FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS
AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

December 15, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 14-50: FINRA Requests Comment on a Proposal to Establish "Pay-to-Play" Rule

Dear Ms. Asquith:

On November 14, FINRA published Regulatory Notice 14-50, requesting comment on a proposed rule to establish "pay-to-play" and related rules (Proposed Rules). The Proposed Rules would regulate the activities of member firms that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers that provide or are seeking to provide, investment advisory services to such government entities. Basing the Proposed Rules on the regulatory framework of SEC Rule 206(4)-5, which addresses pay-to-play practices by investment advisers (SEC Rule), FINRA is proposing Rule 2390 (Engaging in Distribution and Solicitation Activities with Government Entities); Rule 2271 (Disclosure Requirement for Government Distribution and Solicitation Activities); and Rule 4580 (Books and Records Requirements for Government Distribution and Solicitation Activities).

The Financial Services Institute[1] (FSI) appreciates the opportunity to comment on this Regulatory Notice. The SEC Rule, applying to registered investment advisors (RIA) and their representatives, was the result of specific instances where contributions were funneled through solicitors and placement agents to secure client relationships and investments with public pensions.[2] However, as a matter of practical compliance considerations, given the way the rule is written, some FSI members have been forced to apply the rule comprehensively as though independent financial advisers conduct advisory activity in a centralized manner in concert or at the direction of their affiliated RIA. In applying similar restrictions and requirements on broker-dealers with respect to pay-to-play, FSI has a number of concerns with the Proposed Rules, including the language regarding "solicitation and distribution," the proposed point-of-sale disclosure requirements, the treatment of covered investment pools, and the requirements related to books and records. We expand on these concerns below.

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[1] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 100 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Advisor members.

[2] *SEC v. Henry Morris, et al.*, Litigation Release No. 20963 (Mar. 19, 2009).

Background on FSI and its Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their financial advisors. Due to their unique business model, IBDs and their affiliated financial advisers are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 independent financial advisers – or approximately 64 percent of all practicing financial advisors – operate in the IBD channel.[3] These financial advisers are self-employed independent contractors, rather than employees of the IBD firms. These financial advisers provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisers are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisers affiliated with IBDs is comprised of clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisers are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[4] Independent financial advisers get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisers have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisers. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisers play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments

FSI appreciates the opportunity to comment on Regulatory Notice 14-50. While both the SEC Rule and FINRA's Proposed Rules aim to achieve laudable goals, FSI has concerns with regard to the regulatory uncertainty that may follow due to vaguely defined terms within the proposed rule text. Differences between the Proposed Rules and SEC Rule exist, which may lead to unintended consequences with respect to their application upon independent broker-dealers and independent financial advisors. We expand upon these concerns below:

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[3] Cerulli Associates at http://www.cerulli.com/.

[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisers.

I. Lack of Clarity and Unintended Consequences of the SEC Rule

Nearly all FSI member firms maintain both a broker-dealer registration and an investment advisor registration, typically through a separate wholly-owned corporate entity registered with the SEC as an RIA. Independent financial advisors are not employees of either the broker-dealer or RIA, but rather independent contractors. This structure gives advisors the flexibility to build portfolios for clients without pressure from RIA management regarding individual product selection, and freedom to run their advisory practice in the way that best serves clients.

The RIA provides a regulatory and compliance framework for the advisory services, discloses the details of this framework to investors through its Form ADV, and conducts examinations and surveillance for compliance under the federal securities laws, SEC regulations, and the RIA supervisory procedures and Form ADV disclosures. But despite this robust compliance and supervisory system, no central management structure exerts control over the business decisions of individual representatives. Furthermore, federal courts have found no employer-employee relationship between independent financial advisors and broker-dealers in wage and labor disputes.[5]

In the IBD model, financial advisors who share an RIA affiliation very often have no contact whatsoever with each other. Each operates as an independent small business that employs its own staff, rents its own office space, and is the sole point of contact for its clients. Thus, contributions by one such representative do not trigger the threat of pay-to-play corruption in awarding business to another representative of the same RIA, where their only connection is that they are affiliated with the same RIA for regulatory and compliance purposes.

FSI financial advisors may provide advisory or brokerage services to government entities, typically participant-directed plans pursuant to Sections 403(b), 538, or 457 of the Internal Revenue Code. Despite a common affiliation with the same RIA, political contributions are not made in response to a solicitation or instruction from RIA management, nor in coordination with other representatives of the same RIA, who often live in different parts of the country. For example, an independent financial advisor living in San Diego, California may provide investment advisory services to the defined benefit plan for certain employees of the State of Texas. This financial advisor, as an independent contractor, maintains a regulatory and compliance relationship with his or her broker-dealer and RIA (as a registered representative of the broker-dealer and an investment adviser representative of the RIA), but on a day-to-day basis is operating an independent small business. Another independent financial advisor living in Austin, Texas—who has no relationship with the San Diego advisor other than their common affiliation with the same RIA—may contribute to a local politician. The Austin-based advisor makes this contribution without knowledge that the San Diego representative is providing advisory services to employees of the State of Texas. These advisors do not know one another, and are not working in concert or based upon instruction from their affiliated RIA.

FSI member firms have adopted written supervisory procedures to achieve compliance with Rule 206(4)-5 due to the uncertainty that currently exists as to the application of the Rule. This creates a burden upon such entities in a context where there is little to no risk of pay-to-play corruption. The rule has caused some IBD firms to adopt sweeping prohibitions with respect to political

contributions. In the IBD channel, financial advisers conduct advisory activity in a de-centralized manner, whether through a corporate entity registered as an adviser or an independently-registered adviser. However, as a matter of practical compliance considerations, given the way the rule is written, FSI's broker-dealers have been forced to apply the rule comprehensively as if financial advisors conduct advisory activity in a centralized manner. As a consequence, many IBDs have had to impose sweeping prohibitions on any political contributions. FSI is concerned that similar requirements imposed by FINRA may lead to additional uncertainty with respect to applying restrictions to independent financial advisors. As a result, we respectfully request that FINRA provide additional guidance with respect to the application of pay-to-play requirements upon independent financial advisors.

II. Lack of Clarity Regarding "Distribution or Solicitation Activities" of Covered Investment Pools Under FINRA's Proposed Rules

Proposed Rule 2390(h)(3) states that, "a covered member that engages in distribution or solicitation activities with a government entity on behalf of an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though that covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser directly."[6] The Proposed Rules define Covered Investment Pools to include "an investment company registered under the Investment Company Act that is an investment option of a plan or program of a government entity; or any company that would be an investment company under Section 3(a) of the Investment Company Act but for [provided exclusions in the Section.]"[7] Proposed FINRA Rule 2390(e) provides that "a covered member that engages in distribution or solicitation activities with a government entity on behalf of an investment adviser to a covered investment pool in which the government entity invests or is solicited to invest shall be treated as though the covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser directly." FINRA defines "government entity" such that it would also include participant-directed plans such as 403(b), 529, and 457 plans.[8]

FSI is concerned that the above quoted rule text may potentially include traditional brokerage activity, and place restrictions upon a financial advisor's ability to recommend specific products (e.g. mutual funds, variable annuities) in a client's participant-directed plans, such as 403(b), 458, and 529 plans. This would restrict political contributions more than intended by the SEC rule and FINRA's goals, and more than necessary than to address reasonable pay-to-play concerns. The SEC Rule makes clear that its provisions related to pooled investment vehicles affect "the investment of public funds in a hedge fund or other type of pooled investment vehicle;" and "the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan..."[9] This would potentially cover traditional brokerage activities FSI requests additional clarity with respect to the treatment of traditional brokerage activities by a financial advisor as "distribution or solicitation activities" in the context of government entity plans such as 403(b), 458, and 529 plans.

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[6] Proposed FINRA Rule 2390(h)(3).
[7] Proposed FINRA Rule 2390(h)(2).
[8] Proposed FINRA Rule 2390(h)(5).
[9] SEC Release No. IA-3043; File No. S7-18-09 (June 30, 2010) at 98.

III. Disclosure Requirements

FINRA's Proposed Rules also differ from the SEC Rule with respect to the disclosure requirements. Proposed FINRA Rule 2271 would require a covered member engaging in "distribution or solicitation activities for compensation with a government entity on behalf of one or more investment advisers" to make specified disclosure regarding "each investment adviser."[10] The disclosure must cover:

1) The fact that the covered member is engaging in distribution or solicitation activities on behalf of the investment adviser;
2) The name of the investment adviser on whose behalf the covered member is engaging in distribution or solicitation activities;
3) The nature of the relationship, including any affiliation, between the covered member and the investment adviser;
4) A statement that the covered member will be compensated by the investment adviser for its distribution or solicitation activities and the term of such compensation arrangement, including a description of the compensation paid or to be paid to the covered member;
5) Any incremental changes or fees that may be imposed on the government entity as a result of the distribution or solicitation activities engaged in by the covered member;
6) The existence and details of any pecuniary, employment, business or other relationships between the covered member or any covered associate and any person affiliated with the government entity that has influence in the decision-making process in choosing an investment adviser; and
7) The existence of the covered member's internal policies and procedures with respect to political contributions by covered associates and other associated persons.[11]

FSI believes that the requirements related to disclosure may introduce significant challenges, particularly when viewed in concert with the lack of clarity surrounding recommendations of products and services to clients with government entity plans. Much, if not all, of the required disclosures under Proposed FINRA Rule 2271 would be disclosed in the product prospectus to the client. This duplication does not provide a material net benefit to clients or advance the important goals related to preventing pay-to-play. The requirement would also go beyond the requirements of the SEC Rule. The information could also be potentially difficult to classify, particularly with respect to covered investment pools. For example, the requirement that members disclose "incremental changes or fees" may refer to fees charged for different share classes, which is information already provided in a product prospectus. This information would also be potentially difficult to provide with respect to individual sub-accounts within a variable annuity. Therefore, FSI requests that FINRA provide additional clarity to ensure that additional disclosures made to clients for the purposes of preventing pay-to-play at the point of sale do not unnecessarily duplicate information that is included in the product prospectus.

IV. Books and Records Requirements

FINRA's Proposed Rule 4580 "would require covered members that engage in distributions or solicitation activities with a government entity on behalf of any investment adviser that provides or is seeking to provide investment advisory services to such government entity to maintain books

[10] FINRA Rule 2271.
[11] *Id.*

and records that would allow FINRA to examine for compliance…"[12] The proposed rule would require covered members to maintain a list or other record of the following:

1) The names, titles, and business and residence addresses of all covered associates;
2) The name and business address of each investment adviser on behalf of which the covered member has engaged in distribution or solicitation activities with a government entity within the past five years (but not prior to the rule's effective date);
3) The name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities on behalf of an investment adviser within the past five years (but not prior to the rule's effective date); and
4) All direct and indirect contributions made by the covered member or any of its covered associates to an official of a government entity, or direct or indirect payments to a political party of a state or political subdivision thereof, or to a PAC of the investment adviser on whose behalf the covered member is engaging in distribution or solicitation activities.[13]

As with the provisions related to disclosure and covered investment pools, the potential impact of imposing these rules on traditional brokerage activity, and requiring every attempted distribution or solicitation activity to be maintained in books and records, would not advance the purpose of the rule. It would also be significantly burdensome and difficult for firms to implement if FINRA classifies preliminary discussions with non-clients regarding investment options in a government entity plan as solicitation. Applying the books and records requirement to traditional brokerage activities within these government entity plans would also not be useful to FINRA examiners or advance the goal of prohibiting pay-to-play.

V. Treatment of PAC Contributions

Under the Proposed Rules, no covered member or covered associate may "coordinate or solicit any person or political action committee (PAC) to make any:

1) 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
2) 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."[14]

FSI believes the above restrictions on PAC contributions, and the definition of "control" with respect to covered associates under Proposed FINRA Rule 2390(h)(2)(D),[15] are vague and potentially overbroad. It is unclear whether an employee or executive of a member firm that holds a position on a PAC board of directors or other advisory committee would have "control" of the PAC under the Proposed Rules. It would also cover PACs that are not connected to the employee or executive's member firm. FSI requests that FINRA provide additional clarity and address member concerns with respect to the definition of "control."

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[12] Proposed FINRA Rule 4580.
[13] *Id.*
[14] Proposed FINRA Rule 2390(c).
[15] "Covered associate" is defined to include "any political action committee controlled by a covered member or a covered associate."

Conclusion

We are committed to constructive engagement in the regulatory process. We look forward to the opportunity to work with FINRA on this and other important regulatory initiative.

Thank you for your consideration of our comments. Should you have any questions, please contact me at (202) 803-6061.

Respectfully submitted,

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Executive Vice President & General Counsel