a self-regulatory agency subject to CFTC or SEC jurisdiction.

Other Pay-to-Play Restriction: Rule 15Fh-5(a)(1)(vi) requires that SBS dealers and major swap participants have a reasonable basis to believe that third-party representatives of governmental special entity counterparties are subject to pay-to-play restrictions imposed by the CFTC, SEC or a self-regulatory organization subject to CFTC or SEC jurisdiction.

Indirect Violations: An SBS dealer or covered associate also is prohibited from doing indirectly what it is prohibited from doing directly.

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