

# Pay-to-Play Rules for Swap Dealers

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CFTC; Financial Services; Securities; Election and Political Law

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As election season enters full swing, with political candidates at all levels actively soliciting campaign donations from individuals and companies, it is an ideal time for all companies to review the policies and procedures in place for political donations. While the SEC's pay-to-play rules governing registered investment advisers and their "covered associates" are well known, the rules governing swap dealers are more obscure. Specifically, swap dealers and security-based swap dealers are subject to the "pay-to-play" rules of the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) respectively, which impose restrictions on the making of campaign contributions to officials of certain government entities with which a swap dealer does business.

Swap dealers and security-based swap dealers should review their policies, procedures and practices to ensure that they do not run afoul of the pay-to-play rules, and that any campaign contributions and campaign fundraising activities, or the contributions and fundraising activities of their employees, do not disqualify them from doing business with any governmental entities with which they may want to do business.

The CFTC's pay-to-play rule for swap dealers became effective in April 2012. The SEC's pay-to-play rule for security-based swap dealers, which was finalized in April 2016 and became effective on June 27, 2016, is nearly identical to the CFTC's rule.<sup>1</sup> Because neither rule has been applied in an enforcement proceeding or tested in court, guidance for interpreting the rules may be found by the interpretations of the SEC's pay-to-play rules for investment advisers, and the Municipal Securities Rulemaking Board (MSRB) pay-to-play rules for the municipal securities business.

Swap dealers need to be aware of who is covered by the rule, the consequences of triggering the rule, and what activity triggers the rule.

## Covered Persons

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Generally speaking, the pay-to-play rules for swap dealers are triggered by contributions from (1) "swap dealers"; (2) "covered associates" (i.e. certain employees and owners) of "swap dealers" to (3) elected officials of most government bodies (known in the rules as "special entities"). Thus, it is important to understand who is covered under each of these categories.

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<sup>1</sup> The SEC's rules for security-based swap dealers are nearly identical to the CFTC's rule. In addition, although the SEC has issued final pay-to-play rules, as of the date of this alert, securities-based swap dealers are not yet required to register as such. Thus, we will refer throughout to swap dealers generally, and to the CFTC's rules.

### *Swap Dealers and Covered Associates*

The pay-to-play rules cover any person defined as a swap dealer<sup>2</sup> and any person defined as a “covered associate” of a swap dealer.<sup>3</sup> All domestic swap dealers are covered.<sup>4</sup>

The “covered associates” of a swap dealer are the swap dealer’s: (1) central leadership; (2) employees who deal in swaps with government entities (as well as their supervisors); and (3) PACs.<sup>5</sup> A covered associate includes “Any general partner, managing member, or executive officer, or other person with a similar status or function [of the swap dealer].”<sup>6</sup> The regulation also considers “Any employee who solicits a governmental Special Entity for the swap dealer and any person who supervises, directly or indirectly, such employee” to be a covered associate.<sup>7</sup> Solicitation is further defined as “direct or indirect communication by any person with a governmental special entity for the purpose of obtaining or retaining an engagement related to a swap.”<sup>8</sup> This language can have far reaching implications. For example, the MSRB interpreted the identical term to mean that passive attendance at a presentation regarding the firm’s capacities in municipal finance would constitute a solicitation and render a passive and silent attendee a covered associate.<sup>9</sup> Swap dealers should also be aware that parent company leaders may be considered associates of swap dealing subsidiaries, as the Commodity Exchange Act<sup>10</sup> provides for the principal-agent and controlling person liability standards common to this sort of corporate regulation.

The third category of covered associate is any “political action committee controlled by the swap dealer or by any” covered associate.<sup>11</sup> For guidance, in 2010, the MSRB laid out factors to be used to determine whether or not a PAC was under the control of covered associates.<sup>12</sup> In brief, those who participated in the creation of the PAC who are not “wholly disassociated” with it are presumed to be controllers of the PAC; the SEC will also look to management, funding, and control arrangements in a totality-of-the-circumstances inquiry.<sup>13</sup> It is more likely than not that

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<sup>2</sup> A swap dealer is defined as any person who holds itself out as a dealer in swaps, or who makes a market in swaps, or who enters into swaps with counterparties as an ordinary course of business for its own account, or who engages in any activity causing themselves to be known as a swap dealer. 7 U.S.C. § 1a(49); 17 C.F.R. § 1.3(ggg).

<sup>3</sup> Major swap participants, defined as those who maintain a position in swaps without being a swap dealer, are not covered by the regulation since these entities do not “solicit” swap transaction business.

<sup>4</sup> The CFTC has issued no-action relief recognizing that foreign swap dealers, such as those regulated by the Australian Securities and Investments Commission, and various instrumentalities of the European Union, are already “covered” for the purposes of pay-to-play by their home regulator, and thus will not be subject to the CFTC’s pay-to-play rule provided they meet certain conditions. It is unclear whether a foreign swap dealer who entered into a swap with a U.S. government entity, having given significant contributions to officials in that entity through covered (but U.S. citizen) associates, would attract action from the CFTC. There is a risk, however, that such a swap dealer would fall outside of the coverage of the CFTC’s no-action relief.

<sup>5</sup> Although no CFTC case has interpreted these terms, guidance can be gleaned from the SEC’s and MSRB’s pay-to-play rules for investment advisers and the municipal securities industry.

<sup>6</sup> 17 C.F.R. § 241(2)(i). Although this text is the same as that of the SEC’s rule for investment advisers, the SEC’s rule goes on to define the term “executive officer,” whereas the CFTC’s rule does not.

<sup>7</sup> 17 C.F.R. § 241(2)(ii).

<sup>8</sup> 17 C.F.R. § 23.451(a)(2)(ii).

<sup>9</sup> Notice of Filing & Immediate Effectiveness of Proposed Rule Change by the Mun. Sec. Rulemaking Bd. Relating to Interpretation of Rule G-37 on Political Contributions & Prohibitions on Mun. Sec. Bus., SEC Release No. 35544 (Mar. 28, 1995).

<sup>10</sup> 7 U.S.C. § 13c.

<sup>11</sup> 17 C.F.R. § 241(2)(iii).

<sup>12</sup> MSRB Rule Book 284 (Jan. 2015).

<sup>13</sup> MSRB Rule Book 284-85 (Jan. 2015).

because all central leadership would be considered covered associates, a PAC even marginally affiliated with a swap dealing organization will be swept in under the CFTC rule.

Finally, the pay-to-play rules include a broad anti-circumvention provision. This rule, as it has been interpreted by the SEC and MSRB, has the effect of sweeping in any relatives or associates of the covered associate who might be relied upon to make contributions on behalf of the swap dealer with the tacit understanding that these donations would then be taken into account when awarding swaps business.<sup>14</sup> The only limitation to the anti-circumvention rule is the statement in the preamble to the prohibition section that the rule is imposed “as a means reasonably designed to prevent fraud.”<sup>15</sup> The CFTC describes this preamble as a limitation on the rule, though not as limiting as requiring that the political contributions be made “with the intent to solicit swaps business.”<sup>16</sup> A reasonable inference, then, is that a donation made by a relative of a covered associate would not trigger the prohibition unless there was presented some additional information from which the CFTC could reasonably infer a fraudulent purpose. By the same token, however, an advisory or non-voting member of the board of directors (or a member of an advisory board or committee) *could* be considered a covered associate if the CFTC formed the view that this person was being used as a conduit for donations between the swap dealers (and/or covered associates of the same) and relevant officials.

### *Special Entities*

The pay-to-play rule refers to government entities as “special entities.” Special entities covered by the rule include: a State, State agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State; and any governmental plan as defined in Section 3 of ERISA.<sup>17</sup>

The term “official” of a special entity means any person (including any election committee for such person) who was, at the time of the contribution, an incumbent, candidate, or successful candidate for elective office of a governmental special entity, if the office: (i) is directly or indirectly responsible for, or can influence the outcome of, the selection of a swap dealer by a special entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the selection of a swap dealer by a special entity.<sup>18</sup> Under the SEC’s pay-to-play rule for investment advisors, it is the office, and not the officer, from which influence or responsibility is measured. A donation to a *candidate* while they are still a candidate triggers the rule even if that candidate loses, since the CFTC’s rule expressly includes “candidates” for office.<sup>19</sup>

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<sup>14</sup> See, e.g., MSRB Rule Book 271-72 (Jan. 2015) (noting that contributions of lawyers, spouses, and consultants of a covered associate, if used as a means to indirectly convey funds from a covered associate to a covered official, would trigger the two-year bar).

<sup>15</sup> 17 C.F.R. §23.451(b).

<sup>16</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Ref. 9734, 9801 (Feb. 17, 2012).

<sup>17</sup> In No-Action Letter 12-33, the CFTC’s staff issued no-action relief with respect to contributions made to officials of plans of this type. The SEC’s pay-to-play rule for security-based swap dealers only applies to municipal entities. 12 C.F.R. § 240.15Fh-6(b)(1).

<sup>18</sup> 17 C.F.R. § 23.451(a)(4).

<sup>19</sup> 17 C.F.R. § 23.451(a)(4).

Donations made to a political party, where the covered associate knows or has reason to know that said donations will be directed to a covered official, are considered donations to that official.<sup>20</sup>

## Two-Year Timeout

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The immediate consequence of a campaign donation by a covered associate to an official is a two-year “time out” during which the swap dealer may not “offer to enter into or enter into a swap or a trading strategy involving a swap” with a special entity over which that official exercises direct or indirect influence over the selection of a swap dealer. Moreover, the rule expressly bars swap dealers and covered associates from: (i) paying anyone, other than a person already subject to pay-to-play rules, to solicit a government body to enter into a swap with the dealer; and, (ii) coordinating or soliciting any person to make a contribution to an official of a governmental body with which the swap dealer is offering to enter into or has entered into a swap, or coordinating or soliciting payments to the political party in the same jurisdiction as that covered by the governmental body.<sup>21</sup>

Anonymous swaps executed on a Designated Contract Market or Swap Execution Facility are exempt from the timeout.<sup>22</sup> Through no-action relief, the CFTC has exempted non-anonymous swaps with governmental bodies that are intended to be cleared,<sup>23</sup> and swaps with a counterparty executed under a prime brokerage arrangement, to the extent any such obligations have been allocated to another swap dealer and such other swap dealer has accepted such allocation, subject to certain conditions regarding the form of the prime brokerage arrangement.<sup>24</sup>

## Triggering the Time-Out

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A variety of fairly innocuous actions can trigger the two-year time out (or violate the ban on soliciting for covered candidates or political parties). If the CFTC follows the lead of the SEC, it would hold that this regulation is a “broad prophylactic measure,” and that finding a violation of the rule will not require a showing of scienter or a quid pro quo. Indeed, there is no scienter language in the regulation whatsoever.

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<sup>20</sup> Notice of Filing of Proposed Rule Change by the Mun. Sec. Rulemaking Bd. Relating to Rule G-37 on Political Contributions & Prohibitions on Mun. Sec. Bus., & Rule G-8 on Recordkeeping, SEC Release No. 34630 (Sept. 1, 1994) (“For example, if a contribution to a political party is earmarked or known to be provided to an official or officials of a particular issuer, then the dealer would violate the rule’s proscription against indirect violations, thereby triggering the two-year prohibition on business with that issuer.”).

<sup>21</sup> 17 C.F.R. § 23.451(b)(3)(i)-(ii).

<sup>22</sup> 17 C.F.R. § 23.451(b)(2)(iii); *see also* No Action Relief: Swaps Intended to be Cleared, CFTC No-Action Letter 13-33 (Jun. 27, 2013), *available at* <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-33.pdf>

<sup>23</sup> No Action Relief: Swaps Intended to be Cleared, CFTC No-Action Letter 13-70 (Nov. 15, 2013), *available at* <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-70.pdf> (extending the relief granted in the previous letter).

<sup>24</sup> Time Limited Relief for Swap Dealers in Connection with Prime Brokerage Arrangements, CFTC No-Action Letter 13-11 (April 30, 2013), *available at* <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-11.pdf>.

The timeout is triggered for a swap dealer when the swap dealer or any covered associate makes a contribution to any covered official. A contribution is defined as “any gift, subscription, loan, advance, or deposit of money or anything of value made:

- (i) For the purpose of influencing any election for federal, state, or local office; (ii) For payment of debt incurred in connection with any such election; or (iii) For transition or inaugural expenses incurred by the successful candidate for federal, state, or local office.”<sup>25</sup>

The MSRB has held that services donated to campaigns can count as contributions. Thus, for instance, if a covered associate flew out to Texas to volunteer for a candidate, they may have made a “contribution” to the candidate, by paying for their own flight.<sup>26</sup> In a related context, the MSRB has warned that any fundraising activity by an *official* at an event hosted by a municipal bond dealer, would trigger the two-year ban since the dealer would be facilitating a fundraiser in contravention of the rule.<sup>27</sup>

The two-year time out is measured from the moment a donation is made, and *not* when the donor becomes a covered associate.<sup>28</sup> Thus, for example, if a person donated to a covered official on October 2, 2016, and became a covered associate in November 2016, the covered associate’s swap-dealing firm would not be able to engage in any swap or trading strategy involving a swap with any New York State funds until October 2, 2018. The “look-back” period is cut to six months if the covered associate does not herself “solicit the governmental body on behalf of the swap dealer to offer to enter into or enter into a swap or trading strategy involving a swap.”<sup>29</sup>

Total donations of \$350 or less to a candidate for whom a covered associate is entitled to vote, and \$150 or less to a candidate for whom the covered associate is not entitled to vote, are considered *de minimis*, and will not trigger the two-year timeout.<sup>30</sup> These caps apply per election; if the CFTC applies the MSRB’s interpretation, the primary and the general election would be considered separate elections.<sup>31</sup> Also, due to no-action relief from the CFTC, any donations made before a swap dealer was required to register as a swap dealer do not trigger the timeout.<sup>32</sup>

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<sup>25</sup> 17 C.F.R. § 23.451(a)(1). This language is identical to that of the SEC’s pay-to-play rule, 17 C.F.R. § 275.206(4)-5(f)(1).

<sup>26</sup> Notice of Filing of Proposed Rule Change by the Mun. Sec. Rulemaking Bd. Relating to Political Contributions & Prohibitions on Mun. Sec. Bus., SEC Release No. 33482 (Jan. 14, 1994)

<sup>27</sup> MSRB Rule Book 282 (Jan. 2015).

<sup>28</sup> 17 C.F.R. § 23.451(b).

<sup>29</sup> 17 C.F.R. § 23.451(b)(2)(ii). This provision likewise is largely identical to that promulgated in the SEC’s pay-to-play rules. See 17 C.F.R. § 275.206(4)-5(b)(2).

<sup>30</sup> 17 C.F.R. § 23.451(b)(2)(i). If a covered associate goes over the *de minimis* limit, but discovers the error within 120 days and requests a refund within 60 days of discovering the error, the two-year timeout will not be triggered.

<sup>31</sup> MSRB Rule Book 265 (Jan. 2015).

<sup>32</sup> Requests for No-Action Relief from Commission Regulation 23.451 in Connection with Dealings with Certain Governmental Plans and for Clarification Concerning the “Look-Back” Provision of Commission Regulation 23.451, CFTC No-Action Letter 12-33 (Nov. 29, 2012), *available at* <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/12-33.pdf>

Covington is well-positioned to provide market participants with compliance advice related to CFTC and SEC regulations, including pay-to-play rules. We also regularly advise clients on all aspects of campaign finance laws.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our CFTC or Election and Political Law practice groups

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