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Recent developments in federal 'pay-to-play' compliance

New SEC Risk Alert and USD12 million settlement underscore the importance of strong compliance procedures for entities subject to federal pay-to-play regimes

OVERVIEW

In recent years, federal pay-to-play laws have been, and are continuing to be, expanded to cover a broad range of financial services institutions. While such laws were previously limited to regulating the municipal securities industry,[1] there are now federal pay-to-play laws for investment advisers (including exempt reporting advisers and unregistered foreign private advisers)[2] and swap dealers,[3] with additional federal pay-to-play regimes on the horizon for municipal advisors,[4] securities-based swap dealers,[5] and placement agents.[6] Federal pay-to-play laws place restrictions on the ability of certain financial services institutions and their employees to make and solicit political contributions on behalf of an individual that seeks or holds an elective office with the authority to direct business to such institutions. These laws impose penalties on a strict liability basis, meaning that even inadvertent violations can result in an entity being banned from doing business in a particular jurisdiction for a period of years. The increase in federal pay-to-play regulation has led to a corresponding need for many financial services institutions to develop and implement comprehensive pay-to-play compliance programs.

Two recent actions taken by the SEC relating to MSRB Rule G-37, the federal pay-to-play rule applicable to brokers, dealers, and municipal securities dealers engaged in the municipal securities business (collectively, "municipal dealers"), both underscore the need for municipal dealers to create, implement, and assess a risk-based pay-to-play compliance and supervisory program, while also providing insight into the types of

compliance programs that financial institutions subject to other federal pay-to-play regimes should adopt. First, on August 31, 2012, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert ("Risk Alert") identifying common deficiencies in the compliance and supervisory programs of municipal dealers and addressing measures municipal dealers should take to strengthen compliance with Rule G-37.[7] Second, on September 27, 2012, the SEC settled a matter with Goldman Sachs & Co. ("Goldman") relating to Rule G-37, in which Goldman agreed to pay approximately USD12 million in penalties and disgorgement (the "Settlement").[8] The SEC issued an Order in connection with the Settlement, in which the SEC indicated that municipal dealers should implement a tailored, risk-based supervisory framework for those employees whose activities can trigger pay-to-play liability.[9] Taken together, the Risk Alert and the Settlement remind municipal dealers – and by extension other financial institutions subject to a federal pay-to-play regime – of their ongoing obligations to assess their respective pay-to-play risks and to implement a compliance and supervisory program tailored to those unique risks.

Although these two developments directly concern Rule G-37, they are instructive for any financial institution that is either currently subject to, or that will be covered by, a federal pay-to-play regime. All of the recent (and soon to be finalized) pay-to-play regimes share a common foundation and design – Rule G-37. The interpretive guidance, examination reports, and enforcement findings that have been developed over the past 18 years under Rule G-37 by the SEC, FINRA,[10] and the MSRB are likely to be relied upon heavily by these same regulators and the CFTC when interpreting, examining compliance with, and enforcing the new pay-to-play regimes.[11] Accordingly, not only should municipal dealers take steps to ensure that their compliance programs incorporate the key elements identified by the Risk Alert and are consistent with the supervision principles enunciated in the Settlement, but investment advisers and swap dealers also should consider the implications of the Risk Alert and the Settlement as they develop and implement their pay-to-play compliance and supervisory programs. The SEC and the CFTC have both emphasized the similarities among the three federal pay-to-play rules, and indicated their preference for a harmonized approach to federal pay-to-play issues. We expect that the SEC, FINRA and the MSRB will take a similar approach to the prospective federal pay-to-play rules for securities-based swap dealers, placement agents, and municipal advisors.

BACKGROUND: MSRB RULE G-37 AND THE "NEW" FEDERAL PAY-TO-PLAY REGIMES

Adopted in 1994, Rule G-37 is the first federal pay-to-play law and the model for all subsequent federal pay-to-play regimes. Like the other federal pay-to-play laws, Rule G-37 is intended to prevent elected officials who control or have the power to influence the award of state business from corruptly steering such business to firms in exchange for political contributions. To that end, Rule G-37(b) prohibits municipal dealers from engaging in municipal securities business with an issuer for two years after making a contribution to an official of such issuer by the municipal dealer, any municipal finance professional ("MFP") associated with the municipal dealer, or any PAC controlled by the municipal dealer or its MFPs.[12] Rule G-37 includes a *de minimis* exemption for contributions by an MFP that do not exceed USD250 and that are made to candidates for whom the contributor is entitled to vote.[13] The rule also includes an automatic exemption for contributions discovered within four months of the date of the contribution, that did not exceed USD250, and that were returned within 60 calendar days of discovery.[14] Rule G-37 further prohibits municipal dealers and MFPs from soliciting or coordinating contributions to candidates or payments to political parties made by third persons, including affiliates of the municipal

dealers.[15] In connection with Rule G-37, the MSRB Rules also impose a variety of record-keeping requirements, disclosure requirements, and supervisory requirements.[16]

As noted above, both SEC Rule 206(4)-5 and CFTC Rule 23.451 have the same basic structure as Rule G-37, with certain variations in specific areas of each rule, such as differences in the application of the two-year ban and the nature and scope of the *de minimis* exceptions.[17]

THE SEC'S G-37 RISK ALERT: LESSONS FOR AN EFFECTIVE FEDERAL PAY-TO-PLAY COMPLIANCE PROGRAM

In the Alert, OCIE staff identified a number of ways in which, in the staff's view, municipal dealers are deficient in implementing their compliance and supervisory procedures relating to Rule G-37. These deficiencies can be broadly grouped into the following four key areas:

- First, and most significantly, OCIE found that a number of municipal dealers had engaged in municipal securities business with issuers within two years of their MFPs making non *de minimis* contributions to officials of the issuers.[18] This suggests that the municipal dealers either were not aware that their MFPs had made the contributions at issue, or that they had inadequate procedures for determining when they were banned from doing business in a jurisdiction as a result of the contributions. As evidenced by the Settlement, violations of the two-year ban carry the potential for the disgorgement of profits and significant civil penalties, irrespective of whether the municipal dealer was aware of the triggering contribution or even that it was subject to the ban.
- Second, OCIE found that municipal dealers failed to maintain accurate and complete lists of their MFPs and non-MFP executive officers, as required by Rule G-8.[19] In our experience, these lists can prove challenging to maintain given that the covered employee population is constantly changing, i.e. new employees are hired and current employees are being promoted into covered status, and employees are leaving covered status or leaving the municipal dealer completely. Compliance programs should include "on boarding" and "off ramping" procedures, as well as a reasonably designed periodic reassessment policy regarding who is, and who should be, included in the covered employee population.
- Third, OCIE concluded that a number of municipal dealers had failed to file accurate and complete Form G-37s disclosing the municipal securities business in which the dealers were engaged as well as contributions made by MFPs and non-MFP executive officers.
- Finally, OCIE found that some municipal dealers had failed to establish or implement adequate supervisory procedures for their MFPs to ensure compliance with Rules G-37 and G-38.[20] For example, as discussed below, municipal dealers who hire politically active persons into covered positions should ensure that their pay-to-play compliance policies are appropriately tailored to account for such persons' higher risk profiles.

OCIE recognized that municipal dealers design compliance programs with a complex combination of legal requirements in mind – the MSRB rules, as well as other federal, state, and local political law requirements. In addition, because municipal dealers conduct a wide range of business functions, not all practices are applicable for all dealers. The Risk Alert suggests key compliance steps that municipal dealers can take to promote compliance with Rule G-37, and which by extension will also be instructive for other financial institutions subject to analogous federal pay-to-play rules:

- Provide regular training for MFPs on the requirements of Rules G-37 and G-38, and document that the training occurred.[21]

- Require MFPs, non-MFP executive officers and employees who could become MFPs to certify on a regular basis their understanding of and compliance with all of the dealer's requirements regarding political contributions.[22]
- Conduct surveillance to ensure that employees are accurately reporting their political contributions and confirm that contributions are properly reported on the municipal dealer's Form G-37.[23] This surveillance includes external searches for political contributions, as well as internal screening of emails and other communications to ensure no political contributions have been made and not reported.[24]
- Identify and "ring-fence" non-MFPs who may become MFPs in the future as a result of a promotion or change in responsibilities and impose the dealer's political contribution requirements on these employees to mitigate the impact of any required look-back under Rule G-37, should they become MFPs.[25] In addition, require disclosure of prior political contributions from potential employees prior to such individuals joining the municipal dealer to allow for the identification of any issues.[26]
- Pre-clear political contributions from MFPs and certain identified non-MFPs.[27] Alternatively, prohibit non *de minimis* political contributions by MFPs or prospective MFPs as a condition of employment, to the extent permitted by state or local law.[28]
- Separate certain functions, such as surveillance, pre-clearance, and look-backs from any functions that could influence an employee's terms of employment, such as management and human resources, to protect employees from any possible adverse action that could be taken based on the employee's political preferences.[29]

The foregoing compliance steps, while focused on Rule G-37 in this instance, are universal to any financial institution subject to a pay-to-play regime. Accordingly, municipal dealers, investment advisers, and swap dealers should all consider whether their compliance programs are consistent with the recommendations in the Risk Alert.

THE SEC'S SETTLEMENT WITH GOLDMAN SACHS

On September 27, 2012, the SEC announced a USD12 million settlement with Goldman in connection with Goldman's compliance with Rule G-37.[30] The Settlement relates to the actions of a single employee – a former Vice President in Goldman's Boston office, Neil M. M. Morrison. According to the Order, Mr. Morrison solicited underwriting business for Goldman in Massachusetts while also providing in-kind political consultant services from his office by working for the gubernatorial campaign of a sitting state treasurer. According to the Order, Mr. Morrison's time spent on the gubernatorial campaign while on the job and his use of corporate resources amounted to an in-kind contribution attributable to Goldman, which disqualified the firm from soliciting municipal securities business in Massachusetts for two years. The SEC also found that Mr. Morrison made an indirect contribution by giving money to another individual for the purposes of making a contribution to the gubernatorial campaign.

According to the Order, Goldman willfully violated Rule G-37 and related obligations, including the requirement to keep and maintain adequate records of all direct and indirect contributions made by MFPs, the requirement to preserve related records, and the requirement to disclose conflicts of interest when engaging in municipal securities business.[31] Significantly, the SEC stated that Goldman failed to effectively supervise Mr. Morrison. In this context, the SEC suggested that municipal dealers should implement risk-based monitoring to properly supervise employees who are especially politically active. The SEC's Order emphasized that varying levels of supervision may be required depending upon a particular employee's background and personal relationships, stating that

Goldman should have taken into account the individual's "political background," his "personal relationship with [the candidate/officeholder]," and his "close relationship with other issuer employees."[32] And of greatest financial importance, the Settlement required that Goldman disgorge the USD7.5 million in underwriting fees earned while subject to the two-year ban. In addition, the Settlement required payment of a USD3.75 million penalty and USD670,033 in pre-judgment interest. These penalties and a cease-and-desist order were in addition to Goldman's mitigating actions – suspending any solicitation of new municipal securities business with Massachusetts public entities in October 2010 and terminating Mr. Morrison's employment in December 2010.[33]

CONCLUSION

In light of these recent developments, it is important for municipal securities dealers, investment advisers, and swap dealers to review the adequacy of their existing pay-to-play compliance policies. Securities-based swap dealers, placement agents, and future municipal advisors should also consider incorporating recent and past guidance under Rule G-37 into the development of their pay-to-play compliance programs. The Risk Alert discussed above illustrates several common compliance failings, and provides financial institutions with a roadmap for developing some of the essential elements of an effective compliance program. With the publication of the Risk Alert, market participants now have additional information about regulators' concerns, and financial institutions that disregard the Risk Alert's recommendations are unlikely to meet with much sympathy from the SEC or the CFTC. As the SEC suggested in the context of the Settlement, financial institutions may also be required to take account of individual employees' political profiles, and to consider whether to implement risk-based monitoring with respect to employees who have heightened political profiles. The Settlement also highlights that the failure to develop a comprehensive and effective compliance program can lead to significant monetary and reputational consequences.

It is clear that the SEC has marked pay-to-play as an enforcement priority. Indeed, the SEC has formed a dedicated municipal securities enforcement team, which should result in even greater scrutiny in this area in the future. Against that backdrop, the recent developments discussed in this alert provide financial institutions with concrete suggestions for improving their compliance programs, and illustrate the high costs of failing to do so.

Key contacts

If you require advice on any of the matters raised in this document, please call any of our partners or your usual contact at Allen & Overy.

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[1] *See* Municipal Securities Rulemaking Board ("MSRB") Rule G-37.

[2] *See* Securities and Exchange Commission ("SEC") Rule 206(4)-5, 17 C.F.R. § 275.206(4)-5.

[3] *See* Commodity Futures Trading Commission ("CFTC") Rule 23.451, 17 C.F.R. § 23.451.

[4] *See* Proposed MSRB Rule G-42, Securities Exchange Act Release No. 65255 (Sept. 2, 2011), 76 Fed. Reg. 55976, *withdrawn by* MSRB Notice 2011-51 (Sept. 12, 2011).

[5] *See* Proposed SEC Rule 15Fh-6, Securities Exchange Act Release No. 34-64766 (July 18, 2011), 76 Fed. Reg. 42396.

[6] The SEC has indicated that it expects the Financial Industry Regulatory Authority ("FINRA") to issue a pay-to-play rule for placement agents, and FINRA has stated its intention to promulgate such a rule. *See* Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41018, 41042 (July 14, 2010) (the "SEC Investment Adviser Rule"); Letter from Richard G. Ketchum, Chairman & Chief Executive Officer, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, SEC (Mar. 15, 2010), *available at* http://www.sec.gov/comments/s7-18-09/s71809-260.pdf.

[7] *"Pay-to-Play" Prohibitions for Brokers, Dealers and Municipal Securities Dealers Under MSRB Rules*, National Examination Risk Alert by the Office of Compliance Inspections and Examinations ("Risk Alert"), at 6 (Aug. 31, 2012), *available at*: http://www.sec.gov/about/offices/ocie/riskalert-munipaytoplay.pdf.

[8] *SEC Charges Goldman Sachs and Former Vice President in Pay-to-Play Probe Involving Contributions to Former Massachusetts State Treasurer*, SEC Press Release No. 2012-199 (Sept. 28, 2012), *available at* http://www.sec.gov/news/press/2012/2012-199.htm ("Settlement Release"). In connection with the Settlement, the SEC made a number of factual findings as presented in the order. For the purpose of settling the proceedings, and without admitting or denying the findings set forth in the Order (except as to the SEC's jurisdiction over it), Goldman consented to the entry of the Order.

[9] *In the Matter of Goldman, Sachs & Co.*, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Securities Exchange Act of 1934 Release No. 67934 (Sept. 27, 2012).

[10] FINRA is a self-regulatory organization which regulates the conduct of member firms, and in particular those securities firms that do business with the public. FINRA is registered with, and subject to the jurisdiction of, the SEC.

[11] *See, eg*, SEC Investment Adviser Rule, 75 Fed. Reg. 41,018 at 41,203, 41,026 (noting that "Rule 206(4)-5(a)(1) is based largely on MSRB rule G-37," and explaining that this approach may be expected to "minimize the compliance burdens on firms that would be subject to both rule regimes"); Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012) at 9800-01 (stating that "the Commission's approach to final § 23.451 is also consistent with MSRB Rules G-37 and G-38" and that "[t]hrough such harmonization, the Commission achieves its goal of preventing quid pro quo arrangements while avoiding unnecessary burdens").

[12] MSRB Rule G-37(b).

[13] MSRB Rule G-37(b)(i).

[14] MSRB Rule G-37(j)(i).

[15] MSRB Rule G-37(c).

[16] *See generally* MSRB Rules G-8, G-9, G-17, G-27, and G-37(e).

[17] *See, eg*, SEC Rule 206(4)-5(b)(1); CFTC Rule 23.451(b)(2), (e).

[18] Risk Alert, at 6.

[19] Risk Alert, at 7.

[20] *Ibid.*

[21] Risk Alert, at 8.

[22] *Ibid.*

[23] *Ibid.*

[24] *Ibid.*

[25] *Ibid.*

[26] *Ibid.*

[27] *Ibid.*

[28] Risk Alert, at 9.

[29] *Ibid.*

[30] *See* Settlement Release.

[31] Order, at 8.

[32] Order, at 6. This conclusion is consistent with prior MSRB guidance relating to Rule G-27, on supervision, which the MSRB has stated requires each dealer to evaluate its own circumstances and those of its employees to develop supervisory procedures that are reasonably designed to ensure compliance with Rule G-37. *See Supervisory Procedures Relating to Indirect Contributions: Conference Accounts and 527 Organizations*, MSRB Interpretation (Dec. 21, 2006).

[33] Order, at 6.

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