FINRA
Financial Industry Regulatory Authority

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Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. SR-FINRA-2015-056 (Proposed Rule Change to Adopt FINRA Rules 2030 and 4580 to Establish Pay-to-Play and Related Rules)

Dear Mr. Fields:

This letter responds to comments received by the Securities and Exchange Commission ("SEC" or "Commission") to the above-referenced rule filing related to adopting FINRA Rules 2030 and 4580 which would establish a pay-to-play rule and related record-keeping rule for FINRA members.

The Commission published the proposed rule change for public comment in the Federal Register on December 30, 2015.[1] The Commission received ten comment letters from nine commenters directed to the rule filing.[2] Six commenters expressed

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1 See Securities Exchange Act Release No. 76767 (December 24, 2015), 80 FR 81650 (December 30, 2015) (Notice of Filing File No. SR-FINRA-2015-056).

2 See Letter from Patrick J. Moran, Esq., dated December 29, 2015 ("Moran"); letter from Tamara K. Salmon, Assistant General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, SEC, dated January 6, 2016 ("ICI"); letter from H. Christopher Bartolomucci and Brian J. Field, Bancroft PLLC, for the New York Republican State Committee and the Tennessee Republican Party, to Brent J. Fields, Secretary, SEC, dated January 20, 2016 ("State Parties"); letter from David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute ("FSI"), to Brent J. Fields, Secretary, SEC, dated January 20, 2016 ("FSI I"); letter from Hugh D. Berkson, President, Public Investors Arbitration Bar Association, to Robert W. Errett, Deputy Secretary, SEC, dated January 20, 2016 ("PIABA"); letter from David Keating, President, Center for Competitive Politics ("CCP"), to Brent J. Fields, Secretary, SEC, dated January 20, 2016 ("CCP I"); letter from Clifford

general support for the proposed rule change.[3] Five of those commenters, however, also raised concerns regarding various aspects of the proposed rule change and recommended amendments to the proposal.[4] The other three commenters did not support the proposed rule change based primarily on concerns involving the First Amendment to the U.S. Constitution.[5]

The Commission published an order instituting proceedings to determine whether to approve or disapprove the above-referenced rule filing in the Federal Register on April 4, 2016.[6] The Commission received four comment letters following the publication of the Order Instituting Proceedings.[7] Two commenters requested an

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Kirsch and Michael Koffler, Sutherland Asbill & Brennan LLP, for the Committee of Annuity Insurers ("CAI"), to Brent J. Fields, Secretary, SEC, dated January 20, 2016 ("CAI I"); letter from Gary A. Sanders, Counsel and Vice President, National Association of Insurance and Financial Advisors, to Brent J. Fields, Secretary, SEC, dated January 20, 2016 ("NAIFA"); letter from Judith M. Shaw, President, North American Securities Administrators Association, Inc., to Brent J. Fields, Secretary, SEC, dated January 20, 2016 ("NASAA"); and letter from Clifford Kirsch and Michael Koffler, Sutherland Asbill & Brennan LLP, for CAI, to Brent J. Fields, Secretary, SEC, dated February 5, 2016 ("CAI II").

3 See CAI I, FSI I, ICI, NAIFA, NASAA and PIABA. CAI also submitted a supplemental comment letter to reflect CAI's suggested revisions to the proposed rule text filed with the Commission as part of FINRA's rule filing. See CAI II.

4 See CAI I, FSI I, NAIFA, NASAA and PIABA. ICI did not raise additional concerns, but stated that it was satisfied with FINRA's revisions and responses to the proposal as drafted in Regulatory Notice 14-50 (November 2014).

5 See CCP I, Moran and State Parties.

6 See Securities Exchange Act Release No. 77465 (March 29, 2016), 81 FR 19260 (April 4, 2016) (Order Instituting Proceedings to Determine Whether to Approve or Disapprove File No. SR-FINRA-2015-056) ("Order Instituting Proceedings").

7 See Letter from Jason Torchinsky, Holtzman Vogel Josefiak Torchinsky PLLC, to Brent J. Fields, Secretary, SEC, dated April 12, 2016 ("Torchinsky"); letter from Allen Dickerson, Legal Director, CCP, to Brent J. Fields, Secretary, SEC, dated April 15, 2016 ("CCP II"); letter from Allen Dickerson, Legal Director, CCP, to Brent J. Fields, Secretary, SEC, dated April 21, 2016 ("CCP III"); and letter from David T. Bellaire, Executive Vice

opportunity to make an oral presentation to the Commission regarding the proposed rule change.[8] FSI expressed general support for the proposed rule change, but also raised some concerns, primarily on First Amendment grounds.[9] CCP focused its comments on recent amendments to Municipal Securities Rulemaking Board ("MSRB") Rule G-37 and, therefore, such comments are not addressed in this letter.[10]

The following are FINRA's responses, by topic, to the commenters' material concerns.

First Amendment Concerns

The State Parties and CCP opposed the proposed rule change as inconsistent with the First Amendment and beyond the scope of the Commission's statutory authority. In FINRA's view, the points raised by the State Parties and CCP do not warrant changes to, or disapproval of, the proposed rule change.[11]

As an initial matter, the Commission has already reviewed and rejected the State Parties' arguments in a nearly identical context. In 2010, the Commission adopted Rule 206(4)-5 of the Investment Advisers Act of 1940 ("Advisers Act") to address pay-to-play practices by investment advisers ("SEC Pay-to-Play Rule").[12] Several years later, the State Parties filed suit, alleging that the SEC Pay-to-Play Rule exceeded the Commission's statutory authority, and that the Rule violated the First

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President and General Counsel, FSI, to Brent J. Fields, Secretary, SEC, dated April 27, 2016 ("FSI II").

8 See Torchinsky and CCP III.

9 See FSI II.

10 See CCP II.

11 CAI I, FSI I, FSI II and Moran also alluded to First Amendment concerns. FINRA's specific responses to the arguments of the State Parties and CCP, set forth herein, address those concerns as well.

12 See Investment Advisers Act Release No. 3043 (July 1, 2010), 75 FR 41018 (July 14, 2010) (Political Contributions by Certain Investment Advisers) ("SEC Pay-to-Play Rule Adopting Release"). See also Investment Advisers Act Release No. 3221 (June 22, 2011), 76 FR 42950 (July 19, 2011) (Rules Implementing Amendments to the Investment Advisers Act of 1940); Investment Advisers Act Release No. 3418 (June 8, 2012), 77 FR 35263 (June 13, 2012) (Political Contributions by Certain Investment Advisers; Ban on Third Party Solicitation; Extension of Compliance Date).

Amendment. The State Parties' comments opposing the proposed pay-to-play rule reiterate the arguments advanced in their suit against the Commission.[13] That suit was dismissed for lack of jurisdiction in the district court, and the court of appeals affirmed on that ground and on the ground that the State Parties' challenge was untimely.[14] Significantly, although the court did not reach the merits, the Commission's brief in the D.C. Circuit ably demonstrated that the State Parties' arguments are mistaken.[15]

Moreover, the SEC Pay-to-Play Rule requires FINRA to impose "substantially equivalent or more stringent restrictions" on member firms that wish to act as "regulated persons" as the Rule imposes on investment advisers.[16] Unless FINRA imposes sufficiently stringent restrictions, investment advisers and covered associates will be *completely* barred from providing or agreeing to provide, directly or indirectly, payment to member firms to solicit a government entity for investment advisory services on behalf of the investment adviser. Neither the State Parties nor CCP seriously addresses this concern.

The Commission should conclude that the proposed rule change is constitutional and within its statutory authority.

A. The Proposed Rule Change does not Violate the First Amendment

Among other provisions, the proposed rule change would "prohibit a covered member from engaging 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 official of the government entity is made by the covered member or a covered associate (including a person who becomes a covered associate within two years after the contribution is made)."[17] The proposed rule change does not attempt to regulate State and local elections. Nor does it impose restrictions on independent expenditures or ban political contributions. Each of those significant avenues for political expression remains unaffected by the proposed rule change.

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[13] See State Parties, Exhibit A.

[14] See N.Y. Republican State Comm. v. SEC, 799 F.3d 1126 (D.C. Cir. 2015).

[15] See SEC Br., N.Y. Republican State Comm. v. SEC, No. 14-1194 (D.C. Cir. Jan. 21, 2015) ("SEC Br.").

[16] See SEC Pay-to-Play Rule 206(4)-5(f)(9).

[17] 80 FR 81650, 81651.

To be sure, the two-year "time out" provision might result in fewer covered members and their covered associates making political contributions. As previously noted, however, if FINRA were not to adopt a pay-to-play rule, the result under the SEC Pay-to-Play Rule would be a categorical ban on member firms soliciting government entities for investment advisory services for compensation on behalf of investment advisers. FINRA believes that the proposed rule change is a more effective response to the issues addressed in the SEC Pay-to-Play Rule than a complete ban on solicitation.

The State Parties and CCP have expressed First Amendment concerns with the proposed rule change. Among other things, they contend that the proposed rule change infringes the speech and associational rights of member firms, and that the proposed rule change is not sufficiently tailored to survive First Amendment scrutiny.

1. Standard of Review; Associational Freedoms

The constitutional concerns raised by the State Parties and CCP are misplaced. Regulations of campaign contributions are not subject to strict scrutiny, but a "lesser" standard of review, under which "even a significant interference with protected rights of political association may be sustained" if it serves "a sufficiently important interest and employs means closely drawn to avoid unnecessary abridgment of associational freedoms."[18] The State Parties misstate the appropriate standard of review by suggesting that the Commission would bear an "exceedingly high burden in establishing" the proposed rule change's constitutionality. CCP also misstates the appropriate standard by suggesting that strict scrutiny applies.

The proposed rule change is justified by a sufficiently important interest to withstand constitutional scrutiny. The SEC Pay-to-Play Rule, upon which the proposed rule change is based, was modeled in turn on pay-to-play rules drafted by the MSRB and approved by the Commission. The D.C. Circuit upheld those rules against a First Amendment challenge in Blount v. SEC, 61 F.3d 938 (D.C. Cir. 1995). Here, as in that case, the Commission's interest in preventing fraud and in protecting market actors from "unfair, corrupt market practices," are "not only substantial, but . . . compelling."[19] The State Parties note that the Supreme Court has thus far identified "'only one legitimate governmental interest for restricting campaign finance: preventing corruption or the appearance of corruption.'"[20] But the court in Blount

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[18] Wagner v. FEC, 793 F.3d 1, 5 (D.C. Cir. 2015) (en banc), *cert. denied*, Miller v. FEC, 136 S. Ct. 895 (2016) (alteration, emphasis, and citation omitted).

[19] Blount, 61 F.3d at 944 (citation omitted).

[20] State Parties (quoting McCutcheon v. FEC, 134 S. Ct. 1434, 1450 (2014) (plurality opinion)).

made that same observation, and explained that the Commission's interest "in clean bond markets" is just as important as a legislature's interest "in clean elections."[21] The Commission's interest in clean investment advisory markets is equally important.

The proposed rule change is also "closely drawn" to avoid unnecessary abridgment of associational freedoms. Clearing the "closely drawn" hurdle "requires a fit that is not necessarily perfect, but reasonable."[22] As the D.C. Circuit observed in Blount, "the link between eliminating pay-to-play practices and the Commission's goals of 'perfecting the mechanism of a free and open market' and promoting 'just and equitable principles of trade' is self-evident."[23] For example, pay-to-play practices "'raise artificial barriers to competition for those firms that either cannot afford or decide not to make political contributions.'"[24] There is also a "collective action problem tending to make the misallocation of resources persist"-- politicians vying for office are unlikely to curtail the practice from which they might benefit.[25] Moreover, like the pay-to-play rule upheld in Blount, the proposed rule change "restricts a narrow range of . . . activities for a relatively short period of time," and leaves available the "vast majority of political activities."[26]

2. Insufficient Evidence of Corruption

The State Parties nonetheless object to the proposed rule change on the ground that it is not supported by sufficient evidence of corruption. "[N]o smoking gun is needed," however, "where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the [Commission's] purpose prophylactic."[27]

The State Parties evidently understand that Blount is fatal to their arguments, and thus suggest that Blount is not good law. That is incorrect. The unanimous D.C. Circuit, sitting en banc in 2015, repeatedly relied upon Blount in upholding a ban on

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21 Blount, 61 F.3d at 944.

22 Wagner, 793 F.3d at 21 (quotation marks and alteration omitted).

23 Blount, 61 F.3d at 945.

24 Blount, 61 F.3d at 945 (quoting Securities Exchange Act Release No. 33868 (April 7, 1994)).

25 Blount, 61 F.3d at 945.

26 Blount, 61 F.3d at 947-48.

27 Blount, 61 F.3d at 945 (citing FEC v. Nat'l Right to Work Comm., 459 U.S. 197, 210 (1982) (court will not "second-guess a legislative determination as to the need for prophylactic measures where corruption is the evil feared")).

campaign contributions by federal contractors.[28] The State Parties attempt to dismiss Wagner's express reliance on Blount's holding and reasoning as "of no moment," but that odd conclusory assertion is unsupported.[29]

3. Less Restrictive Alternatives

CCP contends that the proposed rule change is invalid because FINRA supposedly did not consider less restrictive alternatives. CCP also objects to a number of the proposed rule change's provisions, such as the "look-back" provisions and definitions, as impermissibly vague and overbroad. As noted above, the SEC must find that FINRA's pay-to-play rule imposes substantially equivalent or more stringent restrictions on member firms than the SEC Pay-to-Play Rule imposes on investment advisers. Accordingly, FINRA modeled the provisions and definitions to which CCP objects on substantially similar elements of the SEC Pay-to-Play Rule. Consequently, FINRA does not believe that CCP's suggested alternatives would satisfy the Commission's requirements. Moreover, FINRA does not agree with the arguments advanced by CCP that the proposed rule change is vague or overbroad; to the extent that interpretive questions arise regarding the application and scope of the provisions and terms used in the proposed rule change, however, FINRA will work with the industry and Commission to address the interpretive questions and provide additional guidance as needed.

4. Other Arguments

The other cases invoked by the State Parties and CCP do not change the constitutional analysis. Citing Randall v. Sorrell, 548 U.S. 230 (2006), for example, they contend that the *de minimis* amount in the proposed rule change is too low. But Sorrell struck down limits that applied to all contributions by the *entire electorate* on the ground that an inappropriately low ceiling would prevent "challengers from mounting effective campaigns against incumbent officeholders, thereby reducing democratic accountability."[30] Neither the State Parties nor CCP suggests that the proposed rule change would make challenges to incumbent officeholders more difficult. The State Parties rely on Davis v. FEC, 554 U.S. 724 (2008), in arguing that the proposed rule change would have an impermissible disparate impact on candidates for office. That case, however, concerned the right to spend one's own money to fund a campaign. The State Parties have not cited any case extending Davis's holding to a

28 See Wagner, 793 F.3d at 20 (quoting Blount, 61 F.3d at 945).

29 CCP also suggests that Blount is no longer good law, but for this proposition, CCP relies entirely on cases decided before Wagner, a case CCP does not even mention. Wagner demonstrates beyond dispute that Blount remains good law.

30 Sorrell, 548 U.S. at 248-49.

rule treating contributions to covered officials differently from contributions to their opponents, who are not covered officials precisely because they are not susceptible to pay-to-play practices. And McCutcheon, which both the State Parties and CCP cite, concerned a cap on aggregate contributions, thus limiting the number of candidates a person could support in one election cycle.[31] The proposed rule change does not affect the number of candidates anyone may support.

Accordingly, the proposed rule change would not violate the First Amendment if approved by the Commission.

B. FINRA has Statutory Authority to Propose a Pay-to-Play Rule

The proposed rule change is also consistent with Section 15A(b)(6) of the Securities Exchange Act of 1934, which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to perfect the mechanism of a free and open market and a national market system. The proposed rule change accomplishes these goals by allowing member firms to continue to engage in distribution or solicitation activities for compensation with governmental entities on behalf of investment advisers, while at the same time deterring member firms from engaging in pay-to-play practices.

The State Parties contend that the proposed rule change interferes with Congress's putatively "exclusive" authority to set contribution limits.[32] The State Parties cite no caselaw in support of this contention; they simply note that Congress has not delegated authority *to the FEC* to set contribution limits. But any suggestion that Congress has reserved exclusive authority to itself over contribution limits cannot account for the pay-to-play rules already adopted by the Commission. More than two decades ago, the MSRB drafted, and the Commission approved, substantially similar rules for municipal securities professionals.[33] The SEC Play-to-Play Rule, which was adopted in 2010, was modeled after the regime upheld in Blount. If Congress believed that those regulations interfered with its supposedly exclusive authority over contribution limits, "it might well have enacted a provision addressing the issue" when it passed the Bipartisan Campaign Reform Act of 2002, the Dodd-Frank Act in 2010, or indeed any of its myriad revisions to the election and securities laws over the

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31 McCutcheon, 134 S. Ct. at 1442-43.

32 CCP argues that the proposed rule change is preempted by the Federal Election Campaign Act. Preemption, however, concerns the intersection of state and federal law, which is not relevant here. See POM Wonderful LLC v. Coca-Cola Co., 134 S. Ct. 2228, 2236 (2014).

33 See Blount, 61 F.3d 938.

years.[34] That Congress did not undermines any suggestion that its authority over contribution limits is exclusive.

The State Parties' extensive reliance on Galliano v. United States Postal Service, 836 F.2d 1362 (D.C. Cir. 1988), is misplaced for the reasons the Commission gave in its prior briefing.[35] In particular, the State Parties' arguments are incompatible with the Supreme Court's unanimous holding and reasoning in POM Wonderful. Among other flaws, the State Parties do not and cannot point to any provision of campaign-finance law withdrawing the Commission's authority to approve the proposed rule change;[36] Congress has not disapproved other pay-to-play rules;[37] and the "greater specificity" of the campaign-finance laws does not matter where their provisions and the proposed rule change can "be implemented in full at the same time."[38]

Finally, the State Parties' argument that the proposed rule change exceeds FINRA's authority because it is categorical and prophylactic is simply a collateral attack on the SEC Pay-to-Play Rule. In any event, the Commission has already explained that the State Parties' argument is meritless.[39] For example, the proposed rule change is reasonably designed to address the distortion of the investment advisory market and collective action problems created by pay-to-play practices.[40]

For the foregoing reasons, the Commission should conclude that the proposed rule change is constitutional and within its statutory authority, and proceed to approve the rule based on its review.

Proposed Pay-to-Play Rule

A. Two-Year Time Out

The proposed pay-to-play rule would impose a two-year time out on engaging in distribution or solicitation activities for compensation with a government entity on

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34 POM Wonderful, 134 S. Ct. at 2237.

35 SEC Br. 39-44.

36 See POM Wonderful, 134 S. Ct. at 2237-38.

37 See POM Wonderful, 134 S. Ct. at 2237.

38 See POM Wonderful, 134 S. Ct. at 2240.

39 See SEC Br. 35-39.

40 See SEC Br. 35-39.

behalf of an investment adviser after the covered member or its covered associates make a contribution to an official of the government entity.[41] PIABA stated that it believes that the two-year time out does not adequately reduce the incentive for FINRA member firms to make political contributions to obtain pay-to-play advantages and would welcome the effect of a four-year time out. FINRA declines to make PIABA's suggested change. As discussed in the rule filing, the proposed two-year time out is consistent with the time-out period in the SEC's Pay-to-Play Rule, and FINRA believes that a two-year time out from the date of a contribution is sufficient to discourage covered members from engaging in pay-to-play practices.

B. Investment Advisers

The proposed pay-to-play rule would apply to covered members acting on behalf of any investment adviser registered (or required to be registered) with the SEC, or unregistered in reliance on the exemption available under Advisers Act Section 203(b)(3) for foreign private advisers, or that is an exempt reporting adviser under Advisers Act Rule 204-4(a).[42] Two commenters suggested that FINRA expand the definition of "investment adviser" to include state-registered investment advisers.[43] PIABA stated, among other things, that while the Commission and FINRA have noted that relatively few state-registered investment advisers manage public pension plans, this alone does not justify permitting those FINRA-member firms that do manage public pension plans, but happen to work with smaller investment advisers, to engage in pay-to-play activities with no repercussions from FINRA. NASAA claimed that state-registered investment advisers now include larger firms and, therefore, it is much more likely that state-registered investment advisers advise or manage public pension plans or similar funds. NASAA stated that, to address this potential gap, FINRA should include state-registered investment advisers in its definition of investment adviser for purposes of its proposed pay-to-play rule. As stated in the rule filing, to remain consistent with the SEC Pay-to-Play Rule, FINRA has determined not to expand the scope of the proposed rule as suggested by commenters.

C. Inclusion of Distribution Activities

The proposed pay-to-play rule would impose a two-year time out on engaging in distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser after the covered member or its covered associates

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41 See proposed FINRA Rule 2030(a).

42 See proposed Rule 2030(g)(7).

43 See PIABA and NASAA.

makes a contribution to an official of the government entity.[44] CAI expressed concern that proposed FINRA Rule 2030 is unnecessarily ambiguous regarding the term "distribution activities" in proposed FINRA Rule 2030(a).[45] CAI claimed that it is unclear what distribution activities "with" a government entity would be prohibited, what compensation is covered by the proposed pay-to-play rule and who must pay it, and when a member firm might be deemed to be acting "on behalf of" an investment adviser.[46] CAI claimed that when combined with the prohibition of proposed FINRA Rule 2030(e) against doing indirectly what cannot be done directly, potential concerns over the proposed pay-to-play rule's ambiguity become even more acute.[47]

In addition, CAI claimed that, while the SEC Pay-to-Play Rule requires regulated persons to be subject to rules that prohibit them from engaging in certain distribution activities if certain political contributions have been made, SEC Pay-to-Play Rule 206(4)-5 does not mandate the use of the term "distribution" in describing the conduct prohibited by the proposed rule, and suggested revised rule text reflecting that assertion.[48] CAI stated its belief that its suggested revisions would, among other things, eliminate the potential concern that a selling firm might violate proposed FINRA Rule 2030 unknowingly due to being deemed to be acting on behalf of investment advisers or sub-advisers of underlying funds with which it has no relationship.[49]

FSI claimed that although the SEC Pay-to-Play Rule requires FINRA to promulgate a pay-to-play rule that "prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made," it does not believe that FINRA's rule should apply to traditional sales activity of brokerage firms.[50] By doing so, FSI states that the proposal would subject its members to additional costs and compliance burdens not required under the SEC Pay-to-Play Rule.[51]

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44 See proposed FINRA Rule 2030(a).

45 See CAI I.

46 See CAI I.

47 See CAI I.

48 See CAI I and CAI II.

49 See CAI I (claiming that CAI's suggested revisions would not result in any inappropriate narrowing of the scope of proposed FINRA Rule 2030).

50 See FSI I. See also FSI II.

51 See FSI I. See also FSI II.

In the rule filing, FINRA pointed to language in the SEC Pay-to-Play Rule Adopting Release supporting the inclusion of distribution activities by broker-dealers in a FINRA pay-to-play rule[52] and noted that based on the SEC's definition of "regulated person"[53] as well as its discussion regarding the treatment of distribution fees paid pursuant to a 12b-1 plan, FINRA believes that its proposed rule must apply to member firms engaging in distribution activities.[54] FINRA continues to maintain this position and, therefore, has determined not to revise the proposed pay-to-play rule to remove references to the term "distribution." In addition, as noted previously, to the extent that interpretive questions arise regarding the application and scope of the provisions and terms used in the proposed rule change, FINRA will work with the industry and Commission to address the interpretive questions and provide additional guidance as needed.

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52 See 80 FR 81650, 81660-81661. Specifically, FINRA pointed to the Commission's discussion regarding under what circumstances distribution payments would violate the SEC's Pay-to-Play Rule. FINRA noted the language in the SEC Pay-to-Play Rule Adopting Release stating that "[m]utual 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 [under the SEC Pay-to-Play Rule] by its terms. Where an adviser pays for the fund's distribution out of its 'legitimate profits,' however, the 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." SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41040 n.298. See also Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (October 28, 1980), 45 FR 73898 (November 7, 1980).

53 The SEC Pay-to-Play Rule prohibits 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." See SEC Pay-to-Play Rule 206(4)-5(a)(2). The SEC Pay-to-Play Rule defines a "regulated person" to include a member firm, provided that FINRA rules prohibit member firms from engaging in *distribution* or solicitation activities if political contributions have been made. See SEC Pay-to-Play Rule 206(4)-5(f)(9)(ii)(A).

54 See 80 FR 81650, 81660-81661.

D. Covered Investment Pools

1. General

With respect to covered investment pools,[55] the proposed pay-to-play rule provides that: "(1) A covered member that engages in distribution or solicitation activities with a government entity on behalf of a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though that covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool directly; and (2) An investment adviser to a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity."[56]

Some commenters expressed concern that proposed FINRA Rule 2030(d) would, in their view, re-characterize "ordinary" or "customary" distribution activities for covered investment pools as the solicitation of clients on behalf of the investment adviser to the covered investment pools.[57] CAI requested that such customary distribution activity by member firms for covered investment pools sold to government entities not be treated as solicitation activity for an investment adviser for purposes of proposed FINRA Rule 2030 simply because an investment adviser provides advisory services to a covered investment pool that is available as an investment option.[58] As explained more fully in its letter, CAI claimed, for example, that proposed FINRA Rule 2030(d) would recast "traditional" broker-dealer activity (*i.e.*, the offer and sale of covered investment pool 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.[59] CAI also claimed that the decision in Goldstein v. SEC, 451 F.3d

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55 Proposed FINRA Rule 2030(g)(3) defines a "covered investment pool" to mean: "(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."

56 See proposed FINRA Rule 2030(d).

57 See CAI I, FSI I and FSI II.

58 See CAI I.

59 See CAI I.

873 (D.C. Cir. 2006), and the Commission staff's interpretive position under Advisers Act Rule 206(4)-3 make proposed FINRA Rule 2030(d) impractical, as it would put selling firms in a contradictory position under FINRA rules and Advisers Act rules.[60] CAI stated 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.[61]

FSI also expressed concern with the application of proposed FINRA Rule 2030(d) to traditional brokerage sales of mutual funds and variable annuities to participant-directed government-sponsored retirement plans.[62] As more fully explained in FSI's letters, this commenter stated that it continues to be concerned that the provisions in proposed FINRA Rule 2030(d) "go beyond that which is required under Rule 206(4)-5(a)(2)(i) and Rule 206(4)-5(c) to the detriment of investors."[63] FSI also claimed that mutual fund sales, as well as variable annuity sales, should be excluded, asserting that the proposed rules serve to redefine the sale of mutual funds as solicitation by a broker-dealer on behalf of an investment adviser and also conflict with the realities of conventional mutual fund selling agreements.[64]

In proposing FINRA Rule 2030(d), FINRA is not intending to re-characterize broker-dealers' selling interests in variable annuities, mutual funds and private funds as soliciting an investment advisory relationship with investors who invest in those products. The purpose of proposed FINRA Rule 2030(d) is to make clear that the prohibition of proposed FINRA Rule 2030(a) would apply when the covered member is engaging in distribution or solicitation activities with a government entity on behalf of a covered investment pool.

As discussed in the rule filing, proposed FINRA Rule 2030(d) is modeled on a similar provision in the SEC Pay-to-Play Rule, Rule 206(4)-5(c).[65] Consistent with

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60 See CAI I.

61 See CAI I.

62 See FSI I and FSI II.

63 FSI I. See also FSI II.

64 See FSI I.

65 SEC Pay-to-Play Rule 206(4)-5(c) provides that "an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity." In adopting this provision, the Commission noted a commenter's questioning of its authority to apply the rule in the context of covered

SEC Pay-to-Play Rule 206(4)-5(c), proposed FINRA Rule 2030(d) is intended to extend the protections of the proposed rule to government entities that access the services of investment advisers through hedge funds and other types of pooled investment vehicles sponsored or advised by investment advisers. In addition, FINRA notes that when adopting SEC Pay-to-Play Rule 206(4)-5(c), the SEC stated that although "an investment in a pooled investment vehicle may not involve a direct advisory relationship with a government sponsored plan [that] does not change the nature of the fraud or the harm that may be inflicted as a consequence of the adviser's pay-to-play activity."[66] Moreover, FINRA notes that the applicability of proposed FINRA Rule 2030(d) is for purposes of FINRA's pay-to-play rule only. Accordingly, FINRA has determined not to make the changes suggested by the commenters.

2. Two-Tiered Investment Products – Variable Annuities

CAI and FSI raised concerns regarding the application of the proposed pay-to-play rule to two-tiered investment products, such as variable annuities.[67] These commenters requested, as a threshold matter, that FINRA confirm that proposed FINRA Rule 2030 would not apply to variable annuities. In support of its request that the proposed rule not apply to the sale of variable annuity contracts, FSI argued that the nature of variable annuities and the way investment options are selected does not implicate the investment advisory solicitation activities contemplated by the SEC Pay-to-Play Rule.[68] FSI also claimed that the relationship between a variable annuity contract holder and the investment adviser to a mutual fund supporting the variable annuity does not rise to a level such that it should implicate a pay-to-play obligation.[69] FSI also requested that, in the event that FINRA does not amend the application of its

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investment pools in light of the opinion of the Court of Appeals for the District of Columbia Circuit in the Goldstein case. The Commission concluded, however, that it has authority to adopt rules proscribing fraudulent conduct that is potentially harmful to investors in pooled investment vehicles pursuant to Section 206(4) of the Advisers Act and, therefore, adopted SEC Pay-to-Play Rule 206(4)-5(c) as proposed. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41045 n.355.

66 SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044-41045.

67 See CAI I, FSI I and FSI II.

68 See FSI I (claiming that applying the proposed pay-to-play rule to variable annuities would significantly increase the compliance burden and as such may limit the options its members make available to 403(b) and 457 plans).

69 See FSI I.

proposed rule to covered investment pools, FINRA apply the proposed rule only to accounts and variable annuity contracts opened after the effective date.[70]

CAI argued that compliance with proposed FINRA Rule 2030 would be impractical for broker-dealers selling variable annuities in the government market.[71] CAI claimed that a covered member selling a variable annuity, particularly where the separate account is registered as a unit investment trust, cannot fairly be seen to be 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 under the separate account and sub-accounts.[72]

CAI also requested that FINRA modify proposed FINRA Rule 2030 to, among other things, clarify that the distribution of a two-tiered investment product such as a variable annuity is not solicitation activity for an investment adviser and sub-advisers managing the funds available as investment options.[73] Furthermore, CAI stated that if FINRA or the Commission determines that broker-dealers selling variable annuities constitute solicitation activities for purposes of proposed FINRA Rule 2030, that determination would raise a host of interpretive questions that, in CAI's view, would require further guidance from FINRA or the Commission.[74]

As discussed above, FINRA is required to propose rules that impose substantially equivalent or more stringent restrictions on member firms as the SEC Pay-to-Play Rule imposes on investment advisers. The Commission did not exclude specific products from the SEC Pay-to-Play Rule, or apply its rule only to contracts or accounts opened after the effective date of the rule. Thus, FINRA does not believe that excluding specific products from its proposed pay-to-play rule or limiting the application of its rule in the way suggested by FSI would satisfy the Commission's requirements. FINRA notes, however, that to the extent interpretive questions arise regarding the application and scope of the provisions and terms used in the proposed rule change, FINRA will work with the industry and Commission to address the interpretive questions and provide additional guidance as needed.

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70 See FSI I.

71 See CAI I.

72 See CAI I.

73 See CAI I.

74 See CAI I.

E. Prohibition on Soliciting and Coordinating Contributions

The proposed pay-to-play rule would prohibit a covered member or covered associate from coordinating or soliciting any person or political action committee ("PAC") to make any: (1) contribution to an official of a government entity in respect of which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser; or (2) payment to a political party of a state or locality of a government entity with which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser.[75] In connection with this prohibition, CAI requested clarification as to whether each and every "contribution" (as defined in proposed FINRA Rule 2030(g)(1)) is, by definition, also a "payment" (as defined in proposed FINRA Rule 2030(g)(9)).[76]

Proposed FINRA Rule 2030(g)(1) defines the term "contribution" to mean "any gift, subscription, loan, advance, or deposit of money or anything of value made for: (A) The purpose of influencing any election for federal, state or local office; (B) Payment of debt incurred in connection with any such election; or (C) Transition or inaugural expenses of the successful candidate for state or local office." Proposed FINRA Rule 2030(g)(9) defines the term "payment" to mean "any gift, subscription, loan, advance or deposit of money or anything of value." As discussed in the rule filing, the definition of "payment" is similar to the definition of "contribution," but is broader, in the sense that it does not include limitations on the purposes for which such money is given (*e.g.*, it does not have to be made for the purpose of influencing an election).

F. Application of the Proposed Rule Change to the Independent Business Model

FSI claimed that its members will face similar difficulties in attempting to comply with the proposed pay-to-play rule as they have faced in attempting to comply with the SEC Pay-to-Play Rule.[77] FSI stated that these difficulties stem, primarily, from a requirement for independent firms to implement a rule that is premised on the notion that solicitation of clients is performed pursuant to a centralized process controlled by the management of a registered investment adviser.[78] FSI claimed that the lack of clarity as to the application of the SEC Pay-to-Play Rule to its members'

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75 See proposed FINRA Rule 2030(b).

76 See CAI I.

77 See FSI I and FSI II.

78 See FSI I. See also FSI II.

business model, and the scope of government officials that trigger the requirements, has led some firms to adopt aggressive compliance programs that prohibit political contributions.[79] Accordingly, FSI claimed that absent clarity concerning the application of the proposed rule to the brokerage services provided to 403(b) and 457 plans, its members will be faced with the choice of either adopting similarly aggressive policies or prohibiting sales to government-sponsored retirement plans.[80]

Consistent with the SEC Pay-to-Play Rule, FINRA has determined not to except from its proposed pay-to-play rule member firms engaged in the independent business model. As noted above, however, to the extent that interpretive questions arise regarding the application and scope of the provisions and terms used in the proposed rule change, FINRA will work with the industry and Commission to address the interpretive questions and provide additional guidance as needed.

G. Requests for Additional Commission Guidance

NAIFA requested that the Commission work with FINRA to clarify the meaning of the term “covered associate” and clarify and delineate the positions that would qualify someone as an “official” in the proposed pay-to-play rule. NAIFA stated that it recognizes that these terms are defined as they are in the SEC Pay-to-Play Rule, but that these definitions in the SEC Pay-to-Play Rule have raised confusion and been problematic and, therefore, seeks additional guidance from the Commission and FINRA. In addition, NAIFA requested further guidance from the Commission and FINRA regarding the factors by which contributions to PACs would or would not trigger the anti-circumvention provision of the proposed pay-to-play rule.[81]

CAI urged the Commission to clarify the meaning of the term “instrumentality” in the definition of “government entity,” noting that “its members have struggled to understand the contours of this term in the context of the SEC Pay-to-Play Rule.[82]

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[79] See FSI I. See also FSI II.

[80] See FSI I. See also FSI II.

[81] Similar to the SEC Pay-to-Play Rule, the proposed pay-to-play rule contains an anti-circumvention provision, stating that “[i]t shall be a violation of the Rule for any covered member or any of its covered associates to do anything indirectly, that, if done directly, would result in a violation of this Rule.” See proposed FINRA Rule 2030(e).

[82] CAI I.

FINRA acknowledges the concerns raised by the commenters and the requests for clarification and additional guidance from the Commission and FINRA. As noted above, to the extent that interpretive questions arise regarding the application and scope of the provisions and terms used in the proposed rule change, FINRA will work with the industry and Commission to address the interpretive questions and provide additional guidance as needed.

H. Exceptions

The proposed pay-to-play rule includes exceptions for *de minimis* contributions and returned contributions.[83] As discussed above, some commenters raised concerns with the *de minimis* exception on First Amendment grounds. In addition, CAI requested that the $350 and $150 amounts "be raised substantially" in both the SEC Pay-to-Play Rule and in proposed FINRA Rule 2030(c)(1), stating that the amounts "fail to take inflation into consideration" and "are unreasonably low."[84] CAI further requested that the $350 limitation on the exception for returned contributions under proposed FINRA Rule 2030(c)(3) be eliminated in both the SEC Pay-to-Play Rule and in FINRA's proposed rule.[85]

As previously discussed, FINRA is required to propose rules that impose substantially equivalent or more stringent restrictions on member firms as the SEC Pay-to-Play Rule imposes on investment advisers. The exceptions for *de minimis* contributions and returned contributions are consistent with similar exceptions in the SEC Pay-to-Play Rule.[86] Thus, FINRA does not believe that raising the limits for the *de minimis* exception or eliminating the limit for returned contributions would satisfy the Commission's requirements.

I. Disgorgement

In Regulatory Notice 14-50, FINRA proposed a "disgorgement" provision that, among other things, would have required that the covered member pay, in the order listed, any compensation or other remuneration received by the covered member pertaining to, or arising from, distribution or solicitation activities during the two-year time out to: (A) a covered investment pool in which the government entity was solicited to invest, as applicable; (B) the government entity; (C) any appropriate entity designated in writing by the government entity if the government entity or covered

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83 See proposed FINRA Rule 2030(c)(1) and (3), respectively.

84 CAI I.

85 See CAI I.

86 See SEC Pay-to-Play Rule 206(4)-5(b).

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. After considering the comments in response to Regulatory Notice 14-50 and, in particular, that FINRA has authority to require disgorgement of fees in enforcement actions, FINRA determined not to include a disgorgement requirement in the proposed rule.

In response to the rule filing, two commenters requested that FINRA include again a mandatory disgorgement provision for violations of its proposed pay-to-play rule.[87] For the reasons discussed in the rule filing and noted above, FINRA has determined not to revise the proposed pay-to-play rule to include a disgorgement requirement.

Proposed Recordkeeping Requirements

CAI claimed that it continues to believe that not all payments to political parties or PACs should have to be maintained under the books and records requirements of proposed FINRA Rule 4580.[88] Instead, CAI believes that only payments to political parties or PACs where the covered member or a covered associate: (i) directs the political party or PAC 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 PAC 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.[89] CAI stated that, while it appreciates FINRA's rationale for proposed FINRA Rule 4580, it believes the costs and burdens associated with the request far outweigh the benefits to FINRA in ensuring compliance with the rule and will lead to periodic "fishing expeditions" by FINRA examiners.[90]

FINRA disagrees and has determined to retain the recordkeeping requirements as proposed in FINRA Rule 4580. As discussed in the rule filing, payments to political parties or PACs can be a means for a covered member or covered associate to funnel contributions to a government official without directly contributing. Thus, FINRA is proposing to require a covered member to maintain a record of all payments to

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87 See PIABA and NASAA.

88 See CAI I.

89 See CAI I.

90 See CAI I.

political parties or PACs as such records would assist FINRA in identifying situations that might suggest an intent to circumvent the rule.

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FINRA believes that the foregoing responds to the material issues raised by the commenters to the rule filing and Order Instituting Proceedings. If you have any questions, please contact me at (202) 728-8104, email: victoria.crane@finra.org. The fax number of the Office of General Counsel is (202) 728-8264.

Best regards,

/s/ Victoria Crane

Victoria Crane
Associate General Counsel