Capital Acquisition Brokers

SEC Approves “Pay-to-Play” and Related Rules for Capital Acquisition Brokers (CABs)

Effective Date: December 6, 2017

Summary

The Securities and Exchange Commission (SEC) approved Capital Acquisition Broker (CAB) Rule 203 (Engaging in Distribution and Solicitation Activities with Government Entities) and CAB Rule 458 (Books and Records Requirements for Government Distribution and Solicitation Activities). These rules apply established “pay-to-play” and related recordkeeping rules to the activities of member firms that have elected to be governed by the CAB Rules. The rules will allow CABs to engage in distribution or solicitation activities for compensation with government entities on behalf of registered investment advisers.

The rules become effective on December 6, 2017.

The text of the rules is set forth in Attachment A.

Questions concerning this Notice should be directed to:

- Joseph P. Savage, Vice President and Counsel, Office of Regulatory Analysis, at (240) 386-4534 or joe.savage@finra.org; or
- Victoria Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104 or victoria.crane@finra.org.

Background and Discussion

Pay-to-Play Rules

In July 2010, the SEC adopted Rule 206(4)-5 under the Investment Advisers Act of 1940 addressing pay-to-play practices by investment advisers (SEC Pay-to-Play Rule).¹ The SEC Pay-to-Play Rule prohibits, in part, an investment adviser and its covered associates from providing or agreeing to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of the investment adviser unless the person is a “regulated person.”² A “regulated person” includes a member firm,
provided that: (a) FINRA rules prohibit member firms from engaging in distribution or solicitation activities if political contributions have been made; and (b) the SEC finds, by order, that such rules impose substantially equivalent or more stringent restrictions on member firms than the SEC Pay-to-Play Rule imposes on investment advisers and that such rules are consistent with the objectives of the SEC Pay-to-Play Rule.\(^5\)

Based on this regulatory framework, on August 25, 2016, the SEC approved FINRA Rules 2030 and 4580 to establish a comprehensive regime to regulate the activities of member firms that engage in distribution or solicitation activities with government entities on behalf of investment advisers.\(^6\) On September 20, 2016, the SEC, by order, found that FINRA Rule 2030 imposes substantially equivalent or more stringent restrictions on member firms than the SEC Pay-to-Play Rule imposes on investment advisers and is consistent with the objectives of the SEC Pay-to-Play Rule.\(^7\) These rules enable member firms to continue to engage in distribution and 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. Rules 2030 and 4580 do not expressly apply to CABs.

In October 2016, FINRA published a Regulatory Notice\(^8\) announcing SEC approval of FINRA Rules 2030 and 4580, which became effective on August 20, 2017.

### FINRA Capital Acquisition Broker Rules

FINRA adopted a separate set of FINRA rules for firms that meet the definition of a “capital acquisition broker” and that elect to be governed under this rule set. CABs are member firms that engage in a limited range of activities, essentially advising companies and private equity funds on capital raising and corporate restructuring, and acting as placement agents for sales of unregistered securities to institutional investors under limited conditions. Member firms that elect to be governed under the CAB rule set are not permitted, among other things, to carry or maintain customer accounts, handle customers’ funds or securities, accept customers’ trading orders, or engage in proprietary trading or market-making.

The CAB Rules became effective on April 14, 2017, after SEC approval.\(^9\) In order to provide new CAB applicants with lead time to apply for FINRA membership and obtain the necessary qualifications and registrations, CAB Rules 101-125 became effective on January 3, 2017.\(^10\)

### Addition of FINRA Pay-to-Play Rules to CAB Rule Set

The CAB Rules subject CABs to a number of FINRA Rules, but do not expressly provide that FINRA Rules 2030 and 4580 apply to CABs. As stated above, the SEC Pay-to-Play Rule prohibits, in part, an investment adviser and its covered associates from providing or agreeing to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of the investment adviser unless the person is a “regulated person.” The SEC Pay-to-Play Rule defines a “regulated person” to include a member firm subject to a FINRA pay-to-play rule.
CAB Rules 203 and 458 make clear that CABs are subject to FINRA’s pay-to-play and related recordkeeping rules and, therefore, that CABs, similarly to non-CAB member firms, are “regulated persons” that can engage in distribution and solicitation activities with government entities on behalf of investment advisers in accordance with the SEC’s Pay-to-Play Rule, while at the same time deterring CABs from engaging in pay-to-play practices.11

The rules become effective on December 6, 2017.

Endnotes


2. “Pay-to-play” practices typically involve a person making cash or in-kind political contributions (or soliciting or coordinating others to make such contributions) to help finance the election campaigns of state or local officials or bond ballot initiatives as a quid pro quo for the receipt of government contracts. See Regulatory Notice 16-40 (October 2016) at 9, note 1.


8. See Regulatory Notice 16-40 (October 2016).


10. See Regulatory Notice 16-37 (October 2016).

11. CABs’ distribution and solicitation activities with government entities on behalf of investment advisers must be consistent with the activities permitted for CABs under CAB Rule 016(c).