CLEARY GOTTLIEB

Alert Memo

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Recent SEC Order Finds Employee's Use of Company Resources Violates Pay to Play Rules

A recent Securities and Exchange Commission ("SEC") action finding violations of municipal securities pay to play rules brings into focus the broad scope of new political contribution regulations under the Investment Advisers Act of 1940 (the "Advisers Act") and new business conduct standards applicable to swap dealers dealing with governmental entities, including state, municipal and county pension funds, and underscores the potential risks posed to dealers by the political activities of their employees.

The SEC found that a broker-dealer and municipal securities dealer violated Municipal Securities Rulemaking Board ("MSRB") rules on political contributions through its employee's use of firm resources in support of the gubernatorial campaign of the Treasurer of Massachusetts. The SEC's order, entered on September 27, 2012, concluded that each instance of an employee's extensive campaign work during work hours or use of firm resources constituted valuable "in-kind" campaign contributions.[1] The firm resources in question included use of the firm's telephone and email systems and the firm's office space, which the SEC found was used for a campaign meeting. Such campaign contributions, the SEC determined, were attributable to the dealer and triggered a two-year ban on municipal securities business with issuers under the authority of the Treasurer of Massachusetts. In addition, pursuant to a settlement, the dealer will pay approximately $7.5 million in disgorgement, $670,000 in prejudgment interest and a $3.75 million penalty.

The contours of the MSRB's pay to play rules are taking on increasing importance with the adoption of new political contribution rules, closely modeled on the MSRB's precedent, under the Advisers Act by the SEC and, more recently, the implementation of the Dodd-Frank Act's external business conduct standards for swap dealers by both the Commodity Futures Trading Commission ("CFTC") and the SEC.

[1] Goldman, Sachs & Co., Exchange Act Release No. 67934 (September 27, 2012), *available at* http://www.sec.gov/litigation/admin/2012/34-67934.pdf; *see also* http://www.sec.gov/news/press/2012/2012-199.htm

Political Contributions under MSRB Pay to Play Rules

MSRB Rule G-37 prohibits a municipal securities dealer from engaging in municipal securities business with an issuer within two years after any "contribution" to an official of the issuer by the dealer, any municipal finance professional associated with the dealer, or any political action committee under their control.[2]

The rule defines "contribution" broadly to include any gift, subscription, loan, advance, or deposit of money or anything of value made for the purpose of influencing any election for federal, state or local office, for payment of debt incurred in connection with any such election or for transition or inaugural expenses incurred by the successful candidate for state or local office.[3] Because of this broad definition, the rule potentially applies to any contributions in-kind, including volunteered services and other firm resources, in addition to cash contributions. As discussed below, this definition of "contribution" has been adopted virtually verbatim by the SEC and CFTC in new pay to play rules.

The MSRB has previously highlighted the rule's coverage of in-kind contributions in guidance interpreting Rule G-37:

> Q: Is a municipal finance professional prohibited from performing volunteer work on an issuer official's behalf?
>
> A: Rule G-37 is not intended to prohibit or restrict municipal finance professionals from engaging in personal volunteer work. However, soliciting and bundling of contributions would invoke application of the rule. In addition, if the municipal finance professional *uses the dealer's resources* (e.g., a political position paper prepared by dealer personnel) *or incurs expenses in the conduct of such volunteer work* (e.g., hosting a reception), then the value of such resources or expenses would constitute a contribution. Personal expenses incurred by the municipal finance professional in the conduct of such volunteer work, which expenses are purely incidental

[2] MSRB Rule G-37(b). "Municipal securities," as defined in Section 3(a)(29) of the Securities Exchange Act of 1934, include those issued by states, their political subdivisions and any agencies or instrumentalities thereof, including municipal corporate instrumentalities, as well as certain industrial development bonds.

[3] MSRB Rule G-37(g)(i). It should be noted that Rule G-37 contains a *de minimis* exception for contributions of $250 or less made by a municipal securities professional (*not* by the firm) entitled to vote for the official. Rule G-37(b)(i) (flush language). In this latest case, however, the SEC determined that the political activities of the employee were attributable to the firm, and presumably therefore not eligible for the *de minimis* exception even if the use of firm resources could reasonably be valued at less than the threshold.

> to such work and *unreimbursed by the dealer* (e.g., cab fares and personal meals), would not constitute a contribution.[4]
>
> Q: If an employee of a dealer is donating his or her time to an issuer official's campaign, does the dealer have to disclose this as a contribution to such official? In addition, would the fact that the employee is taking a leave of absence from the dealer cause a different result?
>
> A: An employee of a dealer generally can donate his or her time to an issuer official's campaign without this being viewed as a contribution by the dealer to the official, as long as the employee is volunteering his or her time during *non-work hours*, or is using previously accrued vacation time or the dealer is not otherwise paying the employee's salary (e.g., an unpaid leave of absence).[5]

Although contributions of what might otherwise be viewed as virtually cost-free use of dealer resources, such as telephone and email services, might be viewed under the prior MSRB guidance as insignificant compared to the examples given (preparation of position papers, hosting receptions), the SEC nevertheless applied the rule to such items in the recent order.

Next Steps

As we discussed above, all three new pay to play regulations use a definition of "contribution" identical to that in MSRB Rule G-37,[6] and both the SEC[7] and CFTC[8] have indicated an intent to closely follow or harmonize with the MSRB's model. In its release

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[4] Rule G-37 Question and Answers II.18 (May 24, 1994) (emphasis added), http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx.

[5] *Id.* at II.19 (August 18, 1994) (emphasis added).

[6] *See* Advisers Act Rule 206(4)-5(f)(1); Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 34-64766, 76 Fed Reg. 42396, 42457 (July 18, 2011) (SEC's proposed business conduct rule Exchange Act Rule 15Fh-6(a)(1)); 17 C.F.R. § 23.451 (final CFTC business conduct rule). Note, however, that the CFTC's final rule for swap dealers expands the definition to include inaugural or transition expenses of federal (in addition to state and local) officials.

[7] *See* Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 3043, 75 Fed. Reg. 41018, 41030 (July 14, 2010); *see* Exchange Act Release No. 34-64766, 76 Fed Reg. 42396, 42433 n.263 (July 18, 2011) (SEC's proposed business conduct rule).

[8] *See* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9800 (February 17, 2012) (release adopting final CFTC business conduct rule).

adopting new Rule 206(4)-5 under the Advisers Act, the SEC expressly cited the MSRB Q&As quoted above, and then went further, suggesting that the use of an adviser's telephones by one of the adviser's employees for a campaign would be considered a contribution.[9]

In light of the significant risks—disqualification from government business, penalties and disgorgement of fees, in addition to negative publicity within a limited universe of customers—municipal securities dealers under the MSRB's rules, swap dealers under the SEC and CFTC business conduct standards, and investment advisers under Rule 206(4)-5, as well as those subject to any other government-specific pay to play rules, should continue to evaluate:

- Whether the firm's political contributions policies appropriately capture the entire field of political activities that might fall within new and existing regulatory regimes,

- Whether employee training sufficiently apprises employees of the limitations to which the firm is subject, and

- Whether the firm's monitoring procedures are adequate to ensure that its business with governmental entities will not be impeded.

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Executive Compensation and ERISA" under the "Practices" section of our website at http://www.clearygottlieb.com.

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[9] Exchange Act Release No. 34-64766, 75 Fed. Reg. at 41030 ("We would not consider a donation of time by an individual to be a contribution, provided the adviser has not solicited the individual's efforts and the adviser's resources, such as office space and telephones, are not used.") The SEC also noted that Rule 206(4)-5 (like Rule G-37 and the new SEC and CFTC business conduct standards) prohibits circumvention of the rule by doing indirectly what the rule would prohibit if done directly. *Id.* at n.157. Note, however, that the SEC has indicated that the MSRB's rule G-37 interpretations are not authoritative interpretations of the SEC's own rules, although they may be "useful to consider" where they directly address an issue not addressed by the SEC. Staff Responses to Questions About the Pay to Play Rule, Question V.2, http://www.sec.gov/divisions/investment/pay-to-play-faq.htm

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Bank of China Tower, 39th Floor
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Odaid Tower
Office 1105, 11th Floor
Airport Road; PO Box 128161
Abu Dhabi, United Arab Emirates
T: +971 2 414 6628
F: +971 2 414 6600