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New Federal and State Pay-to-Play Developments

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"Pay-to-play" laws — which restrict or regulate the political activities of entities that hold or seek government contracts — have been one of the hottest topics in the press over the last few months. Since Election Day 2008:

- Pay-to-play scandals have ensnared the Governor of Illinois and derailed the nomination of the Governor of New Mexico to the President's cabinet;
- Several states – including New Jersey, Colorado, and Illinois – have implemented new (or heavily amended) pay-to-play regimes;
- State and federal regulators have launched sweeping investigations into whether and to what extent gifts and political contributions influenced the placement of state and municipal pension fund investments; and
- The Securities and Exchange Commissions (SEC) has taken steps towards enacting the first federal pay-to-play regime applicable to investment advisers.

This focus on pay-to-play laws potentially confronts companies that do business with the government with substantial legal and reputational risk. The penalties for pay-to-play violations are frequently severe; in many jurisdictions parties who commit pay-to-play violations may be barred from obtaining government contracts for several years. In light of the current, fast-changing regulatory environment, businesses that hold or pursue government contracts at any level of government should (1) evaluate the effectiveness of their management of pay-to-play risks; and (2) take steps to keep abreast of the latest federal, state, and local legislative and

regulatory pay-to-play developments.

These recent developments also have additional implications for investment funds, as the risks associated with pay-to-play laws are aggravated by many funds' use of politically connected intermediaries to sell interests in the funds (placement agents). The use of placement agents is already regulated under federal and state securities laws, and new, overlapping pay-to-play regulation thus increases and complicates the compliance burden for many funds. Moreover, because placement agents and their participation in obtaining state pension fund assets are the current focus of many state and federal regulatory initiatives, there is a significant risk that regulators can (and will) adopt new regulatory structures that will substantially impair investment funds' business models.

I. State Pay-To-Play Developments

a. New Jersey

On November 15, 2008, New Jersey added to an already robust body of pay-to-play law when Executive Order 117 took effect. New Jersey has been one of most active states in regulating pay-to-play risk, and, even before the promulgation of Executive Order 117, virtually any entity holding a state or local government contract in New Jersey was required to make regular pay-to-play filings with the State pursuant to a web of interlocking and overlapping regimes. Executive Order 117 built on this comprehensive, and complex, framework by expanding the parties and the scope of political contributions covered by existing pay-to-play restrictions.

- Before Executive Order 117, New Jersey pay-to-play law restricted contractors holding contracts with the state worth more than $17,500 from making contributions of more than $300 to gubernatorial candidates and to state and county political parties. Any violation potentially disqualified the violator from holding state or local government contracts for several years. This restriction applied not only to a contracting entity, but to its subsidiaries, any affiliated PAC, and to any person with a significant ownership stake in the contracting entity; the contracting entity's officers and directors were not covered by the pay-to-play rules.
- Executive Order 117 extended existing pay-to-play restrictions to key personnel of a contracting entity. Under the Executive Order, the category of parties whose contributions could lead to disqualification has been expanded to include any officer (i.e., any president, vice president with senior management responsibility, secretary, treasurer, CEO, or CFO) of a contracting corporation; any partner of a contracting entity that is a partnership; any member of a contracting entity that is a limited liability company; and the spouse, civil-union partner, or any children of any of the aforementioned individuals who shares a residence with such an individual.
- Executive Order 117 also expands the scope of recipients as to which contributions are covered. Under the Executive Order, contributions to lieutenant governor candidates, legislative leadership committees, and

municipal political party committees now have the potential to trigger disqualification.

b. Illinois

In the wake of a number of political corruption scandals, the Illinois legislature recently enacted the State's first pay-to-play statute, which became effective January 1, 2009. Under the Illinois pay-to-play law, contractors that have or are seeking contracts that exceed $50,000 annually are prohibited from giving political contributions to those state officials with the responsibility for awarding or overseeing the contracts. This prohibition not only applies to the contractor, but also to its affiliates and subsidiaries, other members of the contractor's unitary business group, and sponsored PACs (referred to in the statute as "affiliated entities"), and to certain persons who own more than 7.5% of the contractor, who are executives of the contractor (e.g., the president, chairman, or CEO), or who are monetarily linked to the contracting relationship (collectively "affiliated persons")).

- Under the new Illinois law, contractors that have or are seeking business from the state that exceeds $50,000 annually must register with the state and report all political contributions by the contractor, their affiliated entities, their affiliated persons, and the spouse and minor children of any individuals who are affiliated persons. In addition, contractors must include the name and home address of all affiliated persons on their registration form.
- Under the pay-to-play law, a covered contractor and its affiliated entities and affiliated persons are barred from making a political contribution of any amount (there is no *de minimis* exception) to candidates for the statewide office responsible for awarding or overseeing their contract. The statute potentially applies to contributions to candidates for Governor, Lieutenant Governor, Attorney General, Secretary of State, Comptroller, and Treasurer. In all cases, the proscription only applies to the state office(s) with responsibility for the contractor's contract; a contractor and its affiliated entities and affiliated persons may still contribute to other statewide candidates (e.g., a contractor barred from contributing to gubernatorial candidates may still be permitted to donate to Attorney General candidates). In circumstances where it is not clear which office is responsible for a particular contract, the Governor is viewed as the default covered official.
- Not all contributions to covered officials are covered by the pay-to-play restrictions. A contribution is covered only if it is given to a covered official (1) after an RFP has been issued but before the contract is awarded in cases where the contracting entity has bid on the contract in question; or (2) for the duration of the term of office of the official awarding the contract, or the two year period after the contract terminates or expires, in cases where the contracting entity has been awarded the contract.
- If a contractor or potential contractor violates the law, its existing

contracts are potentially voidable and it may be subject to additional civil penalties. If a contractor or potential contractor commits three or more violations within a three-year period, it will be banned from doing business with the state for three years from the date of the last violation.

c. Colorado

Colorado voters passed a constitutional amendment (Amendment 54) addressing non-competitive contracts that took effect on December 31, 2008. The amendment prevents holders of $100,000 or more in "sole source" contracts (i.e., contracts that were not subject to the normal competitive bidding process) from making a campaign contribution to any candidate for any state or local office or to any political party during the term of their contract and for two years thereafter. It also requires contract holders to report the nature and scope of their sole source contracts to the Colorado Department of Personnel & Administration.

- The amendment applies to the contract holder, its officers, directors, or trustees, and any individual who controls at least 10% of the shares or interest in such contract holder. The ballot initiative proposing the law did not define the scope of these terms, and no clarifying legislation has been enacted yet to assist in the implementation of the new regime.
- The amendment covers sole source contracts with the state or any of its political entities, such as counties, municipalities, or school districts that aggregate to $100,000.
- Any contract holder who intentionally violates Amendment 54 is ineligible to hold any sole source contract or employment with the state or any of its political subdivisions for three years.

d. California, Illinois, New York and New Mexico – Recent Developments Involving Pension Fund Investments

California, Illinois, New York and New Mexico also have recently taken steps to address the use of intermediaries in obtaining investments from state pension funds. New Mexico and California's largest state pension fund, the California Public Employees' Retirement System (CalPERS), have adopted a disclosure requirement (CalPERS additionally requires that all placement agents be registered broker-dealers), while Illinois, New York State (NY) and New York City (NYC) effectively have imposed a flat ban on *all* placement agents.

- CalPERS: On May 11, 2009, the board of directors of CalPERS adopted a new policy requiring external investment managers to disclose any retention of placement agents, the compensation paid, the services performed, and any other details about the engagement. All placement agents hired by managers of CalPERS funds must be registered broker-dealers with the SEC and a member of a self regulatory organization, such as the Financial Industry Regulatory Authority, and must disclose information about key employees of the placement agents, including whether they are registered lobbyists in any state or the federal government.

- Illinois: On April 3, 2009, a new pension reform law (Public Act 096-0006) took effect. Among other things, the law essentially bans funds from employing "intermediaries" to attempt to influence state pension fund decisions whose compensation is contingent (in any way) on the state pension fund's investment decision.
- New York: On April 22, 2009, the State Comptroller announced a ban on the involvement of placement agents, paid intermediaries and registered lobbyists in investments with the $122 billion New York State Common Retirement Fund. Legislation and regulations to codify the ban are currently being developed.
- New York City: The New York City Employees' Retirement System, the New York City Fire Department Pension Fund, and the New York City Police Pension Fund have all suspended the use of placement agents in connection with management of the pension funds' assets, due in large part to calls for a ban by the New York City Comptroller. The New York City Teachers' Retirement System and Board of Education Retirement System are considering similar suspensions.
- New Mexico: On June 19, 2009, a new law (HB 876) takes effect that will require recipients of investments by the State Investment Council and the state's pension funds to disclose the identity of any third-party marketer involved in obtaining the investment and any fee, commission, or retainer paid.

This recent activity follows prior legislative action by states like California and Ohio to address the potential for side payments, campaign contributions, or other favors given to government officials to influence the pension fund investment selection process.

It is unclear how the new Illinois law, as well as the NY and NYC bans and suspension on the use of placement agents by investment funds will be implemented for several reasons. First, the flat prohibition is imprudent because it ignores the federal regulation of placement agents, specifically the registration requirements under the Securities Exchange Act of 1934[1] (Exchange Act), which generally requires the involvement of a registered broker-dealer in the placement of securities interests, including the limited partnership (or membership) interests of a fund that is seeking pension fund assets. While there is an exemption from registration as a broker-dealer under the Exchange Act that may be used by investment managers when placing interests in sponsored investment funds (commonly referred to as the "issuer's exemption"),[2] satisfying the conditions of this exemption is complicated and requires continued monitoring to ensure the investment manager has not fallen outside the boundaries of the safe harbor. Second, it ignores the ability of investment fund organizations to employ individuals who engage in the same questionable practices.

Although investment funds technically can take advantage of the issuer's exemption to registration under federal broker-dealer laws, as a practical matter it is often difficult for funds to satisfy the exemption's requirements. In circumstances in which it is not possible to fall within the exemption, the

use of a broker-dealer registered under federal law is *required* in connection with the placement of interests in investment funds — it is not an option and not something that can be excused or forbidden under State law. In this regard, the approach taken by CalPERS works with the federal securities laws and creates the potential for greater regulatory oversight in the pay-to-play area.

II. Federal Pay-To-Play Developments

A. Federal Rulemaking – SEC Developments

Currently, the federal government only explicitly regulates pay-to-play in the municipal finance area through Municipal Securities Rulemaking Board (MSRB) Rule G-37, which limits municipal dealers' ability to contribute to officials involved in selecting underwriters for bond issuances. Recently, however, SEC Chairman Mary Schapiro has signaled that the SEC is considering a rule that would expressly restrict politically active investment managers from managing state pension fund assets. The Agency had previously drafted a proposal in 1999 that would bar investment managers from managing or seeking to manage state pension fund assets for two years if the manager, its affiliated PAC, or key personnel associated with the manager made campaign contribution in excess of $250 to certain state candidates. In light of the recent investigations into managers of the New York State pension fund, the SEC is revisiting the 1999 rule, although it is not yet clear when a new proposal might be announced.

B. Federal Legislation

In addition, there are also federal legislative efforts underway to expand pay-to-play to areas other than financial services. In April 2009, Reps. Paul