Skadden's 2019 Insights: Political Law: What to Consider When Providing Investment Fund Services to US State and Local Government Entities.

With heightened attention to investment and depository rules as well as increased enforcement of federal and state pay-to-play rules, registered investment advisers (RIAs) and broker-dealers should address the unique legal considerations that may arise when a firm provides or seeks to provide services to U.S. state and local government entities.

Investment Rules

Jurisdiction- and government entity-specific rules apply to firms that manage, hold or invest money for the government. A government entity with significant funds will often adopt a policy specifying how the funds may be invested or what securities may be purchased — delineating the types of investments that are permissible (e.g., prohibitions on swaps, equities, or investments in certain countries and industries), how the government entity views risk, how a portfolio must be diversified and the standard of care required for managers. Agreements with investment advisers or broker-dealers may even incorporate these policies by reference. Additionally, similar restrictions contained in a jurisdiction’s statutes or ordinances may apply to the investments of a particular government entity or to all government funds in the jurisdiction.

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How restrictive they are often depends on whether the money is designated for investment, held by a retirement system or dedicated for some other particular purpose. Although government entities are less diligent about alerting investment advisers and broker-dealers to these restrictions, they can in some cases impose direct liability on the firm if it invests government funds in a manner that is not permitted by the applicable rules.

Depository Rules

The laws of many jurisdictions specify custodial requirements, such as that all government funds be maintained with approved depositories. In some jurisdictions, this means all funds must be held in banks rather than brokerage accounts. Moreover, firms typically need to go through a formal application and review process to become approved depositories.

Federal Pay-to-Play Rules

Under these rules, political contributions made by a company or its covered donors prohibit a covered company from engaging in, or receiving compensation for, certain business with state or local government entities. Importantly, federal pay-to-play rules are strict liability in nature, meaning criminal intent is not needed to trigger their prohibitions. Current federal pay-to-play rules are:

- The Municipal Securities Rulemaking Board's Rule G-37, which covers broker-dealers that underwrite municipal securities and municipal advisers who solicit investment advisory business for third parties, or provide advice to or on behalf of a government entity or obligated person with respect to municipal financial products or the issuance of municipal securities.
- The Securities and Exchange Commission's (SEC) Rule 206(4)-5, which covers registered investment advisers and exempt reporting advisers that provide investment advisory services to state or local government entities either directly (e.g., via a separate managed account) or through a covered investment pool. Covered investment pools include unregistered investment funds in which a government entity invests directly, as well as registered mutual funds that are selected as an option for a participant-directed plan sponsored by a government entity.
- The Commodity Futures Trading Commission's Rule 23.451, which covers swap dealers that offer or engage in commodities-based swaps with state or local governmental counterparties.
- The Financial Industry Regulatory Authority's (FINRA) Rule 2030, which covers FINRA members engaged in soliciting investment advisory services covered by the SEC rule from state or local government entities.

State and Local Pay-to-Play Rules

Certain states and localities have laws that automatically prohibit a company from having government contracts if a covered donor makes a political contribution or solicits one for a covered official or political committee. Common categories of covered donors include:

- the firm itself;
- any affiliate or the affiliate's political action committee;
- senior officers of the firm (e.g., management committee);
- members of the firm's board of directors;
- employees who solicit or manage state or local contracts; and
- in some cases, the spouses and dependent children of the individuals listed above.

These bans on business can, in some cases, last for more than five years. These laws also may impose disclosure requirements regarding political contributions. It is very common for government contracts and requests for proposals (RFP) in these jurisdictions to require a company to certify its compliance with these laws.

Lobby Laws, Placement Agent Policies and Contingent Fee Restrictions

What Triggers Lobbyist Registration

In 31 states and many localities, attempting to obtain the award of government business meets the definition of lobbying and may give rise to an obligation to register as a lobbyist. These laws vary, and many contain useful exemptions, such as for formally responding to an RFP or for in-house employees of the company who act as salespersons. In addition, some lobby laws have a threshold for triggering registration that may be based on the amount of time spent lobbying in the jurisdiction (*e.g.,* North Carolina's threshold is 5 percent of one's working time in a month), the compensation received for lobbying in the jurisdiction (*e.g.*, Indiana's threshold for executive branch lobbying is $1,000 per year) or number of contacts with covered officials (*e.g.,* San Francisco's threshold is five lobbying contacts in a month). In some jurisdictions, registration may be triggered when gifts and entertainment are provided to public officials and employees. Importantly, some jurisdictions aggregate all firm activity for these thresholds, so while a single action may not give rise to an obligation to register, it could when combined with other activities at the firm.

Requirements Once Registration Is Triggered

If registration is triggered, the individual lobbyist and/or company will need to register and report on a periodic basis. These reports typically require the disclosure of gifts and entertainment provided to public officials in the jurisdiction, compensation for lobbying and the issues lobbied. Some jurisdictions impose training requirements and special gift and political contribution restrictions on lobbyists.

Placement Agent Policies

Separate from lobby laws, government entities (particularly public pension funds) have increasingly adopted policies with respect to the use of placement agents by external investment managers. The policies range from requiring investment managers to disclose who is soliciting business to imposing outright prohibitions on investment managers' use of third-party solicitors. The rules may apply even when a firm is using in-house marketing employees to solicit business.

Contingent Fee Prohibitions

Some lobby laws prohibit the payment of contingent fees — any payment (such as a commission or formulaic bonus) that is in whole or in part attributable to a government decision (such as the decision to engage the firm). In addition, some jurisdictions (e.g., Illinois, South Carolina) prohibit contingent fees paid for soliciting certain government business, even if the solicitor does not trigger lobbyist registration. Placement agent policies also can prohibit contingent fees.

Gift Laws

When providing a thing of personal value to an official or employee of a government entity, one must consider the gift rules of that jurisdiction. These restrictions apply to personal benefits such as meals, entertainment, travel and gift items as opposed to political contributions, which may be subject to pay-to-play restrictions as described above. Most jurisdictions have some restriction on gifts and entertainment for public officials, whether it be an absolute ban regardless of value, a fixed dollar limit per occasion or per month or year, or a prohibition on providing gifts that might reasonably tend to influence an official. These gift laws often extend to things of value provided to the official's spouse or dependent children. In some instances, state and local gift laws, such as those in the state of New York, can include gifts given to a third party, such as a charity, at the request or behest of a public official. As noted above, lobbyists and companies employing lobbyists often need to report the gifts or entertainment they provide. Government entities also may have policies requiring vendors or contractors to disclose gifts they provide to their officials.

Legal liability for a violation of these laws can attach to the donor, donee or both, depending on the law. This is especially important to keep in mind in light of the fact that government entities increasingly require certifications of compliance with applicable gift laws. For example, the New York City comptroller requires firms managing city pension fund money to certify they have not given anything of value to employees of the comptroller's office.

Conflicts of Interest

Dual-Hatted Situations

To the extent employees also hold positions with a government entity (such as serving on an unpaid government board), government conflict-of-interest restrictions may apply. Conflict rules frequently prohibit a government official from participating in a decision (such as that to award a contract) involving his or her private employer. In some rare cases, prohibitions can apply to contracts with that government entity even if the official fully recuses. Although legal liability for violations of these laws is typically limited to the official or former official, contracts that are entered into in violation of these conflict laws may be void or voidable by the government entity.

Post-Employment Rules

State and local laws typically restrict former public officials from appearing before their former agency for a period of time (often one or two years) after leaving government office and permanently restrict someone from working on a particular matter (such as a contract or procurement) that he or she personally worked on while in government. Thus, when vetting a prospective or new hire who is a former government official, a firm may want to consider whether the firm does or may seek to do government business in the jurisdiction where the official serves or served.

Takeaways

In addition to the ever-increasing risk of an enforcement action, potential legal violations can bring negative media attention. As such, broker-dealers and RIAs must continue to develop and refine compliance programs to address laws regulating government procurement activities. Common elements among these programs include implementing tailored policies, preclearing certain activities, providing protocols to ensure that registration and ongoing reporting requirements are met, offering training programs for certain officers and employees, and establishing procedures for keeping abreast of the latest developments in this area of law.

by Ki Hong and Tyler Rosen

January 23, 2019

Skadden, Arps, Slate, Meagher & Flom LLP