Chapman and Cutler LLP

Chapman Client Alert

January 4, 2016 Current Issues Relevant to Our Clients

FINRA Revises Proposed "Pay-to-Play" Rules

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently filed with the Securities and Exchange Commission ("SEC") a revised proposal to establish "pay-to-play" rules that would regulate the activities of FINRA member firms engaging in distribution or solicitation activities with government entities on behalf of investment advisers. The revised proposal responds to comments made on a previous FINRA proposal. In addition to making certain clarifications, the revised proposal primarily differs from the prior proposal in that the revised proposal would not (i) require a member firm to provide disclosure to government entities regarding its distribution and solicitation activities or (ii) require a member firm to disgorge fees or other compensation received in violation of the rules. The full text of FINRA's revised, proposed rules is available here.

Why is FINRA Proposing "Pay-to-Play" Rules?

In July 2010 the SEC adopted Rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Advisers Act") addressing pay-to-play practices by investment advisers. The Advisers Act rule generally prohibits an investment adviser from providing advisory services for compensation to a government entity for two years after the adviser or any of its covered associates make a contribution to an official of the entity absent an available exemption. The Advisers Act rule also prohibits advisers from providing direct or indirect payments to any person who solicits a government entity for investment advisory services on behalf of an adviser unless the soliciting person is a "regulated person." FINRA member firms are included in the definition of "regulated person" as long as (1) FINRA rules exist that prohibit member firms from engaging in distribution or solicitation activities if political contributions have been made by the member firm (or its covered associates) to officials of a government entity to which the member firm directs its distribution or solicitation activities and (2) the SEC finds such rules to impose equivalent or more stringent restrictions on member firms than the Advisers Act rule. Current FINRA rules do not include a pay-to-play prohibition that meets this requirement. As a result, FINRA must adopt its own rule to enable member firms to continue to engage in government entity solicitation activities in order for investment advisers to rely on the Advisers Act rule.

In December 2014, FINRA sought comment on proposed rules designed to address this requirement of the Advisers Act rule. For information on FINRA's previous proposal, see our Client Alert available here. In response to comments to the proposal, FINRA revised its proposed pay-to-play rules to more closely align with the Advisers Act rule. FINRA filed the revised proposal with the SEC in December of 2015. If the SEC approves the rules, FINRA will publish an effective date by which member firms should modify their compliance programs to align with the rules. FINRA has noted that the rules' prohibitions would not be trigged by contributions made prior to the effective date, although the Advisers Act rule would apply to any member firm which is an investment adviser covered under that rule.

Proposed Pay-to-Play Restrictions

The proposed FINRA pay-to-play rules would prohibit a covered member from engaging in distribution or solicitation activities with a government entity for compensation 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. We outlined the specifics of the proposed rules in our 2014 Client Alert linked above. The revised proposed rules are largely consistent with the original FINRA proposal with the exception of certain items discussed in the following section.

Revisions to the Proposed Rules

The revised proposal filed with the SEC differs from the previous proposal in the following ways:

- **Definition of Executive Officer:** A "covered associate" for the purposes of the proposed pay-to-play rules includes any general partner, managing member or executive officer of a covered member, or other individual with a similar status or function. Consistent with the

Advisers Act rule, FINRA revised its proposal to define "executive officer of a covered member" to mean: (A) the president; (B) any vice president in charge of a principal business unit, division or function (such as sales, administration or finance); (C) any other officer of the covered member who performs a policy-making function; or (D) any other person who performs similar policy-making functions for the covered member.

- **Clarification of Prohibitions Applied to Covered Investment Pools:** FINRA modified the proposed rule to clarify that for purposes of the proposed rule an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest will be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity. This modification makes a technical clarification that makes clear that the two year time out restriction in the proposed rule applies to advisers to covered investment pools. FINRA also revised its recordkeeping requirements to clarify that covered members must maintain records with regard to distribution or solicitation services with a government entity on behalf of an investment adviser to a covered investment pool in which the government entity invests.

- **Recordkeeping Requirements and Unsuccessful Solicitations:** The proposed rule would require covered members that engage in covered distribution or solicitation activities to maintain books and records that would allow FINRA to examine for compliance with its proposed pay-to-play rules. Consistent with the Advisers Act rule, FINRA revised the proposed rule to clarify that certain recordkeeping requirements do not extend to unsuccessful solicitations of government entities where the covered member does not receive compensation.

- **Removed Disgorgement Requirement:** FINRA's prior proposal contained a provision that, among other things, would have required a covered member to disgorge any compensation received by it that pertains to distribution or solicitation activities for a government entity in the two years following a contribution by the covered member or its covered associates to an official of the government entity. The revised proposal does not contain such a requirement. However, FINRA noted that it maintains the ability to require a disgorgement of fees in an enforcement action.

- **Removed Disclosure Requirements:** FINRA's prior proposal would have required that, at the time of a covered member firm's initial distribution or solicitation activities, it provide written disclosure to government entities disclosing, among other things, the nature of the covered member's compensation arrangement and its relationship with the investment adviser. FINRA received comments indicating that such a disclosure requirement was overly burdensome to member firms and duplicative of existing federally-required disclosure. In response, FINRA eliminated the disclosure requirement, but stated that it may consider a similar disclosure requirement as part of future rulemaking.

Submitting Comments to the SEC

You can submit comments on the rule proposals to the SEC by submitting a hard copy, by using the SEC's internet comment form available by clicking "Submit Comments on SR-FINRA-2015-056" at this link or by sending an email to rule-comments@sec.gov with File Number SR-FINRA-2015-056 in the subject line. Comments must be received within 21 days from the date of publication of the filing in the Federal Register.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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