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Client Alert

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SEC Approves FINRA Pay-to-Play Rules

Investment Adviser Third-Party Solicitor Pay-to-Play Rule to Finally Go Effective

By Matthew R. Silver and Frances V. Ryan

In light of new Financial Industry Regulatory Authority, Inc. (FINRA) rules, firms should review existing policies and practices relating to distribution and solicitation activities with government entities on behalf of investment advisers as well as their applicable solicitation related contracts (involving a FINRA member solicitor or not) to ensure compliance with Securities and Exchange Commission (SEC) Rule 206(4)5 of the Investment Advisers Act of 1940 ("SEC Pay-to-Play Rule"). The period prior to the effective date should provide member firms with needed time to identify their covered associates and to modify their compliance programs (and, if needed, solicitation contracts) to address new obligations under the SEC Pay-to-Play Rule. It is also important that advisers continue to consider state and local rules imposing pay-to-play restrictions on their advisory activities as applicable safe harbor dollar figures, attribution rules and other requirements in various states and cities can differ widely. We discuss these changes in greater detail below.

The SEC has approved new FINRA rules ("FINRA Pay-to-Play Rules") governing various political contribution matters. The FINRA Pay-to-Play Rules will serve to regulate the activities of broker-dealers that engage, for compensation and on behalf of investment advisers, in distribution or solicitation activities involving government entities (including all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as Section 403(b), 457, and 529 plans).

The FINRA Pay-to-Play Rules are modeled upon the SEC Pay-to-Play Rule. "Pay-to-Play" generally refers to a variety of arrangements intended to influence the award of advisory business by making, or soliciting from others, political contributions to the government officials awarding such business. Rule 206(4)-5 does not preempt existing state and local pay-to-play rules, which are often different or more restrictive than the federal rule.

The SEC Pay-to-Play Rule contains three main prohibitions, as follow:

- A two-year (or in some cases, six-month) prohibition on an adviser providing compensated services to a government entity following a political contribution to certain officials of that entity;
- A prohibition on the use of third-party solicitors who are not themselves "regulated persons" subject to pay-to-play restrictions on political contributions; and
- A prohibition on "bundling" (i.e., coordinating and submitting as a group a large number of small employee or other contributions that add up to a greater sum) and other similar efforts by advisers to solicit political contributions to officials of a government entity.

A "regulated person," as defined in the SEC Pay-to-Play Rule, includes a registered broker-dealer, provided that:

- FINRA rules prohibit member firms from engaging in distribution or solicitation activities if political contributions have been made to certain public officials; and
- The SEC, by order, determines that such rules impose substantially equivalent or more stringent restrictions on member firms than the SEC Pay-to-Play Rule imposes on investment advisers and that such rules are consistent with the objectives of the SEC Pay-to-Play Rule.

Pursuant to this regulatory framework, FINRA proposed its own Pay-to-Play Rules to enable its member firms to continue to engage in distribution and solicitation activities for compensation with government entities on behalf of investment advisers.

FINRA Rule 2030 Engaging in Distribution and Solicitation Activities with Government Entities provides, in part, as follows:

- No FINRA member can engage in distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser that provides or is seeking to provide investment advisory services to such government entity within two years after a contribution to an official of the government entity is made by the covered member or a covered associate (including a person who becomes a covered associate within two years after the contribution is made).

- No FINRA member or covered associate may solicit or coordinate any person or political action committee to make any: (a) contribution to an official of a government entity in respect of which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser; or (b) payment to a political party of a state or locality of a government entity with which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser.

Definitions

The definition section of Rule 2030 provides, among other things, that "covered member" means "any member" but excludes members engaging in activities that would require the member to register as a municipal advisor with the SEC (i.e., a FINRA member that would be required to register as a municipal advisor and be subject to the amended MSRB Rule G-37 pay-to-play provisions, as described below).[1] A "covered associate" means any general partner, managing member or executive officer of a "covered member" (or other individuals with a similar status or function); an associated person of a "covered member" who engages in distribution or solicitation activities with a government entity for such "covered member"; an associated person of a "covered member" who supervises, directly or indirectly, the government entity distribution or solicitation activities; and any political action committee (PAC) controlled by a "covered member" or a "covered associate." A "contribution" includes anything of value given for the purpose of influencing any election for federal, state or local office, as well as payment of debt incurred in connection with such election or payment for transition or inaugural expenses of the successful candidate for state or local office. A "government entity" means any state or political subdivision of a state, including any agency, authority or instrumentality of the state or political subdivision; a pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including but not limited to a defined benefit plan as defined in Section 414(j) of the Internal Revenue Code, or a state general fund; a plan or program of a government entity; and officers, agents or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

Practice Point: As a result of FINRA Pay-to-Play Rule definitions, a donation of $400 to a losing third-party candidate for a governor of a state could have implications because it is the ***office*** *that is important, not whether a candidate is successful. Such a donation could block solicitation, for compensation, to many state pension funds (the funds where the successful candidate could appoint board members.) However, other than recordkeeping, a donation to a purely federal candidate who is not currently a state or local official (or running for a state or local office) would not result in a prohibition under the FINRA rules.*

Look-Back

As per Rule 2030(a), a person who becomes a "covered associate" by engaging in distribution or solicitation activities with a government entity would trigger a ban for the "covered member" if he or she had made contributions looking back over the prior two years. However, Rule 2030(c) provides an exception providing for only a six-month "look back" for the "covered member" if a new "covered associate" does not engage in, or seek to engage in, distribution or solicitation activities with a government entity on behalf of the "covered member." Thus, the FINRA member's compliance procedures should provide that **new** "covered associate" contributions are reviewed for the relevant pre-employment look-back period. However, the "look-back" will not cover contributions made prior to the effective date of the FINRA Pay-to-Play Rules.

De minimis Exception

Rule 2030 provides an exception for a "covered associate" who is a natural person who contributes no more, in the aggregate, than $350 per election to a candidate for whom he or she is entitled to vote, or $150, in the aggregate, per election to a candidate for whom he or she is not entitled to vote. Furthermore, Rule 2030(c)(3) provides exceptions for contributions that do not exceed $350 if (1) the "covered member" discovers the contribution within four months, and (2) a refund is obtained within 60 days of discovery. A "covered member" may use this exception only three times (or if the "covered member" has 150 or fewer registered persons, no more than twice) during a calendar year and only once in a lifetime for any one "covered associate." Additionally, a "covered member" may apply to FINRA for discretionary exemptions, in which case FINRA will consider a variety of factors, including whether the applicable compliance procedures were reasonably designed to prevent violations of the FINRA Pay-to-Play Rules, whether the "covered member" had knowledge of the contribution before it was made and the remedial or preventive measures it put it place after discovering the contribution.

Record-Keeping Requirements

Rule 4580 provides that a covered member must maintain books and records that provide the names, titles, and business and residential addresses of all covered associates and the name and business address of each investment adviser on whose behalf the covered member has engaged in distribution or solicitation activities with a government entity within the past five years, but not prior to the FINRA Pay-to-Play Rules' effective date. Further, records must be maintained with the name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities for

1 As noted in the August 25, 2016 SEC release: "FINRA states that a member firm that solicits a government entity for investment advisory services on behalf of an **unaffiliated** investment adviser may be required to register with the SEC as a municipal advisor as a result of such activity. Under such circumstances, FINRA notes that the MSRB rules applicable to municipal advisors, including the pay-to-play rule adopted by the MSRB would apply to the member firm."

compensation on behalf of an investment adviser, or which are or were investors in any covered investment pool on behalf of which the covered member has engaged in distribution or solicitation activities with the government entity on behalf of the investment adviser to such pool, within the past five years, but not prior to the FINRA Pay-to-Play Rules' effective date. Additionally, information regarding all contributions made by the covered member and covered associates to an official of a government entity, a political party of a state or political subdivision thereof or to a PAC must be maintained.

MSRB Regulations

As of August 17, 2017, municipal advisors are subject to various new pay-to-play regulations promulgated by the Municipal Securities Rulemaking Board (MSRB). Thus, the MSRB's municipal securities dealer pay-to-play rule will extend to municipal advisors, including those acting as third-party solicitors. Similar to the existing MSRB rule for dealers, the new regulations generally prohibit municipal advisors from engaging in municipal advisory business with municipal entities for two years if certain political contributions have been made to officials of those entities who could influence the award of business. The SEC announced on August 25 that it was ready to approve the MSRB rule proposals, but gave interested parties until September 19 to request a hearing.

Practice Point: The SEC has looked forward to the adoption of FINRA rules complementary to the SEC Pay-to-Play Rule for some time. As noted by the SEC on June 25, 2015, until the effective date of ***both*** *FINRA and MSRB pay-to-play rules that correspond to the SEC Pay-To-Play Rule, enforcement action would not be recommended against an investment adviser or its covered associates under Rule 206(4)-5(a)(2)(i) (namely, the third-party solicitor pay-to-play provision that would apply whether or not a third-party solicitor was a FINRA member, an MSRB member or a member of neither) for payments made for the solicitation of government entities for investment advisory services. That day is soon at hand.*

Compliance Date

FINRA will announce the effective date of the rule change in a Regulatory Notice to be published either later this month or in October. The effective date must be between six months and one year following FINRA's release. Therefore, the FINRA Pay-to-Play Rules will take effect between March 2017 and October 2017. Should you have any questions about this alert, please feel free to call or email the authors or your contact within our Investment Management Group.

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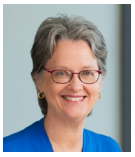

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