

CLIENT MEMORANDUM

SEC Approves FINRA Pay-to-Play Rules

September 8, 2016

AUTHORS

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Introduction

On August 25, 2016, the Securities and Exchange Commission (“SEC”) approved rule changes proposed by the Financial Industry Regulatory Authority (“FINRA”) to regulate political contributions by FINRA member firms that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers.¹ The new FINRA “pay-to-play” rules are closely modeled after the requirements of Rule 206(4)-5 under the Investment Advisers Act of 1940 (“Advisers Act”), which regulates political contributions by investment advisers. FINRA has stated that the new rules will become effective at least six months after publication of the Regulatory Notice announcing the SEC’s approval of the rule change, but no more than 12 months after the date of the SEC’s approval, noted above.²

¹ See Securities Exchange Act Release No. 78683 (Aug. 25, 2016). The rule applies to solicitations on behalf of federally registered investment advisers, exempt reporting advisers, and certain unregistered investment advisers. The rule does not apply to solicitations on behalf of state-registered investment advisers.

² As of the date of this publication, FINRA has not yet issued a Regulatory Notice for this matter.

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Prohibited Contributions and the Two-Year Bar

New FINRA Rule 2030 generally prohibits, subject to certain exceptions, any member from engaging in distribution or solicitation activities for compensation with a government entity³ on behalf of an investment adviser that provides or seeks to provide investment advisory services to that government entity within **two years** after making, or after a covered associate⁴ makes, a contribution⁵ to an official⁶ of the government entity. Further, no member or covered associate may solicit or coordinate any person or political action committee to make any contribution to such an official or any payment⁷ to a political party of a state or locality of a government entity with which the member is engaging in distribution or solicitation activities on behalf of an investment adviser.

Private Funds and Other Investment Pools

Distribution and solicitation activities on behalf of a registered investment company that is an investment option of a plan or program of a government entity, a private investment fund that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 ("1940 Act"), or an entity (such as a collective trust fund or certain insurance company separate accounts) that relies on Section 3(c)(11) of the 1940 Act are subject to the rule as if the activities were conducted on behalf of the investment adviser to such funds.

³ A "government entity" includes any agency, authority or instrumentality of a state or political subdivision, certain pools of assets sponsored or established by them, a plan or program of a government entity and officers, agents and employees of the entity acting in their official capacity.

⁴ A "covered associate" includes any general partner, managing member or executive officer of a member, any associated person of a member (and his or her supervisor(s)) who engages in distribution or solicitation activities with a government entity for a member, and any political action committee controlled by any of them.

⁵ The rule defines "contribution" as including any gift, subscription, loan, advance or deposit of money or anything of value made for the purpose of influencing any election for federal, state or local office, payment of debt incurred in connection with such an election, or transition or inaugural expenses of a candidate.

⁶ The rule defines "official" of a government entity as any person, or his or her election committee, who, at the time of the contribution, is an incumbent, a candidate or a successful candidate for an elective office of a government entity if the office is responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity. The definition also includes any person who has the authority to appoint such an official.

⁷ Like the Advisers Act rule, FINRA Rule 2030 distinguishes "payments" from "contributions." "Payment" is defined as any gift, subscription, loan, advance or deposit of money or anything of value, without regard to its purpose.

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Exceptions and Exemptions

Like the Advisers Act rule, the FINRA rule provides the following exceptions:

- *De minimis* exception – A covered associate that is a natural person may contribute up to \$350 per election to an official for whom the covered associate is entitled to vote, and up to \$150 per election to any other official. There is no *de minimis* exception for contributions by a member firm or other entity associated with it.
- New covered associates – The rule’s prohibitions do not apply to a member as a result of a contribution made by a covered associate more than six months before becoming a covered associate of the member, provided the covered associate does not engage in distribution or solicitation activities with a government entity on behalf of the member.
- Returned contributions – Under certain circumstances, a member will not be barred from engaging in distribution or solicitation activities with a government entity on behalf of an investment adviser if an otherwise violative contribution is returned to the contributor. Reliance upon this exception is subject to various conditions. Among other things, a member with more than 150 registered persons may rely on this exception only three times in any calendar year (a member with 150 or fewer registered persons may rely on this exception twice per year), and never more than once for the same covered associate, regardless of the length of time involved.

FINRA may conditionally or unconditionally grant exemptions from the prohibitions of the rule. FINRA will consider, among other factors, whether granting the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the rule, and whether, before the violative act occurred, the firm had adopted and implemented policies and procedures reasonably designed to prevent violations of the rule. Other factors are described in the rule as well.

Books and Records

The SEC also approved FINRA’s adoption of Rule 4580, which sets forth recordkeeping requirements pertaining to members’ government distribution and solicitation activities. This rule requires members that engage in distribution or solicitation activities with government entities on behalf of any investment adviser to create and maintain certain books and records, including specified information about their covered associates, the investment advisers on whose behalf they have acted, all government entities with which they have engaged in distribution or solicitation activities, or which are or were investors in a covered investment pool on whose behalf the member has acted, and the political contributions made by the member or its covered associates.

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Interplay with the Advisers Act Rule

One purpose of the FINRA rule is to permit member firms to be treated as “regulated persons” under Advisers Act Rule 206(4)-5(a)(2). That provision prohibits an investment adviser from paying any third party to solicit a government entity for investment advisory services on its behalf unless the third party is a “regulated person.” Only certain registered investment advisers, broker-dealers and municipal advisors may be deemed regulated persons. With respect to a broker-dealer, in particular, Rule 206(4)-5 requires that a broker-dealer may be deemed a regulated person only if the rules of a national securities association of which it is a member, such as FINRA, prohibit its members from engaging in distribution or solicitation activities if certain contributions have been made, and the SEC, by order, finds that such rules impose substantially equivalent or greater restrictions on broker-dealers than are imposed on investment advisers under Rule 206(4)-5. The SEC’s order approving the FINRA rules noted several instances where comments requesting changes to the proposed rules were rejected because they were felt to impede the fulfillment of this goal.

Conclusion

As noted by the SEC in approving FINRA’s rule changes, in the absence of these rules, SEC-registered investment advisers could not compensate FINRA members for engaging in distribution or solicitation activities with government entities on their behalf, unless the member also happened to be subject to Advisers Act Rule 206(4)-5 or the pay-to-pay rules adopted by the Municipal Securities Rulemaking Board. Members are urged to consider adopting and implementing appropriate written policies and procedures to ensure that they are in a position to comply with the new rules when they become effective, and to address the training needs of their covered associates.

If you have any questions regarding this memorandum, please contact James R. Burns (202 303 1241; jburns@willkie.com), Richard F. Jackson (202 303 1121; rjackson@willkie.com) or the Willkie attorney with whom you regularly work.

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