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The SEC pay-to-play rule for investment advisers as it turns 12

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As we approach, on March 14, its 12-year anniversary, now is as good a time as any to reflect on Securities and Exchange Commission ("SEC") Rule 206(4)-5 (the "Pay-to-Play Rule"), the impact it has had on the financial services industry and political campaigns, and its future.

Pay-to-play rules restrict companies from doing business with state and local governments when they or certain of their employees make contributions to officials holding or running for office in those jurisdictions. There are numerous state and local pay-to-play rules under which companies doing all manner of government business may find themselves automatically banned from government contracts for a period of years following a contribution; there are several federal rules specific to different types of financial services business.

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Under the SEC Pay-to-Play Rule, an investment adviser is prohibited from receiving compensation for managing a government entity's investments for two years after it, a covered employee, or a PAC they control makes a political contribution to certain state or local candidates or officials. In particular, contributions to candidates who are running for, or occupy, a state or local office that can influence the selection of an adviser or appoint a person to such office trigger a ban—even if the state or local official is running for federal office.

The Pay-to-Play Rule also restricts the investment adviser and its covered employees from fundraising for these candidates, as well as for state and local political parties where the adviser is seeking or doing government investment advisory business. Finally, it prohibits doing indirectly what cannot be done directly, calling into question whether contributions to PACs and other political organizations that contribute to candidates can trigger a ban.

Although Rule 206(4)-5 may be the most well-known of the federal pay-to-play rules because it affects the largest industry, it is not the only one or even the first. The Municipal Securities Rulemaking Board ("MSRB") adopted the very first pay-to-play rule in 1994, Rule G-37, which prohibits broker-dealers from engaging in municipal securities business following a covered contribution and expanded it to apply to municipal advisors in 2016.

After the adoption of Rule 206(4)-5, FINRA adopted Rule 2030 for broker-dealers acting as placement agents for investment advisers, the Commodity Futures Trading Commission adopted Rule 23.451 for swap dealers entering into commodities-based swaps, and the SEC adopted Rule 15Fh-6 for securities-based swap dealers.

Right from the start, there were questions as to whether the strict-liability nature of pay-to-play restrictions was constitutional. In fact, on the day Rule G-37 went into effect, the Chair of the Alabama Democratic Party, William Blount, who was employed in the municipal securities industry, challenged that rule's constitutionality on First Amendment, vagueness, and Tenth Amendment federalism grounds. However, a panel of the District of Columbia U.S. Circuit Court of Appeals rejected his petition in the 1995 decision *Blount v. SEC*, concluding that the rule survives "strict scrutiny." Interestingly, Blount pleaded guilty to unrelated corruption charges in 2009 and was sentenced to more than four years in prison.

When the Supreme Court denied certiorari in *Blount*, the constitutionality of pay-to-play rules was widely viewed as settled. But two decades later, with the promulgation of SEC Rule 206(4)-5 and Supreme Court jurisprudence reflecting growing skepticism of campaign finance restrictions in cases such as *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), observers began to think the time might be right for another challenge.

Moreover, with the proliferation of pay-to-play rules, many more contributors were affected by their restrictions. After several attempts failed to demonstrate standing or clear other procedural hurdles, the New York and Tennessee Republican Parties' challenge to the SEC's approval of FINRA Rule 2030 was argued on the merits before a panel of the D.C. Circuit in 2018. However, as in *Blount*, the panel concluded that the pay-to-play rule was constitutional and the Supreme Court declined to hear the subsequent appeal.

Although these cases confirm the constitutionality of the strict-liability nature of the federal pay-to-play rules, there are still some remining questions as to whether certain portions of the rules

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are constitutional, such as the rules' look-back feature where contributions made up to two-years before the contributor becomes a covered employee triggers a ban.

Having survived constitutional scrutiny, Rule 206(4)-5 has had a real impact on investment advisers and their employees. The SEC has reached a series of settlements with firms for Pay-to-Play Rule violations — including 17 announced in batches in 2017, 2018 and last fall. These settlements generally follow sweeps conducted by the SEC and searches of public databases of contributions. The SEC has targeted both registered investment advisers and exempt reporting advisers with orders imposing civil penalties and censure, as well as a requirement to cease and desist from violations. In the overwhelming majority of these cases, the contributions have been fairly modest (usually no more than a few thousand dollars, and often significantly less) and the SEC has not alleged any corrupt intent.

In addition to these enforcement actions, the SEC has granted nearly 20 discretionary waivers from Rule 206(4)-5. Under the Pay-to-Play Rule, an investment adviser that discovers a ban-triggering contribution may apply to the SEC for an exemptive order from the ensuing ban on accepting compensation for the affected investment advisory services. This process can be a long one — ranging from months to, in a few cases, years — and while the process is playing out, the investment adviser must refrain from accepting implicated compensation.

One way to do so is by establishing an escrow into which the compensation is deposited pending the outcome of the waiver process. The SEC grants the waiver on a discretionary basis by considering numerous factors, such as the strength of the adviser's compliance policies and procedures, the circumstances of the contribution and the contributor's apparent intent, the adviser's remedial measures, and whether the waiver would serve the public interest, among others. The SEC also requires that the contributor has taken all available steps to obtain a refund of the contribution. In short, seeking a waiver is a substantial undertaking that only makes sense if significant funds are at stake.

Beyond these publicly reported enforcement actions and waivers, the most common effects of problematic contributions under the Pay-to-Play Rule have been silent, self-imposed bans that are not disclosed publicly. Because the prohibition is on accepting compensation for providing advisory services following a contribution, rather than the contribution itself, an investment adviser can avoid a violation following a contribution to a covered official by standing down from doing covered business or receiving compensation for that business.

In the early days of the Pay-to-Play Rule, we counted the silent bans triggered by our clients, but stopped within a few years when that number was in the dozens. Although not public, these silent bans reduce the investment options available to affected government entities, as investment advisers stand down from marketing investment opportunities and services for which they cannot be paid.

Interestingly, Rule 206(4)-5's effects have even been felt outside of the investment adviser industry. According to the book, "Collision 2012: Obama vs. Romney and the Future of Elections in America," by Washington Post political correspondent Dan Balz, Republican Presidential nominee Mitt Romney's decision not to pick New Jersey Governor Chris Christie as his running mate was motivated in large part by the Pay-to-Play Rule.

By adding a sitting governor to his ticket, Romney would have brought his campaign in scope for the Pay-to-Play Rule and significantly limited his ability to raise funds from employees of investment advisers (and broker-dealers subject to MSRB Rule G-37). This has also been an issue for state officials running for president themselves, such as former Ohio Governor John Kasich. Even presidential candidates who are not state officials covered by the Pay-to-Play Rule have had to tweak their fundraising practices for the financial services industry.

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Presidential campaigns frequently raise money through joint fundraising committees that include the campaign as well as many state party committees. Because of the "indirect" concerns raised by those state party committees under pay-to-play rules, most presidential campaigns since the adoption of the SEC Pay-to-Play Rule have established alternate joint fundraising committees that only support the candidate and national party committees to allow regulated individuals to participate.

Taking stock of this landscape in her dissent to the enforcement cases in the fall of 2022, SEC Commissioner Hester Peirce described the Pay-to-Play Rule as a "blunt instrument" and "a poorly conceived means to pursue laudable ends." She further noted that the Pay-to-Play Rule intrudes on personal political activity unrelated to investment advisory business, that the SEC has other tools available to punish pay-to-play activity affecting business, and that we should consider how the Pay-to-Play Rule can be improved. Of course, her position did not command a majority, and critics of the Pay-to-Play Rule have been around since it was first proposed, but now that call is coming from inside the SEC. We will have to wait to see what, if anything, happens from this call for reform and whether the Pay-to-Play Rule will survive another 12 years.

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