December 22, 2014

Via Electronic Mail

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Request for Comment on Proposed "Pay to Play" Rule (Regulatory Notice 14-50)

Dear Ms. Asquith:

The Investment Adviser Association ("IAA")[1] appreciates the opportunity to comment on proposed rules of the Financial Industry Regulatory Authority ("FINRA") that would regulate covered members engaged in solicitation activities for compensation with government entities on behalf of investment advisers.[2] The IAA supports FINRA's decision to move forward with its pay to play rule, which is largely consistent with the SEC's pay to play rule. We recommend, however, that FINRA modify the proposed disclosure requirements in Rule 2271 to parallel the SEC regulatory framework for third-party solicitation activities on behalf of investment advisers. We also provide a technical comment to proposed Rule 4580, which would impose new recordkeeping requirements in connection with such activities.

Background

Rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Advisers Act") is intended to prevent advisers and their employees from making political contributions for the purpose of obtaining or retaining advisory contracts with government entities (the "SEC Rule"). The SEC Rule also generally prohibits an investment adviser and its covered associates from doing anything indirectly which, if done directly, would result in a violation of the SEC Rule. The SEC Rule specifically prohibits an adviser and its covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party for solicitation of advisory

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the Securities and Exchange Commission ("SEC"). Our membership consists of investment advisory firms that manage assets for a wide variety of institutional and individual clients, including public pension plans, trusts, investment funds, endowments, and foundations. A number of our member firms are either dually registered or have related firms that are registered as broker-dealers and are members of FINRA. For more information, please visit our website: www.investmentadviser.org.

[2] See FINRA Regulatory Notice 14-50 (November 2014) ("FINRA Notice").

business from any government entity on behalf of such adviser, unless the third party is a "regulated person." A regulated person, in relevant part, includes a registered broker or dealer subject to restrictions adopted by FINRA that are "substantially equivalent or more stringent" than the SEC Rule and consistent with its objectives. Although advisers have been required to comply with most provisions of the SEC Rule since March 14, 2011, the SEC delayed the compliance date of this "third-party solicitor" aspect of the SEC Rule at least in part so that FINRA could adopt a pay to play rule for broker-dealers.[3]

The Proposed Written Disclosure Requirement Should Not Apply to a Solicitor that is a Related Person of the Adviser

The Proposed Disclosure Requirement is Inconsistent with the SEC's Approach to Solicitations by Related Persons

Proposed Rule 2271 (the "Proposed Rule") would require a third-party solicitor to make specified disclosures in writing and provide them at the time of the initial distribution[4] or solicitation, and is modeled largely on Rule 206(4)-3 under the Advisers Act, the SEC's cash solicitation rule. Like proposed Rule 2271, Rule 206(4)-3 is intended primarily to address conflicts of interest inherent in certain solicitation arrangements by alerting a potential client who is approached by a solicitor that the solicitor is being compensated by the investment adviser. We note, however, that the Proposed Rule departs from the provision of the SEC's cash solicitation rule that excludes from its written disclosure requirement solicitors that are related persons or affiliates of the investment adviser ("related persons").[5]

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[3] On June 8, 2012, the SEC extended the compliance date for the third-party solicitor provisions of the SEC Rule from June 13, 2012 until nine months after the compliance date of the SEC rule requiring registration of municipal advisor firms. The final rule for municipal advisor registration included a phased-in compliance schedule. The FINRA Notice states that the compliance date for these provisions is April 1, 2015; but the June 2012 release stated that the SEC plans to formally issue the new compliance date in the *Federal Register*, which it has yet to do. Therefore, the final compliance date has not been formally set. See *Political Contributions by Certain Investment Advisers: Ban on Third-Party Solicitation; Extension of Compliance Date*, Rel. No. IA-3418 (June 13, 2012).

[4] The term "distribution" is used throughout the proposed rules but not defined. We note that under the SEC Rule, the term is used solely in the context of solicitation of investment advisory services. For consistency, we recommend that FINRA clarify that this and other terms in FINRA's proposed rules have the same meaning as used in the SEC Rule, unless otherwise defined.

[5] Under Rule 206(4)-3(a)(2)(ii), a solicitor that is (A) a partner, officer, director or employee of the investment adviser or (B) a partner, officer, director or employee of a person which controls, is controlled by, or is under common control with such investment adviser is required to disclose to the client at the time of solicitation the status of such solicitor as a partner, officer, director or employee of such investment adviser or other person, and any affiliation between the investment adviser and such other

In adopting Rule 206(4)-3, the SEC recognized that in circumstances where "inside" or "related" solicitors are involved, a prospective client would be aware that the solicitor is marketing on behalf of its own company's advisory services and could consider this fact in deciding whether to follow the solicitor's recommendation.[6] The SEC noted, however, that this may not necessarily be the case with respect to unaffiliated solicitors. As a result, the written disclosure requirements of the cash solicitation rule are applicable only to a third-party solicitor that is not related to the investment adviser.[7]

Many investment advisers compensate their related broker-dealers (who, in turn, may compensate their employees and/or associated persons) for soliciting or referring government entities to them for investment advisory services. Requiring related solicitors to provide written disclosure would be a substantial departure from the SEC's cash solicitation rule. As the SEC recognized, the disclosures are unnecessary because the potential government entity client would be sufficiently alerted to the fact that there may be potential conflicts by the affiliated status of the solicitor. Therefore, we recommend that FINRA defer to the SEC's prior policy determinations regarding solicitation activities of persons that are related to the adviser, and revise the Proposed Rule to incorporate the cash solicitation rule's exception for related solicitors.[8]

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person. The written disclosure requirements set forth Rule 206(4)-3(a)(2)(iii)(A) are not applicable to such related persons.

[6] See *Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Rel. No. IA-615 (Feb. 2, 1978).

[7] See Rule 206(4)-3(a)(2)(iii)(A). However, under the cash solicitation rule, related solicitors are required to disclose to potential clients (orally or in writing) the status of such affiliation at the time of the solicitation or referral. See Rule 206(4)-3(a)(2)(ii).

[8] Moreover, we note that when the SEC proposed its pay to play rule, the ban on third-party solicitations would not have applied to related persons of the investment adviser. The SEC stated that the intent of this exclusion was to "enable advisers to compensate parent companies and other owners, subsidiaries and sister companies – as well as employees of related companies – for government entity solicitation activities because… there may be efficiencies in allowing advisers to rely on these particular types of persons to assist them in seeking clients." The SEC also stated that it determined to "make this distinction because related person solicitors are subject to an adviser's (or its affiliates') control and thus should not present the compliance challenges that advisers cited with respect to third-party solicitors." In adopting the final Rule, the SEC modified its proposal to eliminate this exception in light of the fact there would be an exclusion from the third-party solicitor ban for "regulated persons" that are themselves subject to prohibitions against engaging in pay to play practices. See *Political Contributions by Certain Investment Advisers*, Release No. IA-2910 (Aug. 3, 2009).

Requiring Related Persons of Advisers to Make Written Disclosures Would Impose a Significant Compliance Burden

The IAA also urges FINRA to consider the potential costs and benefits that would result from imposing the written disclosure requirement on solicitors that are related to the investment adviser. We submit that the costs and burdens associated with the proposals would outweigh any perceived benefits. We are especially concerned that it would be difficult for employees of related solicitors to overcome the substantial obstacles to complying with this requirement on a "real-time" basis, as discussed below.

In practice, communications between employees of related solicitors and prospective clients may be made principally for reasons other than soliciting particular investment advisory business.[9] For example, in business structures where investment advisory services are offered by a company through related firms as part of its overall services, a dedicated sales force of employees and/or registered representatives may sell not only one product line, but numerous products or services ranging from banking services, insurance services, or investments that would not otherwise be covered by pay to play rules.

In addition, registered representatives acting on behalf of related investment advisers may engage in discussion with government entity officials where at any given moment the registered representative may be asked to discuss separate accounts of the adviser or investment opportunities in mutual funds excluded from pay to play rules (e.g., an investment in an investment pool that is not an investment option of a plan or program of the government entity).[10] For example, in the course of a registered representative's discussion with a government official about one product line or account, the official could also express an interest in additional advisory services of the related adviser. The representative may also make a referral by providing the government official with information (such as a brochure) regarding the company's related investment advisory services. It would be impractical to require that a written disclosure document be prepared in advance of these conversations, especially when the related solicitor must be prepared to respond to client feedback on investment strategies by seamlessly comparing various product or service offerings.

[9] By contrast, concerns over pay to play practices are heightened where a third-party solicitor is engaged exclusively for the purpose of soliciting certain government entities.

[10] Similar to FINRA's proposals, Rule 206(4)-5 applies to advisers that advise a "covered investment pool" in which a government entity invests. These include (i) the investment of public funds in unregistered investment companies, such as hedge funds, private equity funds and venture capital funds and (ii) pooled investment vehicles sponsored or advised by an adviser as a funding vehicle or option within a participant-directed plan or program of a government entity (e.g., 529, 403(b) and 457 plans).

Further complications could result for "dual employees" of the adviser and the related broker-dealer where a lack of alignment could impose additional compliance burdens. The SEC staff has stated that if an adviser's employee is also employed by a related broker-dealer 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 SEC Rule thus subjecting the adviser's employee to FINRA's pay to play rule.[11] Unless FINRA's rules are consistent with the SEC Rule, these dual employees would face the additional burden of complying with a FINRA written disclosure requirement.

Therefore, the IAA recommends that proposed Rule 2271 be modified to follow the SEC's cash solicitation rule by excluding related persons of the adviser from the written disclosure requirement.[12] The proposed text reflecting this revision is attached as an Appendix.

The Timing and Updating Requirements Relating to the Written Disclosures Would Be Unworkable and Would Impose Significant Compliance Burdens

In the alternative, if FINRA determines to proceed with the Proposed Rule without the exclusion for related persons, we request that the timing and updating requirements be revised. As currently drafted, the disclosures would be required in writing and "at the time of the initial distribution or solicitation." In addition, any material changes to the information provided in these disclosures would have to be updated within 10 calendar days of such change.

We are concerned with the feasibility of requiring written disclosures on a "real time" basis at the time of initial solicitation. For example, the disclosure regarding relationships between the covered member and any person affiliated with the government entity would likely require extensive research and due diligence.[13] A readily available document containing general disclosures would not satisfy the Proposed Rule as currently drafted. The written disclosure would have to be highly customized and tailored to the specific facts of

[11] Further, according to the SEC Staff, the dual employee would also be a covered associate of the adviser because of his or her solicitation activities, even if these activities were performed in the capacity as an employee of the broker-dealer. See SEC Staff Responses to Questions About the Pay to Play Rule, Question IV.2, available at: http://www.sec.gov/divisions/investment/pay-to-play-faq.htm.

[12] We note that this exclusion would be limited to a person soliciting on behalf of a *related* adviser and would not extend to solicitation activities on behalf of unaffiliated advisers.

[13] In light of the proprietary and confidential nature of the compensation paid by advisers to related persons, we also recommend that FINRA clarify that only a general description and terms of the fee arrangements would be required.

each particular solicitation and government entity. It would be unlikely that adequate disclosure could be prepared and provided in writing at the time of initial solicitations and be monitored and updated on a continuous basis. We note, also, that "initial" solicitations could include chance encounters at public events, thereby making it nearly impossible for the solicitor to comply with this requirement.

Thus, the IAA recommends permitting solicitors to provide the disclosure and any material updates, at any time prior to the execution of a written contract between the investment adviser and the government entity client.[14] We believe that this approach would balance the need to provide such information in a timely manner and the solicitor's obligation to provide information that is accurate and complete.

Technical Comments Concerning Proposed Rule 4580 (Recordkeeping)

Proposed Rule 4580 would require the maintenance of relevant books and records. The FINRA Notice states that the proposed rule is intended to be consistent with similar recordkeeping requirements imposed on investment advisers in connection with the SEC Rule and cites to Rule 204-2 under the Advisers Act. However, we note that the draft rule text accompanying the Notice inadvertently excludes this reference. We therefore recommend that the text of proposed Rule 4580(d) be revised by adding a reference to Rule 204-2.

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We appreciate the opportunity to provide comments on the proposed rules and would be pleased to provide any additional information. Please contact the undersigned or Kathy D. Ireland, Acting General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/ Sanjay Lamba

Sanjay Lamba
Assistant General Counsel

[14] The IAA also recommends that FINRA take into account that, during some transactions, third-party solicitors may communicate with consultants hired by government entities to search for investment opportunities, and clarify that delivery of disclosure documents to a consultant where the consultant has agreed, in writing, to provide the document to the government entity would satisfy the disclosure requirement.

APPENDIX

REVISED PROPOSED RULE TEXT

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2200. COMMUNICATIONS AND DISCLOSURES

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2271. Disclosure Requirement for Government Distribution and Solicitation Activities

(a) Other than a covered member specified in paragraph (b) of this Rule, ~~A~~a covered member engaging in distribution or solicitation activities for compensation with a government entity on behalf of one or more investment advisers shall, at the time of the initial distribution or solicitation on behalf of each investment adviser, disclose to such government entity in writing (which may be electronic) the following information with respect to each investment adviser:

(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 terms of such compensation arrangement, including a description of the compensation paid or to be paid to the covered member;

(5) Any incremental charges 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 decisionmaking 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.

(b) A covered member who is (A) a partner, officer, director or employee of such investment adviser or (B) a partner, officer, director or employee of a person which controls, is controlled by, or is under common control with such investment adviser shall disclose to the government entity at the time of distribution or solicitation the status of such covered member as a partner,

officer, director or employee of such investment adviser or other person, and any affiliation between the investment adviser and such other person.

(~~b~~c) A covered member shall, during any period in which it is engaging in distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser, update in writing (which may be electronic) any material changes to the information previously provided to the government entity pursuant to~~under this~~paragraph (a) of this Rule within 10 business days of the date of such change.

(~~c~~d) The terms used in this Rule 2271 shall have the same meaning as defined in Rule 2390.

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