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PERSPECTIVE

Pay-to-play rule sticks around for 2016

By Jason A. Abel

On Aug. 25, the U.S. Court of Appeals for the D.C. Circuit threw out a challenge to the Securities and Exchange Commission "pay-to-play" rule for investment advisers. While most of the initial discussion surrounding *New York Republican State Committee and Tennessee Republican Party v. SEC* focused on the merits of SEC Rule 206(4)-5, the Court of Appeals decided the case on procedural grounds, not directly addressing the claims raised by the plaintiffs that the rule infringed on their First Amendment rights.

The rejection virtually ensures that the rule will be maintained throughout the 2016 election cycle. Those who are subject to the rule should continue to maintain their policies and procedures related to political contributions, and possibly prepare for additional scrutiny from an emboldened SEC.

The SEC's intent for the rule is to prohibit pay-to-play practices between investment advisers and certain government officials. An investment adviser is subject to a two-year ban on providing compensated investment advisory services to a particular government entity, if it, or one of its "covered associates," makes a contribution (above the de minimis amounts) to an "official" of that government entity.

Part of the confusion regarding the rule centers on the issue of whom exactly is considered an "official of a government entity." According to the rule, such an "official" is either a candidate for or an incumbent in an office that has the power to influence the selection of an investment adviser. Specifically, if the office "(i) [i]s directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) [h]as authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity," then the incumbent or candidate for that office is covered under the rule.

SEC Rule 206(4)-5 is a strict liability rule, and even an inadvertent contribution above the de minimis amounts will subject the firm to the two-year ban. Violations of the rule occur when (i) that two-year ban is breached; (ii) solicitations (fundraising) take place for certain covered officials by covered associates; or (iii) an investment advisory firm or its covered associates attempt to circumvent the rule (*i.e.*, by making contributions through a third party). While the two-year ban is not considered a penalty, it is still significant, and most seek to avoid the severe restriction on business. Penalties for violating the rule are severe and could include significant fines, loss of business (both past and prospective) and reputational harm.

While states and localities have their own pay-to-play rules that cover interactions with those individuals and entities seeking to do business with the government, the rule is layered on top of those restrictions, thus posing additional compliance burdens for the financial services industry.

Those in the financial services industry are not the only ones that are affected by the rule. Certain officials may claim that they are at a disadvantage since they can raise thousands of dollars less from individuals who work in the financial services sector and are subject to the rule. That claim by state officials and party leaders was, in part, the basis of the lawsuit.

The district court had originally dismissed the plaintiffs' claims due to lack of subject matter jurisdiction, stating that they filed in the wrong court. The district court concluded that the Court of Appeals has exclusive jurisdiction for claims arising from the Investment Advisors Act of 1940, under which the rule was promulgated. Further, the district court raised the issue of the plaintiffs' standing. The plaintiffs both appealed the decision and also refiled their suit in the Court of Appeals for direct review.

The Court of Appeals consolidated the matters and was firm in its dismissal. The rationale focused almost exclusively on administrative procedure and statutory interpretation and did address the merits of whether the rule violated the First Amendment rights of any party.

The Court of Appeals held that the challenge was time-barred, since the 60-day window for challenging an order under the Investment Advisers Act had long-since passed. In making that determination, the Court of Appeals held that rules promulgated under the act (such as SEC Rule 206(4)-5) were in fact subject to the window as it fell under the broad definition of "order," and that such a window not does restrict the constitutional rights of plaintiffs, even when the First Amendment is at issue. While the issue of the plaintiffs' standing was raised by the district court, the Court of Appeals did not address the issue in its opinion.

The New York Times

Hillary Clinton makes a campaign speech in New York in June. The D.C. Circuit's ruling in a recent case means the SEC's pay-to-play rule will be maintained throughout the 2016 election cycle.

At the end of the opinion, the Court of Appeals reminded plaintiffs that they could seek pre-enforcement review by first petitioning the SEC to overturn the rule, and then - if such a petition is rejected - petition the Court of Appeals for review of the SEC's denial.

Moving forward, the plaintiffs and others wishing to challenge the rule have a few options. The plaintiffs can request en banc review by the full D.C. Circuit, or ask the Supreme Court to review the ruling. While a possibility, the odds of the plaintiffs taking that direction (and being successful) are slim given the strict procedural grounds by which the panel ruled. While the Supreme Court has been relatively hostile to campaign finance legislation in recent years (see *Citizens United v. FEC; McCutcheon v. FEC*), the issues presented would not seem to implicate the First Amendment causes that a majority of the court has embraced, and instead would focus on administrative law.

More plausible would be a petition to the SEC to revoke the rule, and then move on to the Court of Appeals after the SEC likely denies such a request. While it appears to be a straight-forward option, there is no telling how long the SEC will sit on such a request, thus denying those petitioners a chance to move to the Court of Appeals.

In all likelihood, the challenge to the pay-to-play rule will come when an investment adviser has been found to violate the rule, and the adviser challenges the violation in court. At that point, the merits of the rule, the alleged constraints on the First Amendment, and the nexus between the time-out and prohibitions and quid pro quo corruption will be examined.

The 2016 cycle is in full-swing, and in addition to the state and local races covered by the rule, there are at least four sitting governors running for president that would still be considered covered officials for purposes of the rule. Since the rule looks as if it is here to stay for at least the next election cycle or two, now would be a perfect time to make sure those investment advisers impacted by the rule have effective policies, procedures and mechanics to ensure compliance.

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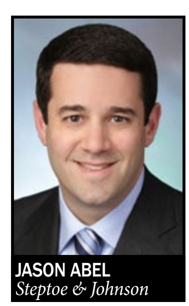

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