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January 2, 2015

VIA ELECTRONIC MAIL

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 a "Pay to Play" Rule

Dear Ms. Asquith:

We are submitting this letter on behalf of our client, the Committee of Annuity Insurers (the "***Committee***"),[1] in response to FINRA Regulatory Notice 14-50, *FINRA Requests Comment on a Proposal to Establish a "Pay to Play" Rule* (the "***Notice***"). The Notice requests comments on FINRA's proposed "pay to play" rule, FINRA Rule 2390 ("***Rule 2390***"), related disclosure and recordkeeping rules, FINRA Rule 2271 ("***Rule 2271***") and FINRA Rule 4580 ("***Rule 4580***"). The Committee appreciates the opportunity to comment on Rule 2390, Rule 2271 and Rule 4580 (collectively, the "***Proposed Rules***").

Among other things, Rule 2390 triggers a two-year "cooling off" period after a covered member[2] or a covered associate[3] (including a person who becomes a covered associate within

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[1] The Committee was formed in 1982 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of securities, banking, and tax policies regarding annuities. For three decades, the Committee has played a prominent role in shaping government and regulatory policies with respect to annuities, working with and advocating before the Commission, CFTC, FINRA, IRS, Treasury, Department of Labor, as well as the NAIC and relevant Congressional committees. Today the Committee is a coalition of many of the largest and most prominent issuers of annuity contracts. The Committee's member companies represent more than 80% of the annuity business in the United States. A list of the Committee's member companies is set forth on the Committee website at www.annuity-insurers.org.

[2] "Covered member" includes any FINRA member except when such member is engaging in activities that would cause such member to be a municipal advisor as defined in Exchange Act Section 15B(e)(4), Securities Exchange Act Rule 15Ba1-1(d)(1) through (4) and other rules and regulations thereunder. *See* FINRA Rule 2390(h).

[3] "Covered associate" means (A) any general partner, managing member or executive officer of a covered member, or other individual with a similar status or function, (B) any associated person of a covered member who engages in distribution or solicitation activities with a government entity for such covered member, (C) any associated person

two years after the contribution is made) makes a contribution to a government entity, during which period a covered member is prohibited from receiving compensation for solicitation activities with a government entity on behalf of an investment adviser that provides or is seeking to provide investment advisory services to such government entity (the "***Time Out Period***"). In addition, Rule 2390 would require covered members to pay back any compensation or remuneration received in violation of the Time Out Period to certain entities, according to the order listed in an enumerated "waterfall."[4]

Rule 2390 also would prohibit a covered member and its covered associates from soliciting or coordinating any person or political action committee to make (i) contributions to government entities or (ii) payments to political parties, where the covered member is or is seeking to engage in solicitation activities on behalf of an investment adviser. Finally, Rule 2390 includes a "catch all" provision prohibiting covered members from doing anything indirectly that, if done directly, would result in a violation of Rule 2390.

Rule 2271 would require covered members engaging in solicitation activities for compensation with a government entity on behalf of one or more investment advisers to make certain disclosures[5] to such government entity at the time of the initial solicitation, and to update such disclosures within 10 calendar days of any changes to them.

Rule 4580 would require covered members engaging in 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 and records relating to Rule 2390 and Rule 2271, including certain specified records enumerated in the rule.[6]

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of a covered member who supervises, directly or indirectly, the government entity distribution or solicitation activities of a person in (B) above and (D) any political action committee controlled by a covered member or covered associate.

[4] Specifically, covered members are required to pay any compensation or other remuneration received by such covered member arising from the distribution or solicitation activities in violation of the Time Out Period in the following order: (A) a covered investment pool in which the government entity was solicited to invest, (B) the government entity, (C) any appropriate entity designated in writing by the government entity designated in writing by the government entity if the government entity or covered investment pool cannot receive such payments or (D) the FINRA Investor Education Foundation if the government entity or covered investment pool cannot receive such payments and the government entity cannot or does not designate in writing any other appropriate entity.

[5] These disclosures include: (A) the fact that the covered member is engaging in solicitation activities on behalf of the investment adviser; (B) the name of the investment adviser on whose behalf the covered member is engaging in solicitation activities; (C) the nature of the relationship, including any affiliation, between the covered member and the investment adviser; (D) a statement that the covered member will be compensated by the investment adviser for its solicitation activities and the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the covered member; (E) any incremental charges or fees that may be imposed on the government entity as a result of the solicitation engaged in by the covered member;(F) 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 (G) the existence of the covered member's internal policies with respect to political contributions by covered associates and other associated persons.

[6] The enumerated records include: (A) the names, titles and business and residence addresses of all covered associates; (B) the name and business address of each investment adviser on behalf of which the covered member

As explained in the Notice, the Proposed Rules respond to Rule 206(4)-5 (the "***Adviser Rule***"), adopted by the Securities and Exchange Commission (the "***Commission***") under the Investment Advisers Act of 1940, as amended (the "***Advisers Act***"), which among other things, prohibits an investment adviser and its covered associates from providing or agreeing to provide, directly or indirectly payment to a member firm to solicit a government entity on behalf of the investment adviser unless the member firm is subject to a FINRA pay-to-play rule.

While the Committee supports FINRA's attempt to deter "pay to play" activity among covered members, certain provisions of the Proposed Rules raise significant concerns for Committee members. In this regard, the Committee's views are informed by its members' experiences in complying with the Adviser Rule. The Committee urges FINRA to refine the rule provisions in order to alleviate the Committee's concerns.

The Committee is particularly concerned about FINRA applying the Proposed Rules to member firms selling variable annuities or other two-tiered investment products. The Committee believes that a covered member selling a variable annuity to a government entity cannot fairly be seen as engaging in solicitation activities on behalf of the investment advisers and sub-advisers that manage the covered investment pools available as investment options through the separate accounts and sub-accounts. The Committee thus urges FINRA to clarify that a covered member selling two-tiered investment products is not engaging in solicitation activities on behalf of the investment adviser and sub-advisers managing the underlying funds.

I. Rule 2390

A. Scope of Rule 2390

Paragraph (a) of proposed Rule 2390 sets forth the following prohibition:

> No covered member shall engage in distribution or solicitation activities for compensation with a government entity 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 office of the government entity is made by the covered member or a covered associate. . .

With respect to activity related to "covered investment pools," Paragraph (e) of proposed rule 2390 requires that:

> For purposes of this Rule, a covered member that engaged 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

has engaged in solicitation activities with a government entity within the past five years (but not prior to the rule's effective date); (C) the name and business address of all government entities with which the covered member has engaged in solicitation activities on behalf of an investment adviser within the past five years (but not prior to the rule's effective date); and (D) all direct or 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.

> 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.

And finally, paragraph (h)(3) of proposed rule 2390 defines "covered investment pool" ("***CIP***") as:

> (A) any investment company registered under the Investment Company Act that is an investment option of a plan or program of a government entity; or (B) any company that would be an investment company under Section 3(a) of the Investment Company Act but for the exclusion provided from that definition by either Section 3(c)(1), 3(c)(7) or 3(c)(11) of that Act.

The Committee is deeply concerned that these provisions capture regular distribution activity conducted by member firms, and not the type of conduct intended to be restricted by the Adviser Rule. The provisions ignore the very important distinction between ordinary distribution activities carried out by member firms on behalf of CIPs, which should not be within the scope of the proposed rule, and solicitation activities on behalf of investment advisers, which is the appropriate target of the proposed rule. First, these provisions are premised in part on the notion that an investment adviser's services are "distributed," a notion that is completely contrary to the nature, scope and provision of investment advisory services. Second, these provisions seek to re-characterize conventional distribution activities for registered and unregistered CIPs – variable annuities, mutual funds, and private investment funds – as "solicitation activities" for the investment advisers, ignoring the contractual relationships governing the activities performed by member firms. Finally, the Committee urges FINRA to clarify that a payment, as part of a customary compensation arrangement for the distribution of variable contracts, mutual funds and/or other investment pools should not create a presumption that a member firm is soliciting on behalf of the investment adviser.

1. References to Distribution of Advisory Services Should Be Deleted

As noted above, proposed Rule 2390 would prohibit a member firm from engaging in ". . distribution . . . activities for compensation with a government entity on behalf of an investment adviser. . ." It is inappropriate and inconsistent with the Advisers Act, its history, and the rules thereunder to suggest that advisory services are "distributed." A fundamental tenet reflected in the Advisers Act and the rules thereunder is "the personalized character of the services of investment advisers."[7] Moreover, a discretionary asset manager acts as a fiduciary on an ongoing basis, and owes duties of loyalty and care to its clients. The Commission adopted the Adviser Rule with a view to restricting pay to play activities in connection with the provision of advisory services and related solicitation activity on behalf of an adviser. The Commission's action in adopting the Adviser Rule was a much more logical and limited act of rulemaking than that proposed by FINRA in proposed Rule 2390(e). In this respect, a retail broker-dealer selling

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[7] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (citing H.R.Rep. No. 2639, 76th Cong., 3d Sess. 28. See also S.Rep. No. 1775, 76th Cong., 3d Sess. 22.).

a variable annuity, mutual fund or a private fund to its government entity customer is not treated under the Advisers Act as acting as a solicitor with respect to advisory services, is typically not serving as a fiduciary to its broker-dealer customer and does not have the same personalized relationship as an investment adviser. Instead, such sales activity is carried out while acting as an agent of the issuer or the issuer's principal underwriter or placement agent.

The frequent use of the term "distribution" in the Notice and proposed Rule 2390 distorts and confuses the activity that was intended to be captured by the Adviser Rule. The term "distribution" is a traditional broker-dealer term that has no meaning under the Advisers Act. Investment advisers are not permitted to underwrite, wholesale, offer, sell or otherwise "distribute" securities without registering as broker-dealers.[8]

Neither the Advisers Act, nor the rules thereunder or regulatory guidance relating thereto, characterizes the activity of persons who find prospective clients for investment advisers as "distribution" or a "distribution" activity. Indeed, the only term used in this context is "solicitation," the term used in Rule 206(4)-3 under the Advisers Act, which governs the receipt of cash payments by persons who refer prospective clients to investment advisers. This difference in terminology is substantive, and recognizes it is not possible to "distribute" investment advisory services, given "the personalized character of the services of investment advisers."[9] As recognized by Rule 206(4)-3 under the Advisers Act, a person can of course communicate with a potential investment advisory client and refer the potential advisory client to an investment adviser. Such activity would be subject to Rule 206(4)-3 under the Advisers Act to the extent the adviser pays cash compensation to such person for the referral.

Since the term "distribution" has no meaning in the context of an investment adviser and is inconsistent with the personal nature of the services provided by investment advisers, the Committee strongly recommends that FINRA eliminate each and every reference to the word "distribution" throughout the Notice and the Proposed Rules. The Committee also notes that its use in the Proposed Rules results in significant confusion. For instance, it is not clear what activity the term "distribution" is meant to cover that is not captured by the term "solicitation." If, notwithstanding the above, FINRA decides to keep the word "distribution" in the Proposed Rules, the Committee urges FINRA to provide clarification regarding what "distribution" means in the context of personalized investment advisory services.

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[8] Division of Trading and Markets, U.S. Securities and Exchange Commission, "Guide to Broker-Dealer Registration" (April 2008), *available at*: http://www.sec.gov/divisions/marketreg/bdguide.htm.

[9] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (citing H.R.Rep. No. 2639, 76th Cong., 3d Sess. 28 (hereinafter cited as House Report). See also S.Rep. No. 1775, 76th Cong., 3d Sess. 22.).

2. *Solicitation Activities Should Not Include Ordinary Distribution Activities for Covered Investment Pools*

a. Proposed Rule 2390(e) is Unworkable and Inconsistent with Precedent Under the Advisers Act

Paragraph (e) of proposed Rule 2390 would appear to re-characterize ordinary distribution activities for CIPs as the solicitation of clients on behalf of the investment adviser to the CIP. The Committee is concerned that this paragraph may capture regular and customary broker-dealer distribution activities conducted by member firms for CIPs that do not implicate "pay to play" issues. The offer and sale of CIPs pursuant to a selling agreement or a placement agent agreement is a customary broker-dealer activity carried out by member firms. However, given the text of paragraph (e), it is unclear whether a covered member would be considered to be engaged in solicitation activities on behalf of an investment adviser for purposes of the rule when the member offers and sells a CIP to a government entity.

The Committee believes that customary distribution activity by member firms for CIPs sold to government entities should not be treated as solicitation activity for an investment adviser for purposes of Rule 2390 simply because an investment adviser provides advisory services to the CIP. In those circumstances, the investment adviser to the CIP is not seeking to provide and will not provide investment advisory services to the government entity purchasing interests in the CIP.

It is well established that the client of an investment adviser providing advisory services to a CIP is the vehicle itself, not the investors in the CIP.[10] The Notice's description of how Rule 2390 would operate in the context of CIPs thus runs counter to the law. Moreover, this effectively subjects ordinary sales activity to the two-year time out in the rule should there happen to be a contribution made by a covered member or a covered associate during the sale of the pooled vehicle. Given the continuous nature of many CIP offerings, the proposed rule will have a profound impact on member firms and would impose extensive costs on member firms seeking to comply with such requirement.

The Committee recognizes that, for purposes of paragraph (c) of the Adviser Rule, an investment adviser to a covered investment pool in which a government entity invests is considered to provide investment advisory services directly to the government entity.[11] However, it does not follow from this Advisers Act rule provision that a covered member selling interests in a CIP to a government entity should be deemed to be soliciting on behalf of the investment adviser directly. First, Advisers Act Rule 206(4)-5(c) concerns the relationship between an *investment adviser* and a *government entity* investor in a covered investment pool managed by the adviser and in that respect disregards the fact that the investment adviser advises the covered investment pool and not the government entity. In contrast, Rule 2390 concerns the

[10] *See Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006) (hereinafter "***Goldstein***").
[11] *See* Rule 206(4)-5(c).

relationship between the *investment adviser* and a *covered member.*[12] The two rules thus concern different relationships; the language in Rule 206(4)-5(c) therefore does not lead to the policy underlying proposed Rule 2390(e)

Second, and more importantly, Rule 206(4)-5(c) did not seek to fundamentally re-characterize the activities engaged in by investment advisers. In contrast, proposed Rule 2390(e) would recast traditional broker-dealer activity (the offer and sale of CIP securities pursuant to a selling or placement agent agreement) into something it is not: the solicitation of investment advisory services on behalf of an investment adviser. This re-characterization is contrary to the distinction drawn by the Commission staff between solicitation activities for investment advisers and distribution activities for pooled investment vehicles.

More particularly, for purposes of Rule 206(4)-3 under the Advisers Act, which applies to solicitation activities on behalf of investment advisers, the Commission staff has stated that "[w]e believe that Rule 206(4)-3 generally does not apply to a registered investment adviser's cash payment to a person solely to compensate that person for soliciting investors or prospective investors for, or referring investors or prospective investors to, an investment pool managed by the adviser." The staff elaborated that:

> While the Rule literally could apply to such payments, we believe that the Commission did not intend for the Rule to apply to those payments, for a number of reasons. First, neither the Proposing Release nor the Adopting Release contains any statement directly or indirectly suggesting that the Rule would apply to investment advisers' cash payments to others solely to compensate them for soliciting investors for investment pools managed by the advisers. While not dispositive of the issue, we believe that the absence of any such statements by the Commission suggests that it did not intend that the Rule should apply to such payments. Second, the Rule is designed so as to clearly apply to solicitations and referrals in which the solicited or referred persons might ultimately enter into investment advisory contracts with the investment adviser, yet investors in investment pools (as such) do not typically enter into investment advisory contracts with the investment advisers of the pools. Third, the Rule's use of the terms "client" and "prospective client," rather than "investor" or "prospective investor," also strongly suggests that the Rule was intended to apply to solicitations and referrals in which the

[12] Proposed rule 2390(e) provides that a covered member that engages in solicitation activities with a government entity on behalf of an investment adviser to a covered investment pool in which a government entity invests shall be treated as though the covered member was engaging in solicitation activity on behalf of the investment adviser directly. While the Notice asserts that "the provision would extend the protection of the proposed rule to public pension plans that access the services of investment advisers through hedge funds and other types of pooled investment vehicles sponsored or advised by investment advisers . . . " the Committee submits that the current text does not in fact accomplish this. Without a provision corresponding to Rule 206(4)-5(c) there is nothing in the proposed rule that deems an investment adviser to a CIP to have a direct investment advisory relationship with investors in the vehicle. Without such a provision, proposed rule 2390(e) would <u>not</u> apply the two year time out restriction in proposed rule 2390(a) to advisers to CIPs. This is because proposed Rule 2390(a) would <u>only</u> apply where an investment adviser "provides or is seeking to provide investment advisory services to such government entity." Based on the *Goldstein* court decision, without a provision corresponding to Rule 206(4)-5(c), an investment adviser does <u>not</u> have an investment advisory relationship with any investor in a CIP (and an adviser to a CIP typically is <u>not</u> seeking to form an investment advisory relationship with the investors in the CIP).

> solicited or referred persons might ultimately enter into investment advisory contracts with the investment adviser.
>
> Furthermore, the *Goldstein* decision supports the conclusion that the Rule generally does not apply to advisers' cash payments to others solely to compensate them for soliciting investors to invest in investment pools managed by the advisers. In *Goldstein,* the court indicated that, for purposes of Section 206 of the Advisers Act, investors in a pooled investment vehicle are not "clients" of the investment adviser of the pool. Similarly, we believe that the references to "client" and "prospective client" in Rule 206(4)-3 under the Advisers Act should not be interpreted to include investors in investment pools or prospective investors in investment pools."
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> . . . .
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> For example, the Rule would not appear to apply to a registered adviser's cash payment to a person for referring other persons to the adviser where the adviser manages only investment pools and is not seeking to enter into investment advisory relationships with other persons, and the adviser's cash payment, under the adviser's arrangement with the referring person, compensates the referring person solely for referring the other persons to the adviser as investors or as prospective investors in one or more of the investment pools managed by the adviser.[13]

Proposed Rule 2390(e) thus would put selling firms in a contradictory position under FINRA rules and Advisers Act rules. Sales of CIPs do not subject them to the provisions of the cash solicitation rule provisions of Rule 206(4)-3 under the Advisers Act because of the Commission staff's recognition that selling interests in a mutual fund or private fund does not entail soliciting on behalf of the investment adviser to the fund (since there is no investment advisory relationship formed or sought to be formed between investors in the fund and the adviser to the fund). In contrast, if proposed Rule 2390(e) were adopted as proposed, then a broker-dealer would be treated as though it were directly soliciting on behalf of an investment adviser to a CIP. In short, Proposed Rule 2390(e) seeks to create a relationship that the Commission staff has concluded does not exist.

We believe that the Second Circuit's decision in the *Goldstein* case and the Commission staff's interpretive position under Rule 206(4)-3 under the Advisers Act makes proposed Rule 2390(e) impractical. It would create significant confusion in the industry and undermine settled practices and understandings, while creating doubt as to the application of the *Goldstein* case and the Commission staff's guidance in the Mayer Brown no-action letter. In fact, proposed Rule 2390(e) would, to a large extent, *effectively* overturn the Second Circuit's decision in the *Goldstein* case and the Commission staff's interpretive guidance under Rule 206(4)-3; in order to comply with the rule's mandate, broker-dealers would be forced to recognize a relationship that is at odds with the holdings of the court decision and the no-action letter.

[13] *Mayer Brown LLP* (pub. avail. July 28, 2008) ("***Mayer Brown***").

In addition, proposed Rule 2390(e) would take activity that FINRA, the Commission, the financial industry and the investing public have long-considered to be pure sales activity and recast it as something more, something very different. Investment advisers do not generally view broker-dealers selling interests in variable annuities, mutual funds and private funds as soliciting an investment advisory relationship with investors who invest in these products (with whom they do not have an investment advisory relationship). Likewise, broker-dealers do not view the offer and sale of variable annuities, mutual funds or private funds as soliciting an investment advisory relationship on behalf of an investment adviser with the investors when there will not be an investment advisory relationship between the investors buying the products and the investment advisers to the funds. Moreover, investors do not think that broker-dealers selling interests in the funds are soliciting an investment advisory relationship with the advisers to the funds they purchase. In short, proposed Rule 2390(e) seeks to create a paradigm that does not comport with the existing regulatory framework or the long-held views of regulators, broker-dealers, investment advisers or investors. The result will be considerable confusion within the industry and on the part of investors, including government entity investors. Accordingly, as discussed below, we believe that should FINRA adopt proposed Rule 2390(e) substantially as proposed, in order to avoid misleading investors, Rule 2271 must require covered members to disclose that there is no investment advisory relationship between the investment adviser to a covered investment pool and the investors in the covered investment pool.

b. Proposed Rule 2390(e) Blurs the Regulation of Broker-Dealers and Investment Advisers

The Committee is concerned that proposed Rule 2390(e) confuses broker-dealer activity and investment adviser activity. The Committee believes that the distribution of mutual fund shares provides a good example of the confusion created by proposed Rule 2390(e). The distribution of mutual fund shares is directly regulated by the Investment Company Act of 1940 ("***Company Act***"). The Company Act contemplates that the distribution of mutual fund shares will be handled by a "principal underwriter" that enters into an agreement with the mutual fund. The Company Act also contemplates that the principal underwriter in turn may enter into selling agreements with other member firms for the distribution of fund shares. Significantly, the principal underwriter's agreement is with the fund, and not with the investment adviser to the fund. Indeed, the authority to offer and sell the fund's shares originates with the mutual fund, not with the investment adviser to the fund. Ordinarily, neither the principal underwriter nor the selling firm is in privity of contract with the investment adviser with respect to the distribution of fund shares. In other words, there typically is no contractual arrangement between the principal underwriter and selling firms, on the one hand, and the fund's investment adviser, on the other hand, covering the distribution of the fund shares. Given the absence of any such relationship, it is not clear how ordinary agreements for the distribution of fund shares can create the paradigm envisioned by proposed Rule 2390(e), that of the principal underwriter and selling firm "soliciting" on behalf of the fund's investment adviser simply because a government entity purchases mutual fund shares.

Stated alternatively, how can it be that a selling firm engaged in offering and selling a mutual fund pursuant to a selling agreement is deemed to be engaged in solicitation activity on behalf of an investment adviser with which it has no relationship? The foregoing question is particularly striking when one considers that the broker-dealer and investment adviser are different types of registrants engaged in different types of activity (distribution activity and discretionary asset management, respectively)

The Committee also takes issue with FINRA's assertion in the Notice that proposed Rule 2390(e) would extend the protection of the proposed rule to public pension plans that access the services of investment advisers through hedge funds and other types of CIPs sponsored or advised by investment advisers. In particular, as currently written, proposed Rule 2390(e) is premised on the notion that "a covered member . . . engages in . . . 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 . . . ." The Committee believes that a broker-dealer that offers and sells interests in a mutual fund or private fund cannot be characterized as soliciting on behalf of the investment adviser to a covered investment pool. There is no basis for this notion given the Commission staff's interpretation in the Mayer Brown no-action letter and the *Goldstein* case discussed above, as well as the lack of any relationship between the selling firm and the investment adviser. It is contrary to reality to characterize the offer and sale of a security in a fund as also involving a solicitation on behalf of an investment adviser. It is a legal fiction that is contrary to the existing legal framework. It is at odds with the fact that in selling a mutual fund a selling firm typically has no relationship with the investment adviser managing the fund.

3. *Clarification is Needed Regarding the Meaning of "Compensation" under Proposed Rule 2390(a) in the Context of Sales of Covered Investment Pools*

The Committee believes that FINRA should clarify that "compensation" in the context of CIPs does not include conventional compensation arrangements for the distribution of mutual funds, variable annuity contracts and other securities included within the definition of "covered investment pools." In this regard, the Committee notes that concerns with such arrangements were raised with the Commission in connection with the adoption of the Adviser Rule. In responding to these comments the Commission observed as follows in a footnote to the Adviser Rule adopting release:

> Mutual fund distribution fees are typically paid by the fund pursuant to a 12b-1 plan, and therefore generally would not constitute payment by the fund's adviser. As a result, such payments would not be prohibited by rule 206(4)-5 by its terms.[14]

Thus, the Commission concluded that conventional broker-dealer compensation arrangements that involve payment from fund assets do not constitute payment by the fund's investment adviser under the rule. The Committee requests that FINRA confirm that it, like the Commission, does not view payment of selling commissions for variable annuities or mutual

[14] Political Contributions by Certain Investment Advisers, SEC Release No. IA-3043, at note 298 (July 1, 2010), *available at*: http://www.sec.gov/rules/final/2010/ia-3043.pdf ("***Footnote 298***").

fund "loads" (whether "front end," "back-end," "spread," or some combination thereof) or any other compensation paid for the sale of securities in a covered investment pool as involving the payment of "compensation" for purposes of the Proposed Rules.

The Committee acknowledges that the Commission also noted in Footnote 298 that:

> Where an adviser pays for the fund's distribution out of its "legitimate profits," however, the [Adviser Rule] would generally be implicated. . . . For private funds, third parties are often compensated by the adviser or its affiliated general partner and, therefore, those payments are subject to the rule.[15]

Footnote 298 suggests that a payment originating with an investment adviser should be treated as a payment for solicitation, regardless of the purpose or context for the payment. Notwithstanding the Commission's statement regarding payments made by investment advisers in the context of activity covered by the Adviser Rule, the Committee urges FINRA to consider this issue afresh.

Committee members have found the Commission's statement to be problematic and challenging. The Committee fails to see why compensation paid to member firms for the distribution of CIPs should be treated differently under the Adviser Rule and proposed Rule 2390, depending on whether the compensation is paid by the fund, from fund assets or by the fund's principal underwriter, adviser or another affiliate thereof, particularly in light of Commission and Commission staff statements through the years concerning compensation arrangements for mutual funds and variable annuity contracts. For example, in connection with so-called "fund supermarket" arrangements, the Commission staff noted that supermarket fees may be paid by a fund under a 12b-1 plan, under a plan or arrangement outside Rule 12b-1 or by a fund's investment adviser or affiliate.[16] What should matter is what the payment is made for and not the identity of the person making the payment. Substance should triumph over form.

The Committee is of the view that the Commission has not afforded an adequate public policy rationale for treating compensation for sales differently under Rule 206(4)-5 and proposed Rule 2390 depending on the source of the payment. In no sense is a retail broker-dealer selling a variable annuity or mutual fund soliciting on behalf of the adviser to the underlying fund or mutual fund merely because the selling firm may receive compensation from the adviser for services associated with the distribution of the annuity or fund shares and maintenance and administrative of investor accounts. In both cases, a payment is made in consideration of the broker-dealer's sale of a security. The fact that the Commission believes that distribution payments made by a principal underwriter out of its profits to a selling firm for sales of a variable annuity or mutual fund can trigger Rule 206(4)-5 demonstrates that the Commission is reading the rule as extending too far. The Committee asks that FINRA not extend the logic of Footnote 298 to proposed Rule 2390(a) and not treat compensation for sales of variable annuities

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[15] *Id.*
[16] *See Investment Company Institute* (pub. avail. October 30, 1998).

or mutual funds differently depending on the mechanism by which it is paid. FINRA should not exacerbate the difficulties created by the Commission's position.

In the context of the sale of private funds that are "covered investment pools" under proposed Rule 2390, the Committee submits that the last sentence of the quoted text above would effectively render the sale of the vast majority of private funds subject to the rule (if a contribution were made by a covered member or a covered associate). That is because in the Committee's experience, it is rare for commissions for sales activity to be paid to a placement agent from the private fund itself (as opposed to, for example, the general partner of the fund paying the placement agent out of its legitimate profits). The language above from Footnote 298 thus subjects virtually all sales of private funds through broker-dealers as being subject to that rule (if a contribution were made by a covered member or a covered associate). We ask that FINRA not extend the logic of this sentence to Rule 2390. Just as is the case with variable annuities and mutual funds, the Committee fails to see why compensation paid for the sale of private funds should be treated differently under Rule 206(4)-5 and proposed Rule 2390 depending on whether it is paid through the fund or by the fund's general partner or investment adviser. What should matter is what the payment is made for and not the manner in which it is paid.

We again note the Commission staff's prior interpretation that payment for selling interests in a CIP is broker-dealer sales activity. In a footnote appearing in the Mayer Brown no-action letter the Commission staff wrote as follows:

> You have not asked, and this letter does not address, whether a person's receipt of cash compensation from an investment adviser of an investment pool for soliciting or referring investors or prospective investors to invest in the pool would result in the person being considered a "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934.

If FINRA were to extend the language in Footnote 298 to Rule 2390, broker-dealers would be forced to deem the receipt of compensation for selling a security as compensation for solicitation on behalf of an adviser to a CIP in a context where the cash solicitation rule under the Advisers Act does not apply because the Commission staff has correctly concluded that there is no solicitation activity conducted on behalf of the adviser. The Committee submits that this does not make sense and will add to the confusion created by the Proposed Rules.

The Committee notes that the Commission considered the issue of "solicitation" more recently in connection with rulemaking under provisions added to the Securities Exchange Act of 1934 for the regulation of municipal advisors. We urge FINRA to instead follow the lead of the Commission in interpreting the meaning of "solicitation" in that context as follows:

> In relevant part, Exchange Act Section 15B(e)(4)(A)(ii) provides that a municipal advisor includes a person that, on behalf of certain types of third-parties, undertakes a solicitation of a municipal entity to engage such parties to perform certain specified activities. In the case of placement agents, the Commission agrees with commenters that a placement

agent for a pooled investment vehicle that is not a municipal entity (e.g., a hedge fund or mutual fund) and that "solicits" a municipal entity to invest in the fund does not, with respect to such activity, meet the statutory definition of the term "solicitation of a municipal entity or obligated person" in Exchange Act Section 15B(e)(9). Such a placement agent does not meet the statutory definition of the term because it is not soliciting on behalf of a third-party broker, dealer, municipal securities dealer, municipal advisor, or investment adviser to obtain or retain an engagement by a municipal entity or obligated person of such third party broker, dealer, municipal securities dealer, municipal advisor, or investment adviser.

B. The Rule's Applicability to Variable Annuities

The Committee notes that neither the Proposed Rules nor the Notice explicitly address the application of the Proposed Rules to two-tier products, such as variable annuities. The Committee seeks confirmation that Rule 2390 would not apply in the context of two-tiered investment products, such as variable insurance products, where the advisory services are far removed from any governmental investor investing in such investment product. The Committee is particularly concerned about this issue, as many of the variable annuities issued by its members are two-tiered investment products, with the variable annuity contract supported by a separate account that provides for investment among an array of specified mutual funds (in the case of registered separate accounts and some unregistered separate accounts relying on Section 3(c)(7) or 3(c)(11) of the Company Act) or unregistered investment pools (often in the case of unregistered separate accounts relying on Section 3(c)(7) or 3(c)(11) of the Company Act). Ordinarily, there is no investment adviser providing investment advisory services to the separate account supporting the variable annuity contract, although there are investment advisers providing investment advisory services to the underlying mutual funds or unregistered investment pools. Neither the Notice nor the Proposed Rules address whether, if at all, a member firm selling a variable annuity to a government entity could be deemed to be soliciting on behalf of an investment adviser to an underlying mutual fund or unregistered investment pool.

The Committee contends that a covered member selling a variable annuity to a government entity, for instance, cannot fairly be seen as engaging in solicitation activities on behalf of all of the investment advisers and sub-advisers that manage the covered investment pools available as investment options through the separate accounts and sub-accounts. The tenuous link between such investment advisers and the government entity in this case mandates this conclusion. The Committee urges FINRA to clarify that a covered member selling two-tiered investment products is not engaging in solicitation activities on behalf of the investment adviser and sub-advisers managing the underlying funds.

Alternatively, if FINRA determines that sales of two-tiered products constitute solicitation activities on behalf of the investment adviser and sub-advisers managing the underlying funds we request FINRA consider and provide guidance on the following questions: Is the selling broker-dealer deemed to be soliciting on behalf of the advisers of each of the underlying funds? Or only of advisers of funds underlying options that are selected by contract holders? What about when an underlying fund is managed by an adviser that uses multiple sub-advisers? Is the selling firm deemed to be soliciting on behalf of all of the sub-advisers? What about when a contract holder on his/her own allocates funds in the variable annuity to an option at a point subsequent (say 5 years) to the purchase of the variable annuity without any involvement of the selling firm? Such transactions typically are done directly with the insurance company – is the selling firm deemed to be soliciting on behalf of the adviser/sub-adviser of the funds underlying the sub-accounts that are selected (including any sub-advisers hired by the advisers of the underlying funds) at that point in time? The Committee submits that the dynamics and structure of variable annuities, and the number of advisers and sub-advisers to the funds underlying sub-accounts makes compliance with proposed Rule 2390 extremely challenging and indeed demonstrates why the rule should not be applied to variable annuities.

II. The Rule's Reach Beyond Covered Members

The Committee is concerned about the scope of FINRA Rule 2390(f), which would make it unlawful for any covered member or any of such covered member's covered associates "to do anything indirectly that, if done directly, would result in a violation of this Rule." While consistent with a similar provision in the Adviser Rule,[17] FINRA has not provided guidance as to what types of indirect activities would be captured by the rule.

Due to the uncertain scope and reach of Proposed Rule 2390(f), but giving consideration to the prophylactic nature of this proposed rule, the Committee believes FINRA should incorporate a knowledge and support requirement into this rule so that it would be violated only if a covered member has direct knowledge of, and takes measures to aid and support, activities undertaken by its affiliates. This approach is in the public interest and consistent with the regulatory objective of the Proposed Rules to "enable member firms to continue to engage in [solicitation activities with government entities on behalf of investment advisers] while at the same time deterring member firms from engaging in pay-to-play practices."[18] Without amending the proposed rule as the Committee suggests, there would be little that a covered member could do to refute a characterization by FINRA staff that an activity of a related person should be imputed to the covered member as an "indirect" activity of the covered member. Refuting such a characterization would require a covered member to "prove a negative" (*i.e.*, that the related person of a covered member was not acting at the instruction or direction of the covered member).

The Committee is particularly concerned about the implications of the rule when officers, directors or employees of member firms also serve as officers, directors or employees of affiliated companies. This practice is common in large financial organizations. The Committee is concerned that FINRA may attribute to covered members "contributions" made by an affiliate of a covered member or efforts by such affiliate to coordinate or solicit any person or political action committee to make any "contribution" or "payment" simply because the two companies share one or more officers, directors or employees. The Committee requests that FINRA confirm that so long as any such officers, directors or employees do not play a role in determining, shaping or directing any "contributions" or efforts to coordinate or to solicit any person or

[17] *See* Rule 206(4)-5(d); *see also* Political Contributions by Certain Investment Advisers, SEC Release No. IA-3043 (July 1, 2010).
[18] *See* the Notice.

political action committee to make any "contribution" or "payment" on the part of the affiliate, such activity would not be imputed to the covered member.

Such an approach could be grounded in guidance provided by the Municipal Securities Rulemaking Board ("***MSRB***") under Rule G-37 on political contributions and prohibitions on municipal securities business.[19] The role (or lack thereof) of the officers, directors or employees could be established by creating and maintaining records, such as board or meeting minutes, setting forth which individuals were present and played a role in determining, shaping or directing any "contributions" or efforts to coordinate or to solicit any person or political action committee to make any "contribution" or "payment" on the part of the affiliate. Under this framework, covered members could take steps to make sure that their officers, directors or employees do not determine, shape or direct any "contributions" or efforts to coordinate or to solicit any person or political action committee to make any "contribution" or "payment" on the part of an affiliate.

Should FINRA decide not to incorporate a knowledge and support provision into Rule 2390, the Committee strongly encourages FINRA to provide more guidance as to when activities of affiliates of covered members would be attributable to the covered member, taking into account the concerns that covered members in large financial organizations have with respect to the scope and reach of this provision.

III. Contributions to Political Action Committees and other Third Parties

The Committee also seeks confirmation that Rule 2390 does not apply when a contribution is made to a political action committee, political party or other third party, where there is no knowledge or indication of how such contribution will be used. This confirmation is essential, given that covered members are prohibited from doing anything indirectly that, if done directly, would violate Rule 2390. The Committee notes that similar guidance has been provided in the context of the Adviser Rule[20] and MSRB Rule G-37.[21]

[19] *See* Rule G-37 Question and Answer No. III.7 (Sept. 22, 2005) (discussing how to ensure compliance with Rule G-37(d) in connection with contributions by dealers or MFPs to non-controlled, but affiliated, PACs by, among other things, adopting information barriers between any affiliated PACs and the dealer or its MFPs), *available at*: http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx.

[20] *See* Political Contributions by Certain Investment Advisers, SEC Release No. IA-3043, at note 337 (July 1, 2010) ("We note that a direct contribution to a political party by an adviser or its covered associates would not violate the rule, unless the contribution was a means for the adviser to do indirectly what the rule would prohibit if done directly (for example, if the contribution was earmarked or known to be provided for the benefit of a particular government official).").

[21] *See* Rule G-37 Question and Answer Nos. III.3 (May 24, 1994), III.4 (August 6, 1996), III.5 (August 6, 1996), *available at*: http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G37-Frequently-Asked-Questions.aspx. The relevant aspects of this guidance are as follows:

> III.3
> Q: Are contributions to national, state or local political parties covered by the rule?
> A: Any such contributions would not trigger the prohibition on business portion of the rule (section (b)) unless such entities are used as a conduit to indirectly contribute to an issuer official, which is prohibited by section (d) of the rule. . . .

IV. Disgorgement Provisions

The Committee contends that requiring covered members to disgorge any compensation received in violation of the Time Out Period—in addition to any other sanction that may be imposed in connection with a violation of the Time Out Period—is unnecessary and misguided. We note that there is no analog in the Adviser Rule nor MSRB Rule G-37 for the disgorgement provision in proposed Rule 2390.

Rule 2390 requires the disgorged compensation to be paid to entities that are not deserving of such compensation. The payment of such disgorged compensation results in a windfall to persons and entities that have no relationship to the activity of the covered member. For example, the disgorgement provisions would require a covered member to pay back any compensation it receives to a "covered investment pool in which the government entity was solicited to invest." The other investors in a covered investment pool typically will have no relationship to the government entity that invested in the CIP.

The Committee notes that the disgorgement provisions of Rule 2390 contemplate the payment of disgorged compensation to "government entities," which include officers, agents or employees of a state. However, such government entities may be prohibited from receiving such compensation under applicable law.[22] Under certain circumstances, such as when a government entity does not invest in a CIP and is not allowed to receive the disgorged income provided in

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III.4

Q: Could contributions to a non-dealer associated PAC or payments to a state or local political party lead to a ban on municipal securities business with an issuer under Rule G-37?
A: . . . A dealer would violate Rule G-37 by doing business with an issuer after providing money to any person or entity when the dealer knows that such money will be given to an official of an issuer who could not receive such a contribution directly from the dealer without triggering the rule's prohibition on business. For example, in certain instances, a non-dealer associated PAC or a local political party may be soliciting funds for the purpose of supporting a limited number of issuer officials. Depending upon the facts and circumstances, contributions to the PAC or payments to the political party might well result in the same prohibition on municipal securities business as would a contribution made directly to the issuer official.

III.5
Q: If a dealer receives a fund raising solicitation from a non-dealer associated PAC or a political party with no indication of how the collected funds will be used, can the dealer make contributions to the non-dealer associated PAC or payments to the political party without causing a ban on municipal securities business?
A: Dealers should inquire of the non-dealer associated PAC or political party how any funds received from the dealer would be used. For example, if the non-dealer associated PAC or political party is soliciting funds for the purpose of supporting a limited number of issuer officials, then, depending upon the facts and circumstances, contributions to the PAC or payments to the political party might well result in the same prohibition on municipal securities business as would a contribution made directly to the issuer official.

See also Rule G-37 Question and Answer No. III.7 (Sept. 22, 2005).

[22] *See, e.g.*, N.J. Stat. Ann. 52:13D-24(a) (prohibiting, among other things, certain New Jersey state officers and employees from receiving anything of value from any source outside of the state of New Jersey, except for certain services or other matters related to such officer's or employee's official duties).

Rule 2390, the disgorged compensation would automatically go[23] to the FINRA Investor Education Foundation.

Lastly, the Committee believes that the disgorgement provisions, which require a covered member to disgorge compensation received in violation of Rule 2390 in addition to (and not a substitute for) sanctions imposed in violation of such rule, are overly punitive. Given the wide scope of the rule and the strong possibility of unintended violations in large financial complexes, the Committee urges FINRA to remove the disgorgement provisions from the rule.

V. Rule 2271 Disclosure Requirement

Another principal concern of the Committee is that proposed Rule 2271 would require covered members to disclose substantially the same information they may already be disclosing to government entities. We are also concerned that in certain respects the rule would impose disclosure obligations on covered members that are impossible to satisfy.

A. Disclosure under Proposed Rule 2271 is Duplicative of Rule 206(4)-3

While proposed Rule 2271 would require covered members receiving *any* compensation for solicitation activities with a government entity on behalf of investment advisers to comply with the disclosure obligations under the rule, covered members receiving *cash* compensation for solicitation activities with the government entity on behalf of an investment adviser already are providing substantially similar disclosures to government entities.[24] As a result, proposed Rule 2271 would require covered members to provide disclosures that are largely duplicative of disclosures they must provide under Rule 206(4)-3 under the Advisers Act.

[23] As a technical matter, the mechanics of the waterfall in proposed Rule 2390 do not require strict adherence to the order provided in the waterfall. The third "level" of the waterfall provides, "any appropriate entity designated in writing by the government entity if the government entity **or** covered investment pool cannot receive such payments" (emphasis added). The fourth level of the waterfall provides "the FINRA Investor Education Foundation if the government entity **or** covered investment pool cannot receive such payments and the government entity cannot or does not designate in writing any other appropriate entity" (emphasis added). The use of the word "or" allows payment of disgorged compensation to the third level of the waterfall if a covered investment pool cannot receive payment of disgorged compensation, and allows payment of disgorged compensation to the fourth level of the waterfall if a covered investment pool cannot receive such payment and the government entity does not designate in writing any appropriate entity (*i.e.*, in both cases, the waterfall skips the second level). The hierarchy of the waterfall is preserved, however, by changing the "or" to "and" in both cases. This change would (1) permit payment to the third level of the waterfall if the government entity (the second level of the waterfall) **and** the covered investment pool (the first level of the waterfall) cannot receive such payment and (2) permit payment to the fourth level of the waterfall if the government entity **and** covered investment pool cannot receive such payments and the government entity cannot or does not designate in writing any other appropriate entity.

[24] Pursuant to Rule 206(4)-3 under the Advisers Act, an investment adviser is allowed to pay cash compensation to certain solicitors for solicitation activities on behalf of the investment adviser as long as such solicitors disclose certain information to clients at the time of solicitation activities for which compensation is paid. "Solicitor" means any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser.

B. Proposed Rule 2271 Requires the Disclosure of Unknown Information in the Context of Variable Annuities

Notwithstanding the comments above, if FINRA were to conclude that the specific disclosures[25] in the Notice apply in the context of sales of variable annuities, it would result in disclosure obligations with respect to which covered members could not comply. Often times, at the time of the initial sales effort, covered members do not have knowledge of (i) the underlying funds, (ii) the name of the investment advisers on whose behalf the covered member is engaging in solicitation activities, (iii) the nature of the relationship between the covered member and the investment adviser or (iv) any incremental charges or fees that may be imposed on the government entity as a result of the solicitation engaged in by the covered member. In this respect, Committee members have noted that the initial sales effort may not progress to include a discussion of the sub-accounts supporting the contract and the underlying funds available as investment options. The Committee thus requests that Rule 2271 be amended to require only disclosure of information if it is available at the time a covered member engages in initial solicitation activities for compensation on behalf of an investment adviser.

C. Proposed Rule 2271is Inconsistent with Existing Precedent and Will Create Investor Confusion

As discussed above, under the *Goldstein* case and the Mayer Brown no-action letter, broker-dealers selling a variable annuity, mutual fund or private fund are not soliciting on behalf of the investment advisers to the underlying fund, mutual fund or private fund respectively. Accordingly, the Committee submits that Proposed Rule 2271(a)(1) is inconsistent with the current regulatory framework and will confuse investors (as well as member firms). The Committee strongly believes that this particular provision needs to be deleted. If it is not, the Committee is concerned that member firms will be required to make misleading statements to investors. In fact, the Committee submits that Rule 2271 should mandate disclosure that in selling a security, the member firm is <u>not</u> soliciting on behalf of the investment adviser to the pooled investment vehicle. Without requiring such disclosure, the Committee is concerned that investors in pooled investment vehicle will mistakenly believe that they have an investment advisory relationship with the investment adviser to the pooled investment vehicle.

VI. Rule 4580 Imposes Unduly Burdensome Requirements

Proposed Rule 4580 requires covered members to maintain books and records of all direct and indirect contributions made by the covered member or any of its covered associates to an official of a government entity. Unlike the recordkeeping requirement in Rule 204-2(a)(18)(i)(C) under the Advisers Act, which does not require investment advisers to maintain a list of contributions to officials of government entities where such entities do not become clients,[26] proposed Rule 4580 would require covered members subject to the rule to keep records

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[25] See footnote 5 for a list of these specific disclosures.

[26] *See* Advisers Act Rule 204-2(a)(18)(iii) ("An investment adviser is only required to make and keep current the records referred to in [paragraph (a)(18)(i)(C), relating to records of contributions to an official of a government entity]... if it provides investment advisory services to a government entity or a government entity is an investor in

of all contributions to government entities, regardless of whether such contributions were made in connection with solicitation activities on behalf of an investment adviser or whether such contributions resulted in a government entity becoming a client of the investment adviser. The Committee requests that Rule 4580 be narrowed in scope, such that records of contributions to an official or payments to political parties or PACs by a covered member or its covered associates would not have to be maintained when those government entities do not become clients of an investment adviser on behalf of which the covered member is soliciting. This amendment would harmonize proposed Rule 4580 with Rule 204-2(a)(18)(iii) under the Advisers Act as well as enhance compliance with the rule by tailoring it to the policy objectives sought to be obtained by FINRA. In addition, the Committee notes that its members do not have a practical way of tracking solicitation attempts that do not result in business since books and records systems are premised on relationships actually being formed.

The Committee also believes that records should not have to be maintained unless a covered member solicits on behalf of an investment adviser that provides or is seeking to provide investment advisory services to the government entity and the covered member makes a contribution to an official of such government entity.

Finally, the Committee believes that not all payments to political parties or political action committees should have to be maintained; instead, only payments to political parties or political action committees where the covered member or a covered associate (i) directs the political party or political action committee to make a contribution to an official of a government entity which the covered member is soliciting on behalf of an investment adviser or (ii) knows that the political party or political action committee is going to make a contribution to an official of a government entity which the covered member is soliciting on behalf of an investment adviser, should have to be maintained.

VII. Miscellaneous

A. Definition of Instrumentality

The Committee urges FINRA to clarify the meaning of "instrumentality" in the definition of "government entity." In this respect, the Committee notes that its members have struggled to understand the contours of this term in the context of the Adviser Rule. Without additional guidance, covered members will continue to struggle with whether a contribution to a given entity should be treated as a contribution to an "instrumentality" of a state or state agency, thus triggering the Time Out Period. For example, member firms continue to wrestle with whether contributions to certain medical centers affiliated with a state university and certain utilities, foundations and transportation authorities are "instrumentalities." The Committee thus asks FINRA for it and/or the Commission to provide additional guidance as to the criteria for determining whether an entity is an "instrumentality" under the Proposed Rules.

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any covered investment pool to which the investment adviser provides investment advisory services."); *see also* Political Contributions by Certain Investment Advisers, SEC Release No. IA-3043 (July 1, 2010) (noting that Rule 204-2 does not require advisers to "maintain lists of government entities solicited that do not become clients.").

B. Definition of Solicitation

Rule 2390 defines "solicitation" to mean, with respect to investment advisory services, "to communicate, directly or indirectly, for the purpose of obtaining a client for, or referring a client to, an investment adviser" and, with respect to a contribution or payment, "to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment." While the definition of "solicitation" under Rule 2390 is similar to the definition of "solicitor" under Rule 206(4)-3[27] and "solicitation" under MSRB Rule G-37,[28] the Committee seeks confirmation that Rule 2390 does not apply when a covered member communicates with a third party and has no intent to obtain a client for, or refer a client to, an investment adviser (in the context of investment advisory services) and there is no intent to obtain or arrange a contribution or payment (in the context of contributions to officials of government entities and payments to political parties).

C. The Rule's Limits on Political Contributions

Proposed Rule 2390 would place substantial restrictions on the ability of covered members and their covered associates to make contributions to officials of government entities. The Committee believes that the proposed provisions are too restrictive in a number of respects:

- The proposed $350 and $150 de-minimis exceptions are the same amounts adopted by the Commission in September 2010. These amounts, which fail to take inflation into consideration, are unreasonably low.

- The $350 amount under the proposed exception for returned contributions is unnecessary. There is no need to have a de-minimis amount at all under this exception. If the contribution is returned as is required under the exception, then no harm will result as both the contributor and contributee are placed in the same position they would have been in had no contribution been made.

The proposed rule's limitations are not drawn with sufficient precision to match FINRA's interests in prohibiting pay to play activities while enabling member firms to continue to engage in solicitation activities on behalf of investment advisers for compensation, and would unnecessarily restrict the ability of covered members and their covered associates from contributing to candidates for government office. In order to avoid substantial limitations on the associational and expressive activities of covered members and their covered associates, the Committee urges that: the $350 and $150 amounts be raised substantially and the $350 amount under the proposed exception for returned contributions be eliminated.

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[27] Under Rule 206(4)-3(d)(1), "solicitor" is defined as "any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser."

[28] MSRB Rules G-37(g)(ix) and G-38(b)(i) define "solicitation" for purposes of MSRB Rule G-37 as "a direct or indirect communication by any person with an issuer for the purpose of obtaining or retaining municipal securities business."

D. Rule 2390 is Categorized under "Special Products"

The Committee notes that Rule 2390 is proposed to be categorized under the FINRA Rule 2300 "sub-Series" entitled "Special Products." The Committee believes that it should more appropriately have its own sub-series within FINRA Rule 2000 Series (entitled "Duties and Conflicts"). Given that Rule 2390 does not deal with products (as do the other rules in the FINRA Rule 2300 sub-Series), the Committee contends that categorizing it in the 2300 Series is confusing as the rule has nothing to do with any particular product or security. If anything, its focus is on what might be termed "Special Customers" or "Special Services."

CONCLUSION

As noted above, the Committee supports the regulatory objectives underlying the Proposed Rules and recognizes the challenges in crafting the Proposed Rules so that they reach all of the activity sought to be eliminated without also prohibiting activity that is harmless. This is a particularly difficult task in the context of a covered member that is part of a large financial complex where the activities of certain associated persons, affiliates or other related persons of covered person may seem, on their face, to involve pay to play activity, but which, in fact, are completely harmless. The Committee hopes FINRA recognizes these challenges and the difficulties that language in the Proposed Rules presents for covered members that are part of such complexes. The Committee strongly believes that the broad and sweeping provisions of the Proposed Rules will result in confusion and uncertainty on the part of covered members as to what activity is permitted and a reduction in salutary business practices that superficially resemble pay to play activities.

The challenges presented by the Proposed Rules will be amplified if they were applied to the sale of two-tiered investment products, such as variable annuities. The Committee is concerned that FINRA does not appreciate the difficulties involved in applying the Proposed Rules to the sale of variable annuities or other two-tiered investment products. The Committee sees little benefit in extending the Proposed Rules to such activities. In this respect, the Committee believes that the offer and sales activity of member firms selling a variable annuity are too far removed from the investment advisory activities of the investment advisers to the funds underlying the product for there to be a material benefit derived from extending the rules to such selling firm activity. The Committee also notes that the investment advisory services provided at the underlying fund level are far removed from the governmental investor investing in the variable annuity. Even if FINRA disagrees with the Committee and concludes that the Proposed Rules should apply to the sale of variable annuities and other two-tiered investment products, the Committee is confident that without specific guidance as to how the Proposed Rules apply in such contexts, the likelihood of uniform compliance by member firms is extremely low and the chance of disparate practices and confusion in the industry is very high.

The Committee appreciates the opportunity to submit comments in response to the Notice. Please do not hesitate to contact Cliff Kirsch (212.389.5052, clifford.kirsch@sutherland.com) or Michael Koffler (212.389.5014, michael.koffler@sutherland.com) if you have any questions regarding this letter.

Respectfully submitted,

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FOR THE COMMITTEE OF ANNUITY INSURERS