ROPES & GRAY

ALERT

Asset Management

October 21, 2016

SEC Approves FINRA Rules Addressing "Pay-to-Play" Practices

The Securities and Exchange Commission (the "SEC") recently approved the Financial Industry Regulatory Authority, Inc. ("FINRA") proposal to adopt FINRA Rules 2030 and 4580, which set forth pay-to-play restrictions, and associated recordkeeping requirements, for broker-dealers engaged in distribution or solicitation activities for compensation with government entities[1] on behalf of investment advisers or their managed funds. The Rules effectively enable broker-dealers to continue to engage in solicitation and distribution activity with government entities by bringing broker-dealers into the class of persons that investment advisers are permitted under SEC rules to hire to perform those activities. The Rules are expected to become effective some time between March and August of 2017.

Background

In 2010, the SEC issued Rule 206(4)-5 (the "SEC Pay-to-Play Rule"), which prohibits certain investment advisers and their covered associates from providing or agreeing to provide payment to a third-party placement agent to solicit a government entity for investment advisory services unless the placement agent is a "regulated person." A "regulated person," as defined in the SEC Pay-to-Play Rule, includes a registered broker-dealer subject to a FINRA rule determined by the SEC to be substantially equivalent to the SEC Pay-to-Play Rule. In light of this regulatory framework, FINRA proposed FINRA Rule 2030.

Scope of Rule

FINRA Rule 2030 will apply to broker-dealers acting on behalf of any investment adviser registered or required to be registered under the Investment Advisers Act of 1940 (the "Advisers Act"), as well as "foreign private advisers" exempt from registration under Section 203(b)(3) of the Advisers Act and "exempt reporting advisers" under Advisers Act Rule 204-4(a). Accordingly, FINRA Rule 2030 will not apply to a broker-dealer acting on behalf of an investment adviser registered with state securities authorities, or an investment adviser relying on another exemption from SEC registration. Moreover, FINRA Rule 2030 will not apply to a broker-dealer engaged in activities that would require municipal advisor registration and compliance with the pay-to-play rule of the Municipal Securities Rulemaking Board. A FINRA member that solicits a government entity on behalf of an affiliated investment adviser is not a municipal advisor and therefore would be subject to FINRA Rule 2030. The new FINRA rule would also apply to a placement agent that solicits a government entity to invest in a pooled investment vehicle such as a private investment fund or a mutual fund included as an investment option in a governmental plan. A broker-dealer to which FINRA Rule 2030 will apply is referred to herein as a "Covered Member."

FINRA Rule 2030 will also apply to the broker-dealer's "covered associates," which term includes (i) any general partner/managing member or executive officer of the broker-dealer, as well as any person with a similar status or function, (ii) any associated person of the broker-dealer who engages in distribution or solicitation activities, or supervises the distribution or solicitation activities, in respect of a government entity, and (iii) any political action committee controlled by the broker-dealer or one of its covered associates.

[1] Government entities include 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 403(b), 457, and 529 plans.

Restricted Activities

FINRA Rule 2030 seeks to prevent abusive practices in the placement activities of Covered Members acting on behalf of investment advisers. Key provisions of the Rule are as follows:

- A Covered Member and its covered associates are prohibited from, for a period of two years beginning on the date of a Prohibited Contribution, receiving compensation for distribution to, or solicitation of, a governmental entity on behalf of an investment adviser. A "Prohibited Contribution" is a greater-than-de minimis contribution by a Covered Member or any of its covered associates to any person who is an incumbent, a candidate, or a successful candidate for elective office of a governmental entity if that office has direct or indirect responsibility for, or can influence the outcome of, the hiring of an investment adviser to manage the governmental entity's investments or that office has authority to appoint any person who has such responsibility or influence.
    - Covered associates are permitted to make certain de minimis contributions, on a per-official, per-election basis, without violating the Rule (up to $350 if the covered associate is entitled to vote for the official and $150 if the covered associate is not entitled to vote for the official).
    - The two-year ban is also triggered by contributions made by a covered associate prior to the covered associate's association with the Covered Member, except where the covered associate both (i) made the contribution more than six months prior to becoming associated with the Covered Member and (ii) is not engaging or seeking to engage in distribution or solicitation activities with the government entity on behalf of the Covered Member.
- A Covered Member and its covered associates are prohibited from soliciting any person or political action committee to make contributions, or bundling smaller contributions into one large contribution, to (i) an official of a government entity in respect of which the Covered Member already provides, or is seeking to provide, distribution or solicitation services on behalf of an investment adviser, or (ii) a political party of a state or locality where the Covered Member is engaging in, or seeks to engage in, distribution or solicitation activities on behalf of an investment adviser.
- Cases in which a Covered Member engages in distribution or solicitation activities on behalf of a "covered pool" will be treated under FINRA Rule 2030 as though the Covered Member were acting directly on behalf of the investment adviser to the covered pool. The Rule defines the term "covered pool" to include (i) any investment company registered under the Investment Company Act of 1940 (the "1940 Act") that is an investment option of a plan or program of a government entity and (ii) any company that would be an investment company under Section 3(a) of the 1940 Act but for the exclusion provided by either Section 3(c)(1), Section 3(c)(7), or Section 3(c)(11) of the 1940 Act such as a hedge fund, private equity fund, venture capital fund, or collective investment trust.
    - The Rule will not apply in respect of a registered investment company that is not an option of a participant-directed plan of a government entity, even if there are government entities that hold shares in the registered investment company. Consistent with the SEC Pay-to-Play Rule, to the extent that mutual fund distribution fees are paid by a fund using fund assets pursuant to a Rule 12b-1 plan, such payments generally would not constitute payments by the fund's investment adviser.
- The Rule prohibits a Covered Member and its covered associates from doing anything indirectly that, if done directly, would violate the Rule.

Exemption for Returned Contributions

Subject to certain limitations, if a covered associate makes a small, inadvertent contribution that would otherwise trigger a two-year "time out," the time out will not apply if the Covered Member discovers the contribution within four months of the date of the contribution and the contribution is returned to the covered associate within 60 days of the discovery. A Covered Member may rely on this exemption a limited number of times. In the case of a contribution that cannot be cured under this exemption, a Covered Member may appeal to FINRA for specific relief.

Recordkeeping

FINRA Rule 4580 will require Covered Members to maintain records designed to allow FINRA to examine for compliance with FINRA Rule 2030. The required records include certain basic information in respect of the covered associates of the Covered Member, the investment advisers on behalf of whom the Covered Member has engaged in distribution or solicitation activities, and the government entities that the Covered Member has solicited or distributed to, as well as a chronological list of direct and indirect contributions made by the Covered Member or any of its covered associates, indicating the name and title of each contributor and each recipient of the contribution, as well as the amount and the date of the contribution, and whether the contribution was subject to the exception for returned contributions.

Next Steps

FINRA is expected to announce the effective date of FINRA Rules 2030 and 4580 in a *Regulatory Notice* to be published no later than the end of October 2016. The effective date of the Rules is expected to be no sooner than six months following the publication of the *Regulatory Notice* and no later than one year following the SEC's approval of the rules. During the period, FINRA members should consider identifying their covered associates and governmental entity clients, and modifying their supervisory procedures to address the requirements of the new rules.

For more information, please contact your usual Ropes & Gray attorney.