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2017 BRINGS NEW "PAY TO PLAY" RULE TO FINRA MEMBERS

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Later this year, a pair of new Financial Industry Regulatory Authority, Inc. (FINRA) rules will go into effect that govern the activities of broker-dealers that engage in distribution or solicitation activities with government entities in exchange for compensation from investment advisers. FINRA member firms that have relationships with government entities and intermediate on behalf of investment advisers should consider whether these new rules will affect their business models and whether any enhancements to their compliance frameworks will be required.

Last fall, FINRA issued a Regulatory Notice that identified August 20, 2017 as the effective date for FINRA Rules 2030 and 4580 (together, the "FINRA Rules").[1] FINRA Rule 2030 governs distribution and solicitation activities, whereas FINRA Rule 4580 imposes certain books and records requirements. FINRA first proposed the FINRA Rules in December 2015 and, after some back-and-forth,[2] they were approved by the US Securities and Exchange Commission (SEC) on August 25, 2016.[3]

Background

The FINRA Rules are the long-awaited FINRA counterpart to an SEC rule that was adopted for investment advisers in July 2010 (the "SEC Rule").[4] The SEC Rule was designed to significantly curtail practices whereby investment advisers or their high-ranking officers and sales personnel make political contributions to persons who, if elected, would be in a position to award (or influence the award of) government contracts for advisory services, commonly referred to as "pay-to-play." The SEC Rule primarily prohibits the receipt of compensation from government clients if the adviser or certain of its personnel made more than *de minimis* political contributions to political officials of such clients. But the SEC Rule also prohibits an investment adviser or its "covered associates" from paying a third-party to solicit a government entity on behalf of the adviser, unless such a third-party is a "regulated person."[5] For purposes of the SEC Rule, a "regulated person" would include a FINRA-member broker-dealer, provided the broker-dealer is subject to pay-to-play restrictions that the SEC has determined, by order, (*i*) impose substantially equivalent or more stringent restrictions as the SEC Rule; and (*ii*) are consistent with the objectives of the SEC Rule.[6]

Because there was no comparable FINRA rule at the time the SEC Rule was

adopted, the SEC indicated that the third-party solicitation provision of the SEC Rule would not go into effect until September 23, 2011. This extended compliance date was designed to provide FINRA with an opportunity to propose, and for the SEC to consider, a comparable rule. The SEC noted that if after such time period a FINRA rule was not yet adopted, advisers would be prohibited from making payments to broker-dealers for distribution or solicitation activities with respect to government entities.[7]

September 2011 came and went and the SEC extended the compliance date with respect to third-party solicitors until June 13, 2012.[8] In June 2012, the SEC again extended the compliance date until July 31, 2015.[9] And on June 25, 2015, the SEC announced that compliance with the third-party solicitation prong of the SEC Rule would be required as of July 31, 2015.[10] However, as of that date, there *still* was not a comparable FINRA rule in effect. Accordingly, to avoid concerns that the SEC staff would recommend enforcement action for violations of this provision of the SEC Rule, the SEC staff concurrently updated its online frequently asked questions (FAQs) on the SEC Rule to clarify that until FINRA adopted a comparable rule (and such rule went into effect), the SEC staff would not recommend enforcement action for violations of the third-party solicitation prong of the SEC Rule.[11]

With the FINRA Rules now adopted and going into effect on August 20, 2017, both broker-dealers who solicit government entity clients for investment advisers and the investment advisers who engage them, can expect compliance with the FINRA Rules and SEC Rule to be an area of focus for regulators in 2017.

Provisions of FINRA Rule 2030

Because the SEC Rule requires that third-party broker-dealers be subject to a rule that the SEC has reviewed and determined to be substantially equivalent or more stringent, it is no surprise that FINRA Rule 2030 is closely modeled after the SEC Rule.[12]

Two-Year "Time Out"

FINRA Rule 2030(a) prohibits covered members[13] from engaging in distribution or solicitation activities for compensation with a government entity[14] on behalf of an investment adviser that provides or is seeking to provide investment advisory services to such government entity within two years after the covered member or a covered associate makes a contribution to an official[15] of the government entity. This would also include a person who becomes a covered associate of the broker-dealer within two years after making such a contribution. Similar to the SEC Rule, FINRA Rule 2030(a) is designed to discourage broker-dealers from participating in pay-to-play practices by imposing a cooling-off period during which the influence of a political contribution can be expected to dissipate.

For purposes of FINRA Rule 2030(a), the term "covered associate" is substantially similar to the definition of "covered associate" set forth in the SEC Rule and includes any (*i*) general partner, managing member or executive officer of the covered member, or other individual with a similar status or function; (*ii*) associated person of the covered member who engages in distribution or solicitation activities with government entities; (*iii*) associated person of the covered member who supervises, directly or indirectly, the activities of persons who engage in distribution or so-

licitation activities with government entities; and (*iv*) political action committee (PAC) controlled by the covered member or a covered associate. The term "contribution" is defined as any gift, subscription, loan, advance, deposit of money or anything of value made for (*i*) the purpose of influencing any election for federal, state or local office; (*ii*) the payment of debt incurred in connection with any such election; or (*iii*) transition or inaugural expenses incurred by a successful candidate for state or local office. "Solicit," with respect to advisory services, is defined as communicating, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser.

FINRA Rule 2030(a) also includes a "look-back" provision whereby the rule attributes to the member firm any contributions made by a person during the two years prior to becoming a covered associate. This is designed to prevent covered members from circumventing the rule by hiring as new employees persons who have made political contributions prior to their employment. This look-back period is reduced to six months in instances where a new covered associate does not engage in, or seek to engage in, distribution or solicitation activities with government entities on behalf of the broker-dealer. Similar to the SEC Rule, this provision highlights the importance of screening potential new employees for political contributions that could affect the broker-dealer's business, as well as screening candidates for internal promotion from positions not considered to be "covered associates" into covered associate positions. For this reason, broker-dealers should consider communicating these potential issues to all employees—particularly during election cycles. However, given the sensitive nexus between the FINRA Rules and individuals' rights to participate in the political process, broker-dealers should be careful to draft appropriately tailored policies and procedures and also be mindful of the tone of their internal communications, policies and training sessions.

Exceptions to the Two-Year "Time Out" Provision

Similar to the SEC Rule, FINRA Rule 2030(c) includes two exceptions from its two-year time out provision. First, a covered associate that is a natural person is permitted to contribute, in the aggregate, up to $350 to any one official per election, provided that the covered associate was entitled to vote for the official at the time of the contribution. If the covered associate was not entitled to vote for an official at the time of the contributions, the contributions in the aggregate must not exceed $150. Second, if a covered associate makes a contribution of less than $350 to an official that the covered associate was *not* entitled to vote for, the two-year time out will not be triggered if (*i*) the broker-dealer discovers the contribution within four months of it being made; and (*ii*) the contribution is returned within 60 days after the broker-dealer discovers the contribution. A covered member may not rely on this exception more than once with respect to a particular covered associate. This second exception is purposefully designed to be narrow in order to reward firms with robust policies and procedures in place to monitor political contributions by their covered associates and then act quickly to take corrective action.

Prohibition as Applied to Covered Investment Pools

Covered members that engage in distribution or solicitation activities with a government entity on behalf of a "covered investment pool" in

which a government entity invests or is solicited to invest are treated as though they were soliciting services on behalf of the investment adviser directly. A "covered investment pool" includes (*i*) a registered investment company that is an investment option of a plan or program of a government entity; or (*ii*) any company that would be an investment company as defined in Section 3(a) of the Investment Company Act of 1940 (Investment Company Act) but for the exclusion from the definition of "investment company" under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act.

Accordingly, member firms cannot limit their policies and procedures to solicitation for advisory separate accounts and must consider whether to apply the FINRA Rules to activities that are traditionally considered to be more like placement agency services, depending on their engagement with the manager or sponsor of the investment pool.

Prohibition on Soliciting and Coordinating Contributions or Payments

Like the SEC Rule, FINRA Rule 2030 also includes multiple layers of compliance. Specifically, Rule 2030(b) prohibits a covered member and its covered associates from (*i*) soliciting any person or PAC to make any contribution, or from coordinating any contributions, to an official of a government entity with which the member firm is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser; or (*ii*) soliciting or coordinating any payments to a political party of a state or locality with which the member firm is engaging or is seeking to engage in distribution or solicitation activities on behalf of an investment adviser. This provision is modeled on a similar provision in the SEC Rule and, according to FINRA, is intended to prevent covered members or covered associates from circumventing the time-out provision by "bundling" (either by soliciting a large number of contributions by employees, or by soliciting payments to a state or local political party).

Record-Keeping Requirements of FINRA Rule 4580

FINRA Rule 4580 requires covered members to maintain books and records that would allow FINRA to examine for compliance with FINRA Rule 2030. These provisions are modeled on the record-keeping provisions of the SEC Rule and require covered members to collect and maintain:

- The names, titles and business and residence addresses of all covered associates;
- The name and business address of each investment adviser to which the covered member has engaged in distribution or solicitation activities with a government entity in the past five years (but not prior to the FINRA Rules' effective date);
- The name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities for compensation on behalf of an investment adviser (directly or through a covered investment pool) in the past five years (but not prior to the FINRA Rules' effective date); and
- All direct and indirect contributions made by the adviser or its covered associates to an official of a government entity or direct

or indirect payments made to a political party or PAC.

Next Steps

Between now and August, broker-dealers should take an inventory of their current relationships and sales practices to identify where they engage in distribution and solicitation activities with government entities on behalf of an investment adviser. Firms should note that the FINRA Rules also apply to pooled investment products. Accordingly, firms that distribute registered or private funds to government entity investors may want to consider imposing a robust policy and procedure in place to comply with the FINRA Rules. Importantly, the FINRA Rules apply not only to broker-dealers who engage in such activities on behalf of SEC-registered advisers, but also those who solicit on behalf of foreign private advisers, exempt reporting advises, or advisers that are not registered but are required to be registered.

Dual registrant firms should be able to substantially leverage their existing policies and procedures designed to comply with the SEC Rule, perhaps only having to make minor tweaks to their existing compliance framework.[16]

A firm that will have to design a new compliance policy will have to consider whether to tailor its policy so that it only applies to "covered associates" or whether to apply a policy broadly to all employees, the latter being easier to implement and monitor but also imposing unnecessary restrictions on some personnel. Such firms should also consider whether to require pre-clearance of all political contributions, or to permit employees to self-determine that contributions below the permitted *de minimis* contributions are in compliance with FINRA Rules. Apart from pre-clearance requirements, firms will likely want to require periodic confirmation that no unreported activity has occurred. These periodic certifications should be designed to fall within the timeframes of the returned contribution exception so that the firm would have time to rectify issues that are identified. In addition, firms that rely on solicitation of government entities on behalf of advisers as a key component of their business may want to consider implementing extra safeguards, such as tasking the compliance department with conducting checks of publicly available information on political contributions—or hiring a third-party vendor to provide a similar compliance solution.

Firms should also remember that for a rule such as this—which deals with common individual activities that take place outside of the office, but which is complex and includes traps for the unwary—education can be a very useful tool. In our experience with the SEC Rule, advisory firms that put together succinct policies and then invest the time to train employees on the required practices and limitations have generally been well-positioned to avoid compliance issues or to rely on the returned contribution exception. A thoughtful approach could also help better position a firm in the event that it later has to request an exemption from FINRA, which, in evaluating such a request, will consider whether the firm has adopted and implemented policies and procedures reasonably designed to prevent violations of the FINRA Rules.

Finally, firms might want to map out a timeline to compliance between now and August, denoting dates for reviewing draft policies with management and boards, setting aside times to meet

with relevant teams (*e.g.*, sales teams, record-keeping and back-office personnel) and for employee training, as well as for identifying a key person or team of people responsible for overseeing the implementation of the firm's new policies and procedures to comply with the FINRA Rules.

ENDNOTES:

[1]*See* FINRA, Political Contributions, Regulatory Notice No. 16-40 (Oct. 2016).

[2]*See* FINRA, Political Contributions, Regulatory Notice No. 14-50 (Nov. 2014).

[3]*See* Securities Exchange Act Rel. No. 78,683 (Aug. 25, 2016) (approving FINRA Rules); Securities Exchange Act Rel. No. 76,767 (Dec. 24, 2015) (proposing FINRA Rules).

[4]*See* Rule 206(4)-5 under the Investment Advisers Act; *see also* Political Contributions by Certain Investment Advisers, Advisers Act Release No. 3043 (July 1, 2010) (Adopting Release).

[5]*See* Rule 206(4)-5(a)(2)(i).

[6]Third-party "regulated persons" would also include registered municipal advisors, provided they are subject to comparable rules of the Municipal Securities Rulemaking Board.

[7]*See* Adopting Release, *supra* note 4, at 124.

[8]*See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Rel. No. 3221 (June 22, 2011).

[9]*See* Political Contributions by Certain Investment Advisers: Ban on Third-Party Solicitation: Extension of Compliance Date, Investment Advisers Act Rel. No. 3418 (June 8, 2012). The July 31, 2015 was designed to be nine months after the compliance date of the final municipal advisor registration rule.

[10]*See* Political Contributions by Certain Investment Advisers: Ban on Third-Party Solicitation: Extension of Compliance Date, Investment Advisers Act Rel. No. 4129 (June 25, 2015).

[11]We note, however, that willful or intention violations could be subject to enforcement under the catch-all provision of the SEC Rule, which prohibits doing something indirectly that one would be prohibited from doing directly.

[12]FINRA Rule 2030 applies to broker-dealers acting on behalf of investment advisers registered (or required to be registered) under the Advisers Act, unregistered advisers relying on the "foreign private adviser" exemption under Section 203(b)(3), or unregistered advisers that are either "private fund advisers" under Rule 203(m)-1 or "venture capital fund advisers" under Rule 203(l)-1 under the Advisers Act.

[13]A "covered member" is defined in Rule 2030(g)(4) to mean "any member" but excludes any member that is engaging in activities that would cause the member to be a municipal adviser as defined in Exchange Act Section 15B(e)(4), SEA Rule 15Ba1-1(d)(1) through (4) and other rules and regulations thereunder. If a member firm solicits a government entity on behalf of an unaffiliated investment adviser, the member may be required to register with the SEC as a municipal advisor and therefore would not be considered a "covered member" under Rule 2030(g)(4). If a member firm solicits a government entity on behalf of an affiliated investment adviser, the member would not be considered a municipal advisor and therefore would be considered a "covered member" under Rule 2030(g)(4).

[14]A "government entity" includes any state or local government, its agencies and instrumentalities, and any public pension plan or other collective government fund, including a participant-directed plan such as a 403(b), 457 and 529 plan.

[15]An "official" of a government entity include an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser. For example, where a governor has the ability to appoint members to the board of a state retirement system, the gover-

nor, as well as each of the board members themselves, each would likely be considered an "official" of a "government entity" for purposes of the FINRA Rule. It is also worth noting that the FINRA Rule would apply even where a candidate ends up not winning the election.

[16]In its 2011 guidance, the SEC staff indicated that if an adviser's employee is also employed by an affiliated broker-dealer (*i.e.*, a dual employee) to solicit government clients on behalf of the adviser, and the adviser pays the broker-dealer for the employee's solicitation services, then the broker-dealer would have to be a "regulated person" under the Rule. Further, according to the staff, the dual employee would be a covered associate of the adviser because of his or her solicitation activities, even if these activities were performed in his or her capacity as an employee of the broker-dealer.