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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No.* SR - 2015 - * 056
Amendment No. (req. for Amendments *)

Filing by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * ☑ Amendment * ☐ Withdrawal ☐

Section 19(b)(2) * ☑ Section 19(b)(3)(A) * ☐ Section 19(b)(3)(B) * ☐

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1) * ☐ Section 806(e)(2) * ☐

Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934

Section 3C(b)(2) * ☐

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to Adopt FINRA Rule 2030 and FINRA Rule 4580 to Establish “Pay-To-Play” and Related Rules

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * Victoria Last Name * Crane
Title * Associate General Counsel
E-mail * victoria.crane@finra.org
Telephone * (202) 728-8104 Fax (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 12/16/2015

By Patrice Gliniecki

(Name *)

(Title *)

Senior Vice President and Deputy General Counsel

Patrice Gliniecki,

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information * Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act," "Act" or "SEA"),[1] Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to adopt FINRA Rules 2030 (Engaging in Distribution and Solicitation Activities with Government Entities)[2] and 4580 (Books and Records Requirements for Government Distribution and Solicitation Activities) to establish "pay-to-play"[3] and related rules that would regulate the activities of member firms that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers**.**

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

At its meeting on February 10, 2010, the FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

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1 15 U.S.C. 78s(b)(1).

2 FINRA published the proposed rule change as FINRA Rule 2390 in Regulatory Notice 14-50 (November 2014) ("Notice"). FINRA has determined that the proposed rule change is more appropriately categorized under the FINRA Rule 2000 Series relating to "Duties and Conflicts."

3 "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.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. FINRA intends to establish an effective date that is no sooner than 180 days following publication of the Regulatory Notice announcing Commission approval of the proposed rule change, and no later than 365 days following Commission approval of the proposed rule change.[4]

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background & Discussion

In July 2010, the SEC adopted Rule 206(4)-5 under the Investment Advisers Act of 1940 ("Advisers Act") addressing pay-to-play practices by investment advisers (the "SEC Pay-to-Play Rule").[5] The SEC Pay-to-Play Rule prohibits an investment adviser from providing advisory services for compensation to a government entity for two years after the adviser or its covered associates make a contribution to an official of the government entity, unless an exception or exemption applies. In addition, it prohibits an investment adviser from soliciting from others, or coordinating, contributions to

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4 See infra Effective Date, for a more detailed discussion regarding the effective date of the proposed rule change.

5 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).

government entity officials or payments to political parties where the adviser is providing or seeking to provide investment advisory services to a government entity.

The SEC Pay-to-Play Rule also 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." 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.[6] The SEC stated that this SEC ban on third party solicitations would be effective nine months after the compliance date of a final rule adopted by the SEC by which municipal advisors must register under the SEA.[7] The SEC adopted such a final rule on September 20, 2013, with a compliance date of July 1, 2014.[8]

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6 See SEC Pay-to-Play Rule 206(4)-5(f)(9). A "regulated person" also includes SEC registered investment advisers and SEC-registered municipal advisors, subject to specified conditions.

7 See Investment Advisers Act Release No. 3418 (June 8, 2012), 77 FR 35263 (June 13, 2012).

8 See Securities Exchange Act Release No. 70462 (September 20, 2013), 78 FR 67468 (November 12, 2013) (Registration of Municipal Advisors). On June 25, 2015, the SEC issued notice of the compliance date for its third party solicitation ban as July 31, 2015. See Investment Advisers Act Release No. 4129 (June 25, 2015), 80 FR 37538 (July 1, 2015). In addition, staff of the Division of Investment Management (the "Division") added Question I.4 to its Staff Responses to Questions About the Pay to Play Rule stating, among other things, that until the later of (i) the effective date of a FINRA pay-to-play rule or (ii) the

Based on this regulatory framework, FINRA is proposing a pay-to-play rule, Rule 2030, modeled on the SEC Pay-to-Play Rule that would impose substantially equivalent restrictions on member firms engaging in distribution or solicitation activities to those the SEC Pay-to-Play Rule imposes on investment advisers. FINRA is also proposing rules that would impose recordkeeping requirements on member firms in connection with political contributions.[9]

The proposed rules would 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. FINRA believes that establishing requirements for member firms that are modeled on the SEC's Pay-to-Play-Rule is a more effective regulatory response to the concerns the SEC identified in the SEC Pay-to-Play Rule Adopting Release regarding third-party solicitations than an outright ban on such activity. For example, in the SEC Pay-to-Play Rule Adopting Release, the SEC

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effective date of an MSRB pay-to-play rule, the Division would not recommend enforcement action to the Commission against an investment adviser or its covered associates under rule 206(4)-5(a)(2)(i) for the payment to any person to solicit a government entity for investment advisory services. See https://www.sec.gov/divisions/investment/pay-to-play-faq.htm. See also infra Effective Date, for a more detailed discussion regarding the effective date of FINRA Rules 2030 and 4580.

9 In connection with the adoption of the SEC Pay-to-Play Rule, the Commission also adopted recordkeeping requirements related to political contributions by investment advisers and their covered associates. See Advisers Act Rule 204-2(a)(18) and (h)(1).

stated that solicitors[10] or "placement agents"[11] have played a central role in actions that it and other authorities have brought involving pay-to-play schemes.[12] The SEC noted that in several instances, advisers allegedly made significant payments to placement agents and other intermediaries to influence the award of advisory contracts.[13] The SEC also acknowledged the difficulties that advisers face in monitoring or controlling the activities of their third-party solicitors.[14] Accordingly, the proposed rules are intended to 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.[15]

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10 "Solicitors" typically locate investment advisory clients on behalf of an investment adviser. See Investment Advisers Act Release No. 2910 (August 3, 2009), 74 FR 39840, 39853 n.137 (August 7, 2009) (Political Contributions by Certain Investment Advisers).

11 "Placement agents" typically specialize in finding investors (often institutional investors or high net worth investors) that are willing and able to invest in a private offering of securities on behalf of the issuer of such privately offered securities. See id.

12 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41037 (discussing the reasons for proposing a ban on using third parties to solicit government business).

13 See id.

14 See id.

15 In response to a request from SEC staff, FINRA previously indicated its intent to prepare rules for consideration by the SEC that would prohibit its member firms from soliciting advisory business from a government entity on behalf of an adviser unless the member firms comply with requirements prohibiting pay-to-play practices. See Letter from Andrew J. Donohue, Director, Division of Investment Management, SEC, to Richard G. Ketchum, Chairman & CEO, FINRA (December 18, 2009), available at http://www.sec.gov/comments/s7-18-09/s71809-252.pdf (requesting whether FINRA would consider adopting a rule preventing pay-to-play activities by registered broker-dealers acting as legitimate placement agents on behalf of investment advisers). See also Letter from Richard

FINRA sought comment on the proposed rule change in the Notice.[16] As discussed further in Item 5 below, commenters were generally supportive of the proposed rule change, but also expressed some concerns. In considering the comments, FINRA has engaged in discussions with SEC staff. In addition, as discussed in Item 4 below, FINRA has engaged in an analysis of the potential economic impacts of the proposed rule change. As a result, FINRA has revised the proposed rule change as published in the Notice. In particular, as discussed in more detail in Item 5, FINRA has determined not to propose a disclosure requirement for government distribution and solicitation activities at this time. In addition, FINRA has determined not to propose a disgorgement requirement as part of the pay-to-play rule. FINRA believes that these revisions will more closely align FINRA's proposed pay-to-play rule with the SEC Pay-to-Play Rule and help reduce cost and compliance burden concerns raised by commenters.

The proposed rule change, as revised in response to comments on the Notice, is set forth in further detail below.

G. Ketchum, Chairman & CEO, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, SEC (March 15, 2010), available at http://www.sec.gov/comments/s7-18-09/s71809-260.pdf (stating "[w]e believe that a regulatory scheme targeting improper pay to play practices by broker-dealers acting on behalf of investment advisers is . . . a viable solution to a ban on certain private placement agents serving a legitimate function").

16 See supra note 2.

Proposed Pay-to-Play Rule

A. Two-Year Time Out

Proposed Rule 2030(a) would prohibit a covered member from engaging in distribution[17] or solicitation[18] 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). As discussed in more detail below, the terms and scope of this prohibition are modeled on the SEC Pay-to-Play Rule.[19]

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17 As discussed in Item 5 below, FINRA is not eliminating the term "distribution" from the proposed rule as suggested by some commenters. Thus, subject to the limitations discussed in Item 5, the proposed rule would apply to covered members engaging in distribution (as well as solicitation) activities with government entities. Specifically, the proposed rule would apply to distribution activities involving unregistered pooled investment vehicles such as hedge funds, private equity funds, venture capital funds, and collective investment trusts, and registered pooled investment vehicles such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.

18 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(11) defines the term "solicit" to mean: "(A) With respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and (B) With respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment." The determination of whether a particular communication would be a solicitation would depend on the facts and circumstances relating to such communication. As a general proposition, any communication made under circumstances reasonably calculated to obtain or retain an advisory client would be considered a solicitation unless the circumstances otherwise indicate that the communication does not have the purpose of obtaining or retaining an advisory client. See also infra note 40.

19 See SEC Pay-to-Play Rule 206(4)-5(a)(1).

The proposed rule would not ban or limit the amount of political contributions a covered member or its covered associates could make. Instead, it 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 make a contribution to an official of the government entity. Consistent with the two-year time out in the SEC Pay-to-Play Rule, the two-year time out in the proposed rule is intended to discourage covered members from participating in pay-to-play practices by requiring a cooling-off period during which the effects of a political contribution on the selection process can be expected to dissipate.

1. Covered Members

Proposed Rule 2030(g)(4) defines a "covered member" to mean "any member except when that member is engaging in activities that would cause the member to be a municipal advisor as defined in Exchange Act Section 15B(e)(4), SEA Rule 15Ba1-1(d)(1) through (4) and other rules and regulations thereunder." As noted above, the SEC Pay-to-Play Rule includes within its definition of "regulated person" SEC-registered municipal advisors, subject to specified conditions.[20] Specifically, the SEC Pay-to-Play Rule prohibits an investment adviser from providing or agreeing to provide, directly or indirectly, payment to an SEC-registered municipal advisor unless the municipal advisor is subject to a Municipal Securities Rulemaking Board ("MSRB") pay-to-play rule.[21]

A member firm that solicits a government entity for investment advisory services on behalf of an *unaffiliated* investment adviser may be required to register with the SEC

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20 See supra note 6.

21 See SEC Pay-to-Play Rule 206(4)-5(a)(2)(i)(A) and 206(4)-5(f)(9).

as a municipal advisor as a result of such activity.[22] Under such circumstances, MSRB rules applicable to municipal advisors, including any pay-to-play rule adopted by the MSRB, would apply to the member firm.[23] On the other hand, if the member firm solicits a government entity on behalf of an *affiliated* investment adviser, such activity would not cause the firm to be a municipal advisor. Under such circumstances, the member firm would be a "covered member" subject to the requirements of proposed Rule 2030.[24]

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[22] See Exchange Act Section 15B(e)(9) and Rule 15Ba1-1(n) thereunder (defining "solicitation of a municipal entity or obligated person" to mean "a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser . . . that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.")

[23] On August 18, 2014, the MSRB issued a Regulatory Notice requesting comment on draft amendments to MSRB Rule G-37, on political contributions made by brokers, dealers and municipal securities dealers and prohibitions on municipal securities business, to extend the rule to cover municipal advisors. See MSRB Regulatory Notice 2014-15 (August 2014). MSRB Rule G-37 was approved by the Commission in 1994 and, since that time, has prohibited brokers, dealers and municipal securities dealers engaging in municipal securities business from participating in pay-to-play practices. See Securities Exchange Act Release No. 33868 (April 7, 1994), 59 FR 17621 (April 13, 1994) (Order Approving File No. SR-MSRB-94-2).

[24] FINRA notes that a person that is registered under the SEA as a broker-dealer and municipal advisor, and under the Advisers Act as an investment adviser could potentially be a "regulated person" for purposes of the SEC Pay-to-Play Rule. Such a regulated person would be subject to the rules that apply to the services the regulated person is performing. See also supra note 23 (noting that brokers, dealers and municipal securities dealers engaging in municipal securities business are subject to MSRB Rule G-37).

2. Investment Advisers

The proposed 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 Section 203(b)(3) of the Advisers Act for foreign private advisers, or that is an exempt reporting adviser under Advisers Act Rule 204-4(a).[25] Thus, it would not apply to member firms acting on behalf of advisers that are registered with state securities authorities instead of the SEC, or advisers that are unregistered in reliance on exemptions other than Section 203(b)(3) of the Advisers Act. The proposed rule's definition of "investment adviser" is consistent with the definition of "investment adviser" in the SEC Pay-to-Play Rule.[26]

3. Official of a Government Entity

An official of a government entity would include an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.[27] Government

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

26 See SEC Pay-to-Play Rule 206(4)-5(a)(1). FINRA notes that, consistent with the SEC Pay-to-Play Rule, the proposed rule would not apply to state-registered investment advisers as few of these smaller firms manage public pension plans or other similar funds. See also infra note 98 and accompanying text.

27 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(8) defines an "official" to mean "any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (A) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (B) Has authority to appoint any

entities would include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b),[28] 457,[29] and 529 plans.[30]

Thus, the two-year time out would be triggered by contributions, not only to elected officials who have legal authority to hire the adviser, but also to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser. As noted in the SEC Pay-to-Play Rule Adopting Release, a person appointed by an elected official is likely to be subject to that official's influences and recommendations. It is the scope of authority of the particular office of an official, not the influence actually exercised by the individual that would determine whether the individual has influence over the awarding of an investment advisory contract under the definition.[31]

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person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity."

[28] A 403(b) plan is a tax-deferred employee benefit retirement plan established under Section 403(b) of the Internal Revenue Code of 1986 (26 U.S.C. 403(b)).

[29] A 457 plan is a tax-deferred employee benefit retirement plan established under Section 457 of the Internal Revenue Code of 1986 (26 U.S.C. 457).

[30] A 529 plan is a "qualified tuition plan" established under Section 529 of the Internal Revenue Code of 1986 (26 U.S.C. 529). Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(6) defines a "government entity" to mean "any state or political subdivision of a state, including: (A) Any agency, authority or instrumentality of the state or political subdivision; (B) A pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including but not limited to a "defined benefit plan" as defined in Section 414(j) of the Internal Revenue Code, or a state general fund; (C) A plan or program of a government entity; and (D) Officers, agents or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity."

[31] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41029 (discussing the terms "official" and "government entity").

4. Contributions

The proposed rule's time out provisions would be triggered by contributions made by a covered member or any of its covered associates. A contribution would include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing the election for a federal, state or local office, including any payments for debts incurred in such an election. It would also include transition or inaugural expenses incurred by a successful candidate for state or local office.[32] Consistent with the SEC Pay-to-Play Rule, FINRA would not consider a donation of time by an individual to be a contribution, provided the covered member has not solicited the individual's efforts and the covered member's resources, such as office space and telephones, are not used.[33] Similarly, FINRA would not consider a charitable donation made by a covered member to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code,[34] or its equivalent in a foreign

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32 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(1) defines a "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."

33 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030. The SEC also noted that a covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the adviser is not otherwise paying the employee's salary (e.g., an unpaid leave of absence). See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030 n.157. FINRA would take a similar position in interpreting the proposed rule.

34 Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. 501(c)(3)) contains a list of charitable organizations that are exempt from Federal income tax.

jurisdiction, at the request of an official of a government entity to be a contribution for purposes of the proposed rule.[35]

5. Covered Associates

As stated in the SEC Pay-to-Play Rule Adopting Release, contributions made to influence the selection process are typically made not by the firm itself, but by officers and employees of the firm who have a direct economic stake in the business relationship with the government client.[36] Accordingly, consistent with the SEC Pay-to-Play Rule, under the proposed rule, contributions by each of these persons, which the proposed rule describes as "covered associates," would trigger the two-year time out.[37]

Contributions by an executive officer of a covered member would trigger the two-year time out. As discussed in Item 5 below, commenters requested that FINRA define the term "executive officer" for purposes of the proposed pay-to-play rule. Accordingly, consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(5) defines an "executive officer of a covered member" to mean: "(A) The president; (B) Any vice

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35 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030 (discussing the scope of the term "contribution" under the SEC Pay-to-Play Rule). Note, however, proposed Rule 2030(e) providing that it shall be a violation of Rule 2030 for any covered member or any of its covered associates to do anything indirectly that, if done directly, would result in a violation of the rule.

36 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41031.

37 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(2) defines a "covered associate" to mean: "(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 of a covered member who supervises, directly or indirectly, the government entity distribution or solicitation activities of a person in subparagraph (B) above; and (D) Any political action committee controlled by a covered member or a covered associate."

president in charge of a principal business unit, division or function (such as sales, administration or finance); (C) Any other officer of the covered member who performs a policy-making function; or (D) Any other person who performs similar policy-making functions for the covered member." Whether a person is an executive officer would depend on his or her function or activities and not his or her title. For example, an officer who is a chief executive of a covered member but whose title does not include "president" would nonetheless be an executive officer for purposes of the proposed rule.

In addition, a covered associate would include a political action committee, or PAC, controlled by the covered member or any of its covered associates as a PAC is often used to make political contributions.[38] Under the proposed rule, FINRA would consider a covered member or its covered associates to have "control" over a PAC if the covered member or covered associate has the ability to direct or cause the direction of governance or operations of the PAC.

6. "Look Back"

Consistent with the SEC Pay-to-Play Rule, the proposed rule would attribute to a covered member contributions made by a person within two years (or, in some cases, six months) of becoming a covered associate. This "look back" would apply to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the proposed rule. A person would become a "covered associate" for purposes of the proposed rule's "look back" provision at the time he or she is hired or promoted to a position that meets the definition of a "covered associate."

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38 See id.

Thus, when an employee becomes a covered associate, the covered member must "look back" in time to that employee's contributions to determine whether the time out applies to the covered member. If, for example, the contributions were made more than two years (or, pursuant to the exception described below for new covered associates, six months) prior to the employee becoming a covered associate, the time out has run. If the contribution was made less than two years (or six months, as applicable) from the time the person becomes a covered associate, the proposed rule would prohibit the covered member that hires or promotes the contributing covered associate from receiving compensation for engaging in distribution or solicitation activities on behalf of an investment adviser from the hiring or promotion date until the two-year period has run.

In no case would the prohibition imposed be longer than two years from the date the covered associate made the contribution. Thus, if, for example, the covered associate becomes employed (and engages in solicitation activities) one year and six months after the contribution was made, the covered member would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. This "look back" provision, which is consistent with the SEC Pay-to-Play Rule, is designed to prevent covered members from circumventing the rule by influencing the selection process by hiring persons who have made political contributions.[39]

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39 Similarly, consistent with the SEC Pay-to-Play Rule, to prevent covered members from channeling contributions through departing employees, covered members must "look forward" with respect to covered associates who cease to qualify as covered associates or leave the firm. The covered associate's employer at the time of the contribution would be subject to the proposed rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate or remains employed by the covered member. Thus, dismissing a covered associate would not relieve the covered member from the two-year time

B. Prohibition on Soliciting and Coordinating Contributions

Proposed Rule 2030(b) would prohibit a covered member or covered associate from coordinating or soliciting[40] any person or 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[41] to a political party of a state or locality of a government entity

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out. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41033 (discussing the "look back" in that rule).

40 Proposed Rule 2030(g)(11)(B) defines the term "solicit" with respect to a contribution or payment as "to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment." This provision is consistent with a similar provision in the SEC Pay-to-Play Rule. See SEC Pay-to-Play Rule 206(4)-5(f)(10)(ii). Consistent with the SEC Pay-to-Play Rule, whether a particular activity involves a solicitation or coordination of a contribution or payment for purposes of the proposed rule would depend on the facts and circumstances. A covered member that consents to the use of its name on fundraising literature for a candidate would be soliciting contributions for that candidate. Similarly, a covered member that sponsors a meeting or conference which features a government official as an attendee or guest speaker and which involves fundraising for the government official would be soliciting contributions for that government official. Expenses incurred by the covered member for hosting the event would be a contribution by the covered member, thereby triggering the two-year ban on the covered member receiving compensation for engaging in distribution or solicitation activities with the government entity over which that official has influence. Such expenses may include, but are not limited to, the cost of the facility, the cost of refreshments, any expenses paid for administrative staff, and the payment or reimbursement of any of the government official's expenses for the event. The de minimis exception under proposed Rule 2030(c)(1) would not be available with respect to these expenses because they would have been incurred by the firm, not by a natural person. See also SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043 n.328, 329 (discussing the term "solicit" with respect to a contribution or payment).

41 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(9) defines the term "payment" to mean "any gift, subscription, loan, advance or deposit of money or anything of value." This definition 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

with which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser. This provision is modeled on a similar provision in the SEC Pay-to-Play Rule[42] and is intended to prevent covered members or covered associates from circumventing the proposed rule's prohibition on direct contributions to certain elected officials such as by "bundling" a large number of small employee contributions to influence an election, or making contributions (or payments) indirectly through a state or local political party.[43]

In addition, as discussed in Item 5 below, in response to a request for clarification from a commenter regarding the application of this provision of the proposed rule, FINRA notes that, consistent with guidance provided by the SEC in connection with SEC Pay-to-Play Rule 206(4)-5(a)(2), a direct contribution to a political party by a covered member or its covered associates would not violate the proposed rule unless the contribution was a means for the covered member 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).

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the purpose of influencing an election). Consistent with the SEC Pay-to-Play Rule, FINRA is including the broader term "payments," as opposed to "contributions," to deter a covered member from circumventing the proposed rule's prohibitions by coordinating indirect contributions to government officials by making payments to political parties. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043 n.331 and accompanying text (discussing a similar approach with respect to restrictions on soliciting and coordinating contributions and payments).

[42] See SEC Pay-to-Play Rule 206(4)-5(a)(2).

[43] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043 (discussing restrictions on soliciting and coordinating contributions and payments).

C. Direct or Indirect Contributions or Solicitations

Proposed Rule 2030(e) further provides that it shall be a violation of Rule 2030 for any covered member or any of its covered associates to do anything indirectly that, if done directly, would result in a violation of the rule. This provision is consistent with a similar provision in the SEC Pay-to-Play Rule[44] and would prevent a covered member or its covered associates from funneling payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the covered member as a means to circumvent the proposed rule.[45] In addition, as discussed in Item 5 below, in response to a request for clarification from a commenter regarding the application of this provision of the proposed rule, FINRA notes that, consistent with guidance provided by the SEC in connection with SEC Pay-to-Play Rule 206(4)-5(d), proposed Rule 2030(e) would require a showing of intent to circumvent the rule in order for such persons to trigger the two-year time out.

D. Covered Investment Pools

Proposed Rule 2030(d)(1) provides that a covered member that engages in distribution or solicitation activities with a government entity on behalf of a covered

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44 See SEC Pay-to-Play Rule 206(4)-5(d).

45 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 (discussing direct and indirect contributions or solicitations). This provision would also cover, for example, situations in which contributions by a covered member are made, directed or funded through a third party with an expectation that, as a result of the contributions, another contribution is likely to be made by a third party to "an official of the government entity," for the benefit of the covered member. Contributions made through gatekeepers thus would be considered to be made "indirectly" for purposes of the rule.

investment pool[46] in which a government entity invests or is solicited to invest shall be treated as though the covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool directly.[47] Proposed Rule 2030(d)(2) 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.[48]

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46 Consistent with the SEC Pay-to-Play Rule, proposed 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." Thus, the definition includes such unregistered pooled investment vehicles as hedge funds, private equity funds, venture capital funds, and collective investment trusts. It also includes registered pooled investment vehicles, such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.

47 Consistent with the SEC Pay-to-Play Rule, under the proposed rule, if a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year time out is made, the covered member must forgo any compensation related to the assets invested or committed by the government entity in the covered investment pool. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41047.

48 As discussed in Item 5 below, FINRA has added proposed Rule 2030(d)(2) in response to comments on the Notice to clarify, for purposes of the proposed rule, the relationship between an investment adviser to a covered investment pool and a government entity that invests in the covered investment pool.

Proposed Rule 2030(d) is modeled on a similar prohibition in the SEC Pay-to-Play Rule[49] and would apply the prohibitions of the proposed rule to situations in which an investment adviser manages assets of a government entity through a hedge fund or other type of pooled investment vehicle. Thus, 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 as a funding vehicle or investment option in a government-sponsored plan, such as a "529 plan."[50]

E. Exceptions and Exemptions

As discussed in more detail below, the proposed rule contains exceptions that are modeled on similar exceptions in the SEC Pay-to-Play Rule for de minimis contributions, new covered associates and returned contributions.[51]

In addition, proposed Rule 2030(f) includes an exemptive provision for covered members that is modeled on the exemptive provision in the SEC Pay-to-Play Rule[52] that would allow covered members to apply to FINRA for an exemption from the proposed rule's two-year time out. Under this provision, FINRA would be able to exempt covered members from the proposed rule's time out requirement where the covered member discovers contributions that would trigger the compensation ban after they have been

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49 See SEC Pay-to-Play Rule 206(4)-5(c).

50 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 (discussing the applicability of the SEC Pay-to-Play Rule to covered investment pools).

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

52 See SEC Pay-to-Play Rule 206(4)-5(e).

made, and when imposition of the prohibition would be unnecessary to achieve the rule's intended purpose. This provision would provide covered members with an additional avenue by which to seek to cure the consequences of an inadvertent violation by the covered member or its covered associates that falls outside the limits of one of the proposed rule's exceptions. In determining whether to grant an exemption, FINRA would take into account the varying facts and circumstances that each application presents.

1. De Minimis Contributions

Proposed Rule 2030(c)(1) would except from the rule's restrictions contributions made by a covered associate that is a natural person to government entity officials for whom the covered associate was entitled to vote[53] at the time of the contributions, provided the contributions do not exceed $350 in the aggregate to any one official per election. If the covered associate was not entitled to vote for the official at the time of the contribution, the contribution must not exceed $150 in the aggregate per election. Consistent with the SEC Pay-to-Play Rule, under both exceptions, primary and general

[53] Consistent with the SEC Pay-to-Play Rule, for purposes of proposed Rule 2030(c)(1), a person would be "entitled to vote" for an official if the person's principal residence is in the locality in which the official seeks election. For example, if a government official is a state governor running for re-election, any covered associate who resides in that state may make a de minimis contribution to the official without causing a ban on the covered member being compensated for engaging in distribution or solicitation activities with that government entity on behalf of an investment adviser. If the government official is running for president, any covered associate in the country would be able to contribute the de minimis amount to the official's presidential campaign. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034 (discussing the applicability in the SEC Pay-to-Play Rule of the exception for de minimis contributions).

elections would be considered separate elections.[54] These exceptions are based on the theory that such contributions are typically made without the intent or ability to influence the selection process of the investment adviser.

2. New Covered Associates

Proposed Rule 2030(c)(2) would provide an exception from the proposed rule's restrictions for covered members if a natural person made a contribution more than six months prior to becoming a covered associate of the covered member unless the covered associate engages in, or seeks to engage in, distribution or solicitation activities with a government entity on behalf of the covered member. This provision is consistent with a similar provision in the SEC Pay-to-Play Rule.[55] As stated in the SEC Pay-to-Play Rule Adopting Release, the potential link between obtaining advisory business and contributions made by an individual prior to his or her becoming a covered associate who is uninvolved in distribution or solicitation activities is likely more attenuated than for a covered associate who engages in distribution or solicitation activities and, therefore, should be subject to a shorter look-back period.[56] This exception is also intended to balance the need for covered members to be able to make hiring decisions with the need to protect against individuals marketing to prospective employers their connections to, or influence over, government entities the employer might be seeking as clients.[57]

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[54] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034.

[55] See SEC Pay-to-Play Rule 206(4)-5(b)(2).

[56] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034 (discussing the applicability of the "look back" in the SEC Pay-to-Play Rule).

[57] See id.

3. Certain Returned Contributions

Proposed Rule 2030(c)(3) would provide an exception from the proposed rule's restrictions for covered members if the restriction is due to a contribution made by a covered associate and: (1) the covered member discovered the contribution within four months of it being made; (2) the contribution was less than $350; and (3) the contribution is returned within 60 days of the discovery of the contribution by the covered member.

Consistent with the SEC Pay-to-Play Rule, this exception would allow a covered member to cure the consequences of an inadvertent political contribution to an official for whom the covered associate is not entitled to vote. As the SEC stated in the SEC Pay-to-Play Rule Adopting Release, the exception is limited to the types of contributions that are less likely to raise pay-to-play concerns.[58] The prompt return of the contribution provides an indication that the contribution would not affect a government entity official's decision to award business. The 60-day limit is designed to give contributors sufficient time to seek the contribution's return, but still require that they do so in a timely manner. In addition, the relatively small amount of the contribution, in conjunction with the other conditions of the exception, suggests that the contribution was unlikely to have been made for the purpose of influencing the selection process. Repeated triggering contributions suggest otherwise. Thus, the proposed rule would provide that covered members with 150 or fewer registered representatives would be able to rely on this exception no more than two times per calendar year. All other covered members would be permitted to rely on this exception no more than three times per calendar year. In addition, a covered member would not be able to rely on an exception more than once

[58] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41035.

with respect to contributions by the same covered associate regardless of the time period. These limitations are consistent with similar provisions in the SEC Pay-to-Play Rule.[59]

Proposed Recordkeeping Requirements

Proposed Rule 4580 would require covered members that engage in distribution or solicitation activities with a government entity on behalf of any investment adviser that provides or is seeking to provide investment advisory services to such government entity to maintain books and records that would allow FINRA to examine for compliance with its pay-to-play rule. This provision is consistent with similar recordkeeping requirements imposed on investment advisers in connection with the SEC Pay-to-Play Rule.[60] The proposed rule would require covered members to maintain a list or other record of:

- the names, titles and business and residence addresses of all covered associates;
- the name and business address of each investment adviser on behalf of which the covered member has engaged in distribution or solicitation activities with a government entity within the past five years (but not prior to the rule's effective date);
- the name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities for

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59 See SEC Pay-to-Play Rule 206(4)-5(b)(3). The SEC Pay-to-Play Rule includes different allowances for larger and smaller investment advisers based on the number of employees they report on Form ADV.

60 See Advisers Act Rule 204-2(a)(18) and (h)(1).

compensation[61] on behalf of an investment adviser, or which are or were investors in any covered investment pool on behalf of which the covered member has engaged in distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool, within the past five years (but not prior to the rule's effective date); and

- 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.

The proposed rule would require that the direct and indirect contributions or payments made by the covered member or any of its covered associates be listed in chronological order and indicate the name and title of each contributor and each recipient of the contribution or payment, as well as the amount and date of each contribution or payment, and whether the contribution was the subject of the exception for returned contributions in proposed Rule 2030.

Effective Date

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval.

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61 As discussed in Item 5 below, FINRA has added "for compensation" to proposed Rule 4580(a)(3) to clarify that, consistent with the SEC recordkeeping requirements, FINRA's proposed recordkeeping requirements would apply only to government entities that become clients.

FINRA intends to establish an effective date that is no sooner than 180 days following publication of the Regulatory Notice announcing Commission approval of the proposed rule change, and no later than 365 days following Commission approval of the proposed rule change. This transition period will provide members firms with time to identify their covered associates and government entity clients and to modify their compliance programs to address new obligations under the rules.

Proposed Rule 2030(a)'s prohibition on 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 is made to the government entity, will not be triggered by contributions made prior to the effective date. Similarly, the prohibition will not apply to contributions made prior to the effective date by new covered associates to which the two years or, as applicable, six months "look back" applies.

As of the effective date, member firms must begin to maintain books and records in compliance with proposed Rule 4580. Members firms will not be required, however, to look back for the five years prior to the effective date of the proposed rule to identify investment advisers and government entity clients in accordance with proposed Rule 4580(a)(2) and (a)(3).

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[62] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote

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[62] 15 U.S.C. 78o-3(b)(6).

just and equitable principles of trade, and, in general, to protect investors and the public interest.

FINRA believes that the proposed rule change establishes a comprehensive regime to allow member firms to continue to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers following the compliance date for the SEC's ban on third party solicitations while deterring member firms from engaging in pay-to-play practices. In the absence of a FINRA pay-to-play rule, covered members will be prohibited from receiving compensation for engaging in distribution and solicitation activities with government entities on behalf of investment advisers. FINRA believes that establishing a pay-to-play rule modeled on the SEC Pay-to-Play Rule is a more effective regulatory response to the concerns identified by the SEC regarding third-party solicitations than an outright ban on such activity. At the same time, FINRA believes that the proposed two-year time out will deter member firms from engaging in pay-to-play practices and, thereby, protect investors and the public interest.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

As discussed above, FINRA published the Notice to request comment on the proposed rule change.[63] The Notice included an analysis of the economic impacts of the proposed rule change and requested comment regarding the analysis. The assessment

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63 See supra note 2.

below includes a summary of the comments received regarding the economic impact of the proposed rule change as set forth in the Notice as well as FINRA's responses to the comments.[64]

Economic Impact Assessment

A. Need for the Rule

As discussed above, 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." 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. Thus, FINRA must propose its own pay-to-play rule to enable member firms to continue to engage in distribution and solicitation activities for compensation with government entities on behalf of investment advisers.

B. Regulatory Objective

The proposed rule change would 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. FINRA aims to enable member

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64 All references to commenters are to comment letters as listed in Exhibit 2b and as further discussed in Item 5 of this filing.

firms to continue to engage in such activities for compensation while at the same time deterring member firms from engaging in pay-to-play practices.

C. Economic Baseline

The baseline used to evaluate the impact of the proposed rule change is the regulatory framework under the SEC Pay-to-Play Rule and the MSRB pay-to-play rules.[65] In the absence of the proposed rules, some member firms currently engaging in distribution or solicitation activities with government entities on behalf of investment advisers may not be able to receive payments from investment advisers for engaging in such activities. Since a "regulated person" also includes SEC-registered investment advisers and SEC-registered municipal advisors that would be subject to MSRB pay-to-play rules, member firms dually-registered with the SEC as investment advisers or municipal advisors may be able to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers.[66]

The member firms that would have to cease their distribution or solicitation activities for compensation with government entities on behalf of investment advisers may bear direct losses as a result of the loss of this business. In addition, the absence of a FINRA pay-to-play rule that the SEC finds by order is substantially equivalent to or more stringent than the SEC Pay-to-Play Rule may impact investment advisers and public pension plans.

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65 See supra note 23 (discussing MSRB Rule G-37).

66 See supra note 24 (noting that a regulated person that is registered under the SEA as a broker-dealer and municipal advisor, and under the Advisers Act as an investment adviser would be subject to the rules that apply to the services the regulated person is performing).

Specifically, without such a rule, there could be a decrease in the number of third-party solicitors which may reduce the competition in the market for solicitation services. Some investment advisers may need to search for and hire new solicitors as a result of the absence of a FINRA pay-to-play rule to continue their solicitation activities. Due to the potentially limited capacity of third-party solicitors, investment advisers may encounter difficulties in retaining solicitors or delays in solicitation services. These changes would likely increase the costs to investment advisers that rely on third-party solicitors to obtain government clients.

To the extent that higher costs may reduce the number of investment advisers competing for government business, public pension plans may face more limited investment opportunities. In such an instance, there may be an opportunity cost to a government entity either as it may not invest its assets optimally, or when seeking capital due to limitations on its access to funding.

C. Economic Impacts

1. Benefits

The proposed rule change would enable member firms to continue to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers within the regulatory boundaries of the proposed rule change. The proposed rule change would prevent a potentially harmful disruption in the member firms' solicitation business, and accordingly may help member firms avoid some of the likely losses associated with the absence of such a rule change. The proposed rule change may also help promote competition by allowing more third-party solicitors to participate in the market for solicitation services, which may in turn reduce costs to investment advisers and improve competition for advisory services.

The proposed rule change is intended to establish a comprehensive regime to allow member firms to continue to engage in distribution or solicitation activities with government entities on behalf of investment advisers while deterring member firms from engaging in pay-to-play practices. FINRA believes the proposed rules would curb fraudulent conduct resulting from pay-to-play practices and, therefore, help promote fair competition in the market and protect public pension funds and investors. FINRA also believes the proposed rules would likely reduce the search costs of government entities and increase their ability to efficiently allocate capital, and thereby would promote capital formation.

2. Costs

FINRA recognizes that covered members that engage in distribution or solicitation activities with government entities on behalf of investment advisers would incur costs to comply with the proposed rules on an initial and ongoing basis. Member firms would need to establish and maintain policies and procedures to monitor contributions the firm and its covered associates make and to ensure compliance with the proposed requirements. In addition, member firms that wish to engage in distribution or solicitation activities with government entities may face hiring constraints as a result of the two-year (or, in some cases, six months) "look back" provision.[67]

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[67] FINRA notes, however, the availability of the exemptive provision in proposed Rule 2030(f) that would allow covered members to apply to FINRA for an exemption from the proposed rule's two-year time out.

The compliance costs would likely vary across member firms based on a number of factors such as the number of covered associates, business models of members firms and the extent to which their compliance procedures are automated, whether the covered member is (or is affiliated with) an investment adviser subject to the SEC Pay-to-Play Rule, and whether the covered member is a registered municipal securities dealer and thus subject to MSRB pay-to-play rules.[68] A small covered member with fewer covered associates may expend fewer resources to comply with the proposed rules than a large covered member. Covered members subject to (or affiliated with entities subject to) the SEC Pay-to-Play Rule or MSRB pay-to-play rules may be able to borrow from or build upon compliance procedures already in place. For example, FINRA estimates that approximately 400 member firms are currently subject to the MSRB pay-to-play rules.

The potential burden arising from compliance costs associated with the proposed rules can be initially gauged from the SEC's cost estimates for the SEC Pay-to-Play Rule. The SEC has estimated that investment advisers would spend between 8 and 250 hours to establish policies and procedures to comply with the SEC Pay-to-Play Rule.[69] The SEC further estimated that ongoing compliance would require between 10 and 1,000 hours annually.[70] The SEC estimated compliance costs for firms of different sizes. The SEC assumed that a "smaller firm" would have fewer than five covered associates that would be subject to the SEC Pay-to-Play Rule, a "medium firm" would have between five and

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68 See supra note 23 (discussing MSRB Rule G-37).

69 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41056.

70 See id.

15 covered associates, and a "larger firm" would have more than 15 covered associates.[71] The SEC estimated that the initial compliance costs associated with the SEC Pay-to-Play Rule would be approximately $2,352 per smaller firm, $29,407 per medium firm, and $58,813 per larger firm.[72] It also estimated that the annual, ongoing compliance expenses would be approximately $2,940 per smaller firm, $117,625 per medium firm, and $235,250 per larger firm.[73]

In addition, the SEC estimated the costs for investment advisers to engage outside legal services to assist in drafting policies and procedures. It estimated that 75 percent of larger advisory firms, 50 percent of medium firms, and 25 percent of smaller firms subject to the SEC Pay-to-Play Rule would engage such services.[74] The estimated cost included fees for approximately 8 hours of outside legal review for a smaller firm, 16 hours for a medium firm and 40 hours for a larger firm, at a rate of $400 per hour.[75]

The SEC estimated that the recordkeeping requirements of the SEC Pay-to-Play Rule would increase an investment adviser's burden by approximately 2 hours per year,[76] which would cost the adviser $118 per year based on the SEC's assumption of a compliance clerk's hourly rate of $59.[77] In addition, the SEC estimated that some small

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[71] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41055.

[72] See supra note 69.

[73] See id.

[74] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41057.

[75] See id.

[76] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41063.

[77] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41061 n.541.

and medium firms would incur one-time start-up costs, on average, of $10,000, and larger firms would incur, on average, $100,000 to establish or enhance current systems to assist in their compliance with the recordkeeping requirements.[78]

In the Notice, FINRA requested comment on the economic impacts of the proposed rule change as set forth in the Notice, including on whether the proposed rule change would impose similar compliance costs on member firms as the SEC estimated for investment advisers. Several commenters raised cost and compliance burden concerns in connection with the disclosure requirements set forth in the Notice, stating among other things, that the disclosure requirements are "overly burdensome and create difficult compliance challenges"[79] and that FINRA's cost estimates in the Notice "do not accurately reflect the true compliance costs associated with the Proposed Rules, and particularly the costs associated with the disclosure requirements . . . ."[80]

Monument Group stated that the vast majority of independent placement agents that would be subject to the proposed rules are small businesses, many of which are minority- or women-owned. Monument Group stated that these firms operate with focused staff and no revenues from other lines of business. Accordingly, Monument Group stated that incremental regulatory requirements that have little impact on larger firms can create significant resource and cost issues for these smaller firms. Specifically, Monument Group stated that the disclosure requirements would place significant and unique burdens on independent third-party private fund placement agents. Another

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78 See supra note 76.

79 Monument Group.

80 SIFMA.

commenter, 3PM, stated that the proposed rule change would add a new and significant burden on small firms in terms of the disclosure and recordkeeping requirements. 3PM also stated that not only would small firms be impacted by cost, but also by their limited personnel resources who would have to take on additional responsibilities to comply with the proposed rule change.

Monument Group requested that FINRA consider the already existing state, municipal and local lobbying registration, disclosure and reporting requirements and pay-to-play regimes in calculating the cost and competitive impact of the proposed rule change. Monument Group stated that the proposed rule change disproportionately affects FINRA-registered placement agents (as compared with other broker-dealers) and has the largest economic and anti-competitive effect on small independent firms.

As discussed above and in more detail in Item 5 below, after considering the comments, FINRA has determined not to propose a disclosure requirement for government distribution and solicitation activities at this time. FINRA believes that this determination will reduce substantially the cost and compliance burden concerns raised by commenters regarding the proposed rule change. FINRA however may consider a disclosure requirement for government distribution and solicitation activities as part of a future rulemaking and would consider the economic impact of any such revised proposed disclosure requirement as part of that rulemaking.

Although FINRA has determined to retain a recordkeeping requirement, FINRA notes that, in response to commenter concerns to the Notice regarding the significant costs associated with maintaining lists of unsuccessful solicitations,[81] FINRA has

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81 See, e.g., 3PM.

modified the proposed rule such that covered members would only be required to maintain lists of government entities that become clients.[82]

Since the scope of the proposed rule after the modifications is substantially equivalent to the SEC Pay-to-Play Rule, FINRA believes that the SEC's cost estimates serve as a reasonable reference for the potential compliance costs on member firms. In response to the question on the costs of engaging outside legal services to assist in drafting policies and procedures to comply with the proposed rule, 3PM estimated that the majority of member firms would spend between $1,500 and $2,500 or approximately five to 10 hours of a professional consultant's time. In addition, 3PM estimated that a member firm would exert approximately 10 to 20 additional hours of compliance oversight in connection with the proposed rule each year. These estimates are slightly lower than the SEC's estimates discussed above.

The proposed rule is not expected to have competitive effects among member firms engaging in distribution or solicitation activities, since all member firms will be subject to the same prohibitions. Moreover, because the restrictions imposed by the proposed rule are substantially equivalent to the restrictions imposed by the SEC Pay-to-Play Rule, the proposed rule is not expected to create an uneven playing field between member firms and investment advisers. There may be a potential impact on the competition between member firms and municipal advisors depending on the differences between the proposed rule and the finalized MSRB rules regulating similar activities of municipal advisors.[83]

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[82] See proposed Rule 4580(a)(3).

[83] See supra note 23.

E. Regulatory Alternatives

Since the SEC requires that FINRA impose "substantially equivalent or more stringent restrictions" on member firms that wish to act as "regulated persons" than the SEC Pay-to-Play Rule imposes on investment advisers, FINRA believes it is appropriate (and achieves the right balance between the costs and benefits) to model the proposed rule change on the SEC Pay-to-Play Rule rather than impose a regulatory alternative, including a more stringent regulatory alternative, on such member firms.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 14-50 (November 2014) ("Notice"). FINRA received 10 comment letters in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached as Exhibit 2b.[84] Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.

Most commenters expressed appreciation or support for FINRA's decision to propose a pay-to-play rule, noting the potential disruption of an SEC ban on third party solicitations if FINRA were not to propose and adopt a pay-to-play rule. The commenters raised, however, a number of concerns with the proposed pay-to-play rule, as well as the related proposed disclosure and recordkeeping requirements. A summary of the comments and FINRA's responses are discussed below.[85]

84 All references to commenters are to the comment letters as listed in Exhibit 2b.

85 Comments that speak to the economic impacts of the proposed rule change are addressed in Item 4 above.

<u>First Amendment Concerns</u>

CCP expressed First Amendment concerns with the proposed rule change. Among other things, CCP raised vagueness and over-breadth concerns with a number of the provisions in the proposed rule change,[86] and asserted that the prohibition on soliciting and coordinating contributions is a "grave infringement of the basic 'right to associate for the purpose of speaking.'"

In light of CCP raising these constitutional concerns, FINRA notes that the proposed pay-to-play rule does not impose any restrictions on making independent expenditures, ban political contributions, or attempt to regulate State and local elections. FINRA acknowledges that the two-year time out provision may affect the propensity of covered members and their covered associates to make political contributions.[87] As discussed in the <u>Notice</u> and as recognized by CCP, however, establishing requirements to regulate the activities of member firms that engage in distribution or solicitation activities with government entities on behalf of investment advisers is a more effective response to the requirements of the SEC Pay-to-Play Rule than an outright ban on such activity. If

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86 <u>See</u> CCP (discussing, among other things, the proposed definitions of the terms "official of a government entity," "solicit" and "contribution," as well as the provision prohibiting any covered member or any of its covered associates from doing anything indirectly that, if done directly, would result in a violation of the proposed pay-to-play rule).

87 CCP requested that FINRA state explicitly whether the proposed rule would permit contributions in support of independent expenditures. FINRA notes that, consistent with the SEC Pay-to-Play Rule, the proposed rule would not in any way impinge on a wide range of expressive conduct in connection with elections. For example, the rule would not impose any restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches, and other conduct. <u>See</u> <u>also</u> SEC Pay-to-Play Adopting Release, 75 FR 41018, 41024 (discussing independent expenditures).

FINRA were not to have a pay-to-play rule, the result would be a ban on member firms soliciting government entities for investment advisory services for compensation on behalf of investment advisers.

Moreover, for an investment adviser and its covered associates to provide or agree to provide, directly or indirectly, payment to a member firm to solicit a government entity for investment advisory services on behalf of the investment adviser, 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 and that FINRA's rule is consistent with the objectives of the SEC Pay-to-Play Rule. CCP suggested alternative approaches to the proposed pay-to-play rule that it argued would be "less restrictive," but FINRA does not believe that CCP's suggested less restrictive alternatives would meet the SEC's requirements. Accordingly, FINRA has crafted its proposal such that it is substantially similar to the SEC's Pay-to-Play Rule.[88]

FINRA notes that the SEC modeled the SEC Pay-to-Play Rule on similarly designed MSRB Rule G-37, which the United States Court of Appeals for the District of Columbia Circuit upheld against a First Amendment challenge in Blount v. SEC.[89] As stated in the SEC Pay-to-Play Rule Adopting Release, the Blount opinion served as an important guidepost in helping the SEC shape the SEC Pay-to-Play Rule.[90] Similar to

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[88] In addition, FINRA notes that, to the extent there are interpretive questions regarding the application and scope of the provisions and terms used in its pay-to-play rule, FINRA will work with the industry to understand the interpretive questions and provide additional guidance where warranted.

[89] 61 F.3d 938 (D.C. Cir. 1995), cert. denied, 517 U.S. 1119 (1996).

[90] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41023.

MSRB Rule G-37 and the SEC Pay-to-Play Rule, FINRA believes it has closely drawn its proposal to accomplish the goal of preventing quid pro quo arrangements while avoiding unnecessary burdens on the protected speech and associational rights of covered members and their covered associates. This analysis is further supported by the Court of Appeals for the District of Columbia Circuit's recent unanimous en banc decision in Wagner v. FEC, which relied on Blount to uphold against a First Amendment challenge a law barring campaign contributions by federal contractors.[91] As detailed below, the proposed rule is closely drawn in terms of the conduct it prohibits, the persons who are subject to its restrictions, and the circumstances in which it is triggered.

Proposed Pay-to-Play Rule

A. Two-Year Time Out

Consistent with the Notice, proposed Rule 2030(a) 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 make a contribution to an official of the government entity. NASAA stated that member firms should be prohibited from engaging in distribution or solicitation activities on behalf of an investment adviser directed at any government entity for a period of four years following any qualifying contribution by the member firm. In addition, NASAA stated that if a member firm has engaged in solicitation or distribution activities with a government entity on behalf of an investment adviser, the member firm should be prohibited from making any qualifying contributions to that

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91 Wagner v. FEC, No. 13-5162, 2015 U.S. App LEXIS 11625 (D.C. Cir. July 7, 2015).

government entity for a period of four years following the conclusion of the solicitation or distribution activities. FINRA has declined to make NASAA's suggested changes. 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.

1. Government Entity

Government entities would include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b),[92] 457,[93] and 529[94] plans. CAI urged FINRA or the SEC to provide additional guidance as to the criteria for determining whether an entity is an "instrumentality" under the proposed rule. CAI noted that its members have struggled to understand the contours of this term in the context of the SEC Pay-to-Play Rule. As stated in the Notice and above, the definition of a "government entity" is consistent with the definition of that term in the SEC Pay-to-Play Rule. The SEC has not provided additional guidance regarding the meaning of the term "instrumentality" in connection with its Rule. Thus, at this time, FINRA declines to provide additional guidance as part of the proposed rule. FINRA recognizes, however, the concerns raised by CAI and will continue to discuss with the industry interpretive questions relating to the proposed rule change.

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92 See supra note 28.

93 See supra note 29.

94 See supra note 30.

2. Solicitation

Consistent with the Notice, the proposed pay-to-play rule defines the term "solicit" to mean, with respect to investment advisory services, "to communicate, directly or indirectly, for the purpose of obtaining or retaining 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."[95] CAI sought confirmation that the proposed rule would 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).

As stated in the Notice and above, the determination of whether a particular communication is a solicitation for investment advisory services or a contribution or payment would be dependent upon the specific facts and circumstances relating to such communication. As a general proposition, if there is no intent to obtain a client for, or refer a client to, an investment adviser (in the context of investment advisory services) or to obtain or arrange a contribution or payment (in the context of contributions to officials of government entities and payments to political parties), FINRA would not consider the communication to be a solicitation.[96]

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95 Proposed Rule 2030(g)(11).

96 See supra notes 18 and 40.

3. 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 Section 203(b)(3) of the Advisers Act for foreign private advisers, or that is an exempt reporting adviser under Advisers Act Rule 204-4(a).[97] NASAA and 3PM suggested that FINRA expand the definition of "investment adviser" to include state-registered investment advisers, stating, among other things, that it would further reduce the disruptions created by pay-to-play schemes. 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. FINRA notes that the SEC declined to make a similar change to its proposed rule, stating that it is their understanding that few of these smaller firms manage public pension plans or other similar funds.[98]

4. Covered Associates/Executive Officers

A "covered associate" includes any general partner, managing member or executive officer of a covered member, or other individual with a similar status or function.[99] SIFMA requested that FINRA define the term "executive officer" for purposes of the proposed rule. Consistent with the SEC Pay-to-Play Rule and for purposes of the FINRA pay-to-play rule only, FINRA has added proposed Rule 2030(g)(5) to define an "executive officer of a covered member" to mean: "(A) The

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

98 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41026.

99 See supra note 37 (defining the term "covered associate").

president; (B) Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance); (C) Any other officer of the covered member who performs a policy-making function; or (D) Any other person who performs similar policy-making functions for the covered member."

A covered associate also would include a PAC controlled by the covered member or any of its covered associates. FSI asserted that the restrictions on PAC contributions, and the definition of "control" with respect to covered associates are vague and potentially over-broad. For example, FSI stated that "[i]t is unclear whether an employee or executive of a member firm that holds a position on a PAC board of directors or other advisory committee would have 'control' of the PAC under the Proposed Rules. It would also cover PACs that are not connected to the employee or executive's member firm." As stated in the Notice and above, FINRA would consider a covered member or its covered associates to have "control" over a PAC if the covered member or covered associate has the ability to direct or cause the direction of governance or operations of the PAC. This position is consistent with the position taken by the SEC in connection with the SEC Pay-to-Play Rule.[100]

5. Distribution

a. Inclusion of Distribution Activities

Consistent with the Notice, proposed Rule 2030(a) 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 makes a contribution to an official of the government entity. Some

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[100] See SEC Pay-to-Play Adopting Release, 75 FR 41018, 41032 (discussing PACs).

commenters questioned the meaning of the term "distribution" in the context of the proposed rule. For example, SIFMA stated that it is their understanding "that the phrase 'distribution and solicitation,' as used in the SEC Pay-to-Play Rule, is interpreted to mean 'the solicitation of investment advisory services.'" CAI stated that "[s]ince 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, [it] strongly recommends that FINRA eliminate each and every reference to the word 'distribution' throughout the Notice and the Proposed Rules . . . . [I]t is not clear what activity the term 'distribution' is meant to cover that is not captured by the term 'solicitation.'"

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."[101] 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.[102] Thus, the SEC Pay-to-Play Rule requires FINRA to have a rule that prohibits member firms from engaging in distribution (as well as solicitation) activities if political contributions have been made.

Language in the SEC Pay-to-Play Rule Adopting Release further supports the inclusion of distribution activities by broker-dealers in a FINRA pay-to-play rule. For example, when discussing comments related to its proposed ban on using third parties to

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[101] See SEC Pay-to-Play Rule 206(4)-5(a)(2).

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

solicit government business, the SEC addressed commenters' concerns that the provision would interfere with traditional distribution arrangements of mutual funds and private funds by broker-dealers, by clarifying under what circumstances distribution payments would violate the SEC's Pay-to-Play Rule.[103]

Based on the SEC's definition of "regulated person" as well as its discussion regarding the treatment of distribution fees paid pursuant to a 12b-1 plan, FINRA believes its proposed rule must apply to member firms engaging in distribution activities. Accordingly, FINRA has not revised the proposed rule to remove references to the term "distribution."[104]

b. Scope of Distribution Activities

ICI requested confirmation that, with respect to mutual funds, the proposed rule would be triggered only when a member firm solicits a government entity to include a mutual fund in a government entity's plan or program and not when the member is selling mutual fund shares to a government entity. FSI asked for clarification with

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[103] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41040 n.298 (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.")

[104] In addition, FINRA notes that many of the concerns raised by commenters in connection with including distribution activities in the proposed rule related to the additional burden associated with the proposed disclosure requirements and such activities. As discussed further below, FINRA has determined not to propose a disclosure rule relating to government distribution and solicitation activities.

respect to the treatment of traditional brokerage activities by a financial advisor as "distribution or solicitation activities" in the context of government entity plans.

As discussed above, the proposed pay-to-play rule would apply to distribution activities by covered members. FINRA notes, however, that based on the definition of a "covered investment pool," the proposed rule would not apply to distribution activities related to registered investment companies that are not investment options of a government entity's plan or program.[105] Thus, the proposed rule would apply to distribution activities involving unregistered pooled investment vehicles such as hedge funds, private equity funds, venture capital funds, and collective investment trusts, and registered pooled investment vehicles such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.[106]

CAI requested clarification that "compensation" in the context of covered investment pools 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 pool." Consistent with the SEC Pay-to-Play

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105 Proposed 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."

106 Although the proposed rule would not apply to distribution activities relating to all registered pooled investment vehicles, FINRA notes the language of proposed Rule 2030(e) that "[i]t shall be a violation of this 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."

Rule, to the extent the mutual fund distribution fees are paid by the fund pursuant to a 12b-1 plan, such payments would not be prohibited under the proposed rule as they would not constitute payments by the fund's investment adviser. If, however, the adviser pays for the fund's distribution out of its "legitimate profits," the proposed rule would generally be implicated.[107] For private funds, third parties are often compensated by the investment adviser or its affiliated general partner. Thus, such payments would be subject to the proposed rule. In addition, FINRA notes that structuring such a payment to come from the private fund for purposes of evading the rule would violate the rule.[108]

B. Prohibitions as Applied to Covered Investment Pools

1. General

In the Notice, proposed Rule 2390(e) (now proposed as Rule 2030(d)) provided that a covered member that engages in distribution or solicitation activities with a government entity on behalf of an investment adviser to a covered investment pool in

107 For a discussion of a mutual fund adviser's ability to use "legitimate profits" for fund distribution, see Investment Company Act of 1940 Release No. 11414 (October 28, 1980), 45 FR 73898 (November 7, 1980) (Bearing of Distribution Expenses by Mutual Funds) (explaining, in the context of the prohibition on the indirect use of fund assets for distribution, unless pursuant to a 12b-1 plan, "[h]owever, under the rule there is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources . . . . Profits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the [Investment Company] Act.").

108 See also SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41040 n.298 and accompanying text. CAI also asked FINRA to consider afresh the SEC's position in its Pay-to-Play Rule that payments originating with an investment adviser should be treated as a payment for solicitation, regardless of the purpose or context for the payment. As discussed above, for purposes of the proposed rule, FINRA is taking a position consistent with the SEC's position in its Pay-to-Play Rule.

which a government entity invests or is solicited to invest shall be treated as though the covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser directly. CAI raised concerns regarding the application of the prohibitions of the proposed rule to covered investment pools stating, among other things, "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." CAI reasoned that "[t]here is no basis for this notion given the [SEC] staff's interpretation in the Mayer Brown no-action letter and the Goldstein case . . . , as well as the lack of any relationship between the selling firm and the investment adviser."[109]

After considering CAI's concerns, FINRA has modified the language of the proposed rule to recognize the relationship between the selling member and the covered

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[109] See Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) and Mayer Brown LLP, SEC No-Action Letter ("Mayer Brown letter"), available at https://www.sec.gov/divisions/investment/noaction/2008/mayerbrown072808-206.htm#P15_323. In Goldstein, the court held that the SEC's "Hedge Fund Rule," which would have given the SEC greater oversight over hedge funds, was invalid because it was arbitrary and in conflict with the purpose of the underlying statute in which the new rule was included. The court concluded that hedge fund investors are not clients of fund advisers for the purpose of the Adviser's Act registration requirement.

In the Mayer Brown letter, SEC staff stated 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 letter distinguishes between a person referring other persons to the adviser where the adviser manages only investment pools and is not seeking to enter into advisory relationships with these other persons (but rather the other persons will be investors or prospective investors in one or more of the investment pools managed by the adviser), versus referring other persons as prospective advisory clients. The letter notes that whether the rule applies will depend on the facts and circumstances.

investment pool, but also to clarify that for purposes of the proposed rule, a covered member engaging in distribution or solicitation activities on behalf of a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though the covered member was engaging in, or seeking to engage in, distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool directly.[110]

As stated in the Notice, proposed Rule 2390(e) (now proposed as Rule 2030(d)) was modeled on a similar provision in the SEC Pay-to-Play Rule, Rule 206(4)-5(c),[111] and was 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.[112] As noted by CAI, however, FINRA recognizes that without a provision corresponding more closely to SEC Pay-to-Play Rule 206(4)-5(c), there is nothing in the proposed rule that deems an investment adviser to a covered investment pool to have a direct investment advisory

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110 See proposed Rule 2030(d).

111 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."

112 In adopting this provision, the SEC noted a commenter's questioning of its authority to apply the rule in the context of covered investment pools in light of the opinion of the Court of Appeals for the District of Columbia Circuit in the Goldstein case. See supra note 109. The SEC 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.

relationship with government entities investing in the pool. CAI noted that: "Without such a provision, proposed rule 2390(e) would not apply the two year time out restriction in proposed rule 2390(a) to advisers to [covered investment pools]. This is because proposed Rule 2390(a) would only apply where an investment adviser 'provides or is seeking to provide investment advisory services to such government entity.'"

Accordingly, FINRA has modified the proposed rule to include proposed Rule 2030(d)(2) that provides that for purposes of the proposed rule "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."

2. Two-Tiered Investment Products

CAI sought confirmation from FINRA that the proposed pay-to-play rule would not apply in the context of two-tiered investment products, such as variable annuities. CAI asserted, among other things, that "[o]rdinarily, 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." CAI requested clarification 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. FINRA notes that the SEC did not exclude specific products from the SEC Pay-to-Play Rule and, therefore, FINRA has determined not to exclude specific products from its proposed rule.

C. Disgorgement

In the Notice, 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 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.

NASAA expressed support for FINRA's inclusion of a disgorgement provision for violations of the proposed rule. Most commenters, however, opposed the requirement.[113] SIFMA stated that "[w]hile disgorgement is the almost universal remedy for violations of various pay-to-play rules, . . . making application of the remedy mandatory could have the deleterious effect of dissuading covered members from voluntary disgorgement of fees where such members discover pay-to-play violations themselves." ICI stated that "including disgorgement as a penalty is not necessary given that the SEC and FINRA both have full authority to require disgorgement of fees, and indeed, disgorgement has been the penalty universally applied (along with additional penalties) in enforcement actions under existing pay-to-play rules, such as MSRB Rule G-37 and SEC Rule 206(4)-5."

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113 See, e.g., SIFMA, CAI and ICI.

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

D. Prohibition on Soliciting and Coordinating Contributions

Consistent with the Notice, proposed Rule 2030(b) would prohibit a covered member or covered associate from coordinating or soliciting any person or 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. As stated in the Notice and above, this provision is modeled on a similar provision in the SEC Pay-to-Play Rule.[114]

CAI sought confirmation that the proposed prohibition on soliciting and coordinating contributions would 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. Similar to guidance provided in the context of SEC Pay-to-Play Rule 206(4)-5(a)(2), FINRA notes that a direct contribution to a political party by a covered member or its covered associates would not violate the proposed rule unless the contribution was a means for the covered member to do indirectly what the rule would prohibit if done directly (for example, if the contribution

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[114] See SEC Pay-to-Play Rule 206(4)-5(a)(2).

was earmarked or known to be provided for the benefit of a particular government official).[115]

E. Direct or Indirect Contributions or Solicitations

Consistent with the Notice, proposed Rule 2030(e) provides that it shall be a violation of the proposed pay-to-play 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 the rule. CAI requested that FINRA incorporate a knowledge and support requirement into this provision of the proposed 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. As stated in the Notice and above, this provision is modeled on SEC Pay-to-Play Rule 206(4)-5(d). Consistent with guidance provided by the SEC in connection with that provision, FINRA has clarified that it would require a showing of intent to circumvent the rule for a covered member or its covered associates funneling payments through a third party to trigger the two-year time out.[116]

F Exceptions

In the Notice, FINRA included exceptions to the prohibition in the proposed pay-to-play rule for de minimis contributions and returned contributions. CAI and CCP stated that they believe that the $350 and $150 de minimis contribution limits are unreasonably low. CAI stated that it believes the $350 amount for returned contributions is unnecessary because “[i]f the contribution is returned as is required under the exception,

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115 See also SEC Pay-to-Play Adopting Release, 75 FR 41018, 41044 n.337.

116 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 n.340.

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."

FINRA has determined not to modify the proposed exceptions. As stated in the Notice and above, the exceptions are modeled on similar exceptions in the SEC Pay-to-Play Rule for de minimis contributions and returned contributions.[117] Moreover, FINRA believes that it is necessary to keep the amounts at the levels as proposed in the Notice to meet the requirement in the SEC Pay-to-Play Rule that the restrictions in FINRA's rule must be substantially equivalent to, or more stringent than, the restrictions in the SEC Pay-to-Play Rule.

Proposed Recordkeeping Requirements

A. Unsuccessful Solicitations

Proposed Rule 4580 would require covered members that engage in distribution or solicitation activities with a government entity on behalf of any investment adviser that provides or is seeking to provide investment advisory services to such government entity to maintain books and records that would allow FINRA to examine for compliance with its proposed pay-to-play rule. SIFMA requested that FINRA not extend the recordkeeping requirements to unsuccessful solicitations where the covered member does not receive compensation because maintaining such records would impose significant costs on covered members with little corresponding benefit.[118]

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

118 See also CAI, 3PM and FSI (requesting that FINRA not apply the proposed recordkeeping requirements to unsuccessful solicitations of government entities).

FINRA intends that the recordkeeping requirements of proposed Rule 4580 be consistent with similar recordkeeping requirements imposed on investment advisers in connection with the SEC Pay-to-Play Rule.[119] The SEC does not require investment advisers to maintain lists of government entities that do not become clients.[120] Accordingly, FINRA has added the term "for compensation" to proposed Rule 4580(a)(3) to clarify that the proposed Rule would not apply to unsuccessful solicitations.

B. Indirect Contributions

Consistent with the Notice, proposed Rule 4580(a)(4) would require a covered member 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, or direct or indirect payments to a political party of a state or political subdivision thereof or to a PAC. 3PM requested that FINRA eliminate the requirement to maintain a list of indirect contributions, arguing that "requiring firms to . . . track and monitor indirect contributions could become extremely time consuming and costly for firms." CAI asserted that not all payments to political parties or PACs should have to be maintained. Instead, CAI stated that only payments to political parties or PACs where the covered member or 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.

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[119] See Advisers Act Rule 204-2(a)(18) and (h)(1).

[120] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41050.

As stated in the Notice and above, the proposed recordkeeping requirements are intended to allow FINRA to examine for compliance with its proposed pay-to-play rule. Thus, the reference to indirect contributions in proposed Rule 4580(a)(4) is intended to include records of contributions or payments a covered member solicits or coordinates another person or PAC to make under proposed Rule 2030(b) (Prohibition on Soliciting and Coordinating Contributions).[121] In addition, 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 political parties or PACs as such records would assist FINRA in identifying situations that might suggest an intent to circumvent the rule.[122]

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[121] This interpretation is consistent with the SEC's interpretation of a similar provision in Advisers Act Rule 204-2(a)(18)(i).

[122] ICI stated that if FINRA applies the requirements of proposed Rule 4580(a)(4) to a member firm holding an omnibus account on behalf of another broker-dealer that solicited a government entity, and the omnibus dealer is unaware of the broker-dealer's solicitation activities, the omnibus dealer will likely be unable to maintain records required by proposed Rule 4580. As a potential way in which to address this concern, ICI referenced an SEC staff no-action relief letter that addresses a similar concern regarding the recordkeeping requirements related to the SEC Pay-to-Play Rule. See ICI referencing Investment Company Institute, SEC No-Action Letter dated September 12, 2011, available at http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204-incoming.pdf. FINRA recognizes the concern raised by ICI and will address interpretive questions as needed regarding the application of the proposed recordkeeping requirements to covered members holding omnibus accounts on behalf of other broker-dealers that engage in distribution or solicitation activities with government entities.

Proposed Disclosure Requirements

In the Notice, FINRA proposed Rule 2271 to require a covered member engaging in distribution or solicitation activities for compensation with a government entity on behalf of one or more investment advisers to make specified disclosures to the government entity regarding each investment adviser. Several commenters raised concerns regarding the proposed disclosure requirements.[123] For example, commenters raised concerns regarding the scope and timing of the disclosure requirements[124] and that the requirements would be duplicative of existing federal and state investor protection-related disclosure requirements.[125] In addition, commenters raised concerns regarding the costs and compliance burdens associated with the proposed disclosure requirements.[126]

After considering the comments, FINRA has determined not to propose a disclosure rule at this time. FINRA will continue to consider whether such a rule would be appropriate. If FINRA determines to propose a disclosure rule at a later date, it would do so pursuant to FINRA's notice and comment rulemaking process.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.[127]

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123 See, e.g., SIFMA, Monument Group, ICI, IAA, FSI, CAI and 3PM.

124 See, e.g., SIFMA, Monument Group, ICI, IAA, CAI and 3PM.

125 See, e.g., SIFMA, Monument Group and FSI.

126 See, e.g., SIFMA, Monument Group and 3PM.

127 15 U.S.C 78s(b)(2).

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

FINRA believes that the proposed rule change would impose substantially equivalent restrictions on member firms engaging in distribution or solicitation activities to those that the SEC Pay-to-Play Rule imposes on investment advisers and that it is consistent with the objectives of the SEC Pay-to-Play Rule.

9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

11. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Regulatory Notice 14-50 (November 2014).

Exhibit 2b. List of commenters in response to Regulatory Notice 14-50 (November 2014).

Exhibit 2c. Comment Letters received in response to Regulatory Notice 14-50 (November 2014).

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2015-056)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2030 and FINRA Rule 4580 to Establish "Pay-To-Play" and Related Rules

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act," "Act" or "SEA")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on , Financial Industry Regulatory Authority, Inc. filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt FINRA Rules 2030 (Engaging in Distribution and Solicitation Activities with Government Entities)[3] and 4580 (Books and Records Requirements for Government Distribution and Solicitation Activities) to establish "pay-to-play"[4] and related rules that would regulate the activities of member firms that engage

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 FINRA published the proposed rule change as FINRA Rule 2390 in Regulatory Notice 14-50 (November 2014) ("Notice"). FINRA has determined that the proposed rule change is more appropriately categorized under the FINRA Rule 2000 Series relating to "Duties and Conflicts."

4 "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

in distribution or solicitation activities for compensation with government entities on behalf of investment advisers.

The text of the proposed rule change is available on FINRA's website at http://www.finra.org, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background & Discussion

In July 2010, the SEC adopted Rule 206(4)-5 under the Investment Advisers Act of 1940 ("Advisers Act") addressing pay-to-play practices by investment advisers (the "SEC Pay-to-Play Rule").[5] The SEC Pay-to-Play Rule prohibits an investment adviser

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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.

5 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

from providing advisory services for compensation to a government entity for two years after the adviser or its covered associates make a contribution to an official of the government entity, unless an exception or exemption applies. In addition, it prohibits an investment adviser from soliciting from others, or coordinating, contributions to government entity officials or payments to political parties where the adviser is providing or seeking to provide investment advisory services to a government entity.

The SEC Pay-to-Play Rule also 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." 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.[6] The SEC stated that this SEC ban on third party solicitations would be effective nine months after the compliance date of a final rule adopted by the SEC by

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Contributions by Certain Investment Advisers; Ban on Third Party Solicitation; Extension of Compliance Date).

6 See SEC Pay-to-Play Rule 206(4)-5(f)(9). A "regulated person" also includes SEC registered investment advisers and SEC-registered municipal advisors, subject to specified conditions.

which municipal advisors must register under the SEA.[7] The SEC adopted such a final rule on September 20, 2013, with a compliance date of July 1, 2014.[8]

Based on this regulatory framework, FINRA is proposing a pay-to-play rule, Rule 2030, modeled on the SEC Pay-to-Play Rule that would impose substantially equivalent restrictions on member firms engaging in distribution or solicitation activities to those the SEC Pay-to-Play Rule imposes on investment advisers. FINRA is also proposing rules that would impose recordkeeping requirements on member firms in connection with political contributions.[9]

The proposed rules would 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. FINRA believes that establishing

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7 See Investment Advisers Act Release No. 3418 (June 8, 2012), 77 FR 35263 (June 13, 2012).

8 See Securities Exchange Act Release No. 70462 (September 20, 2013), 78 FR 67468 (November 12, 2013) (Registration of Municipal Advisors). On June 25, 2015, the SEC issued notice of the compliance date for its third party solicitation ban as July 31, 2015. See Investment Advisers Act Release No. 4129 (June 25, 2015), 80 FR 37538 (July 1, 2015). In addition, staff of the Division of Investment Management (the "Division") added Question I.4 to its Staff Responses to Questions About the Pay to Play Rule stating, among other things, that until the later of (i) the effective date of a FINRA pay-to-play rule or (ii) the effective date of an MSRB pay-to-play rule, the Division would not recommend enforcement action to the Commission against an investment adviser or its covered associates under rule 206(4)-5(a)(2)(i) for the payment to any person to solicit a government entity for investment advisory services. See https://www.sec.gov/divisions/investment/pay-to-play-faq.htm. See also infra Effective Date, for a more detailed discussion regarding the effective date of FINRA Rules 2030 and 4580.

9 In connection with the adoption of the SEC Pay-to-Play Rule, the Commission also adopted recordkeeping requirements related to political contributions by investment advisers and their covered associates. See Advisers Act Rule 204-2(a)(18) and (h)(1).

requirements for member firms that are modeled on the SEC's Pay-to-Play-Rule is a more effective regulatory response to the concerns the SEC identified in the SEC Pay-to-Play Rule Adopting Release regarding third-party solicitations than an outright ban on such activity. For example, in the SEC Pay-to-Play Rule Adopting Release, the SEC stated that solicitors[10] or "placement agents"[11] have played a central role in actions that it and other authorities have brought involving pay-to-play schemes.[12] The SEC noted that in several instances, advisers allegedly made significant payments to placement agents and other intermediaries to influence the award of advisory contracts.[13] The SEC also acknowledged the difficulties that advisers face in monitoring or controlling the activities of their third-party solicitors.[14] Accordingly, the proposed rules are intended to 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.[15]

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10 "Solicitors" typically locate investment advisory clients on behalf of an investment adviser. See Investment Advisers Act Release No. 2910 (August 3, 2009), 74 FR 39840, 39853 n.137 (August 7, 2009) (Political Contributions by Certain Investment Advisers).

11 "Placement agents" typically specialize in finding investors (often institutional investors or high net worth investors) that are willing and able to invest in a private offering of securities on behalf of the issuer of such privately offered securities. See id.

12 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41037 (discussing the reasons for proposing a ban on using third parties to solicit government business).

13 See id.

14 See id.

15 In response to a request from SEC staff, FINRA previously indicated its intent to prepare rules for consideration by the SEC that would prohibit its member firms from soliciting advisory business from a government entity on behalf of an

FINRA sought comment on the proposed rule change in the Notice.[16] As discussed further in Item II.C below, commenters were generally supportive of the proposed rule change, but also expressed some concerns. In considering the comments, FINRA has engaged in discussions with SEC staff. In addition, as discussed in Item II.B below, FINRA has engaged in an analysis of the potential economic impacts of the proposed rule change. As a result, FINRA has revised the proposed rule change as published in the Notice. In particular, as discussed in more detail in Item II.C, FINRA has determined not to propose a disclosure requirement for government distribution and solicitation activities at this time. In addition, FINRA has determined not to propose a disgorgement requirement as part of the pay-to-play rule. FINRA believes that these revisions will more closely align FINRA's proposed pay-to-play rule with the SEC Pay-to-Play Rule and help reduce cost and compliance burden concerns raised by commenters.

The proposed rule change, as revised in response to comments on the Notice, is set forth in further detail below.

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adviser unless the member firms comply with requirements prohibiting pay-to-play practices. See Letter from Andrew J. Donohue, Director, Division of Investment Management, SEC, to Richard G. Ketchum, Chairman & CEO, FINRA (December 18, 2009), available at http://www.sec.gov/comments/s7-18-09/s71809-252.pdf (requesting whether FINRA would consider adopting a rule preventing pay-to-play activities by registered broker-dealers acting as legitimate placement agents on behalf of investment advisers). See also Letter from Richard G. Ketchum, Chairman & CEO, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, SEC (March 15, 2010), available at http://www.sec.gov/comments/s7-18-09/s71809-260.pdf (stating "[w]e believe that a regulatory scheme targeting improper pay to play practices by broker-dealers acting on behalf of investment advisers is . . . a viable solution to a ban on certain private placement agents serving a legitimate function").

16 See supra note 3.

Proposed Pay-to-Play Rule

A. Two-Year Time Out

Proposed Rule 2030(a) would prohibit a covered member from engaging in distribution[17] or solicitation[18] 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). As discussed in more detail below, the terms and scope of this prohibition are modeled on the SEC Pay-to-Play Rule.[19]

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17 As discussed in Item II.C below, FINRA is not eliminating the term "distribution" from the proposed rule as suggested by some commenters. Thus, subject to the limitations discussed in Item II.C, the proposed rule would apply to covered members engaging in distribution (as well as solicitation) activities with government entities. Specifically, the proposed rule would apply to distribution activities involving unregistered pooled investment vehicles such as hedge funds, private equity funds, venture capital funds, and collective investment trusts, and registered pooled investment vehicles such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.

18 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(11) defines the term "solicit" to mean: "(A) With respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and (B) With respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment." The determination of whether a particular communication would be a solicitation would depend on the facts and circumstances relating to such communication. As a general proposition, any communication made under circumstances reasonably calculated to obtain or retain an advisory client would be considered a solicitation unless the circumstances otherwise indicate that the communication does not have the purpose of obtaining or retaining an advisory client. See also infra note 40.

19 See SEC Pay-to-Play Rule 206(4)-5(a)(1).

The proposed rule would not ban or limit the amount of political contributions a covered member or its covered associates could make. Instead, it 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 make a contribution to an official of the government entity. Consistent with the two-year time out in the SEC Pay-to-Play Rule, the two-year time out in the proposed rule is intended to discourage covered members from participating in pay-to-play practices by requiring a cooling-off period during which the effects of a political contribution on the selection process can be expected to dissipate.

1. Covered Members

Proposed Rule 2030(g)(4) defines a "covered member" to mean "any member except when that member is engaging in activities that would cause the member to be a municipal advisor as defined in Exchange Act Section 15B(e)(4), SEA Rule 15Ba1-1(d)(1) through (4) and other rules and regulations thereunder." As noted above, the SEC Pay-to-Play Rule includes within its definition of "regulated person" SEC-registered municipal advisors, subject to specified conditions.[20] Specifically, the SEC Pay-to-Play Rule prohibits an investment adviser from providing or agreeing to provide, directly or indirectly, payment to an SEC-registered municipal advisor unless the municipal advisor is subject to a Municipal Securities Rulemaking Board ("MSRB") pay-to-play rule.[21]

A member firm that solicits a government entity for investment advisory services on behalf of an unaffiliated investment adviser may be required to register with the SEC

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20 See supra note 6.

21 See SEC Pay-to-Play Rule 206(4)-5(a)(2)(i)(A) and 206(4)-5(f)(9).

as a municipal advisor as a result of such activity.[22] Under such circumstances, MSRB rules applicable to municipal advisors, including any pay-to-play rule adopted by the MSRB, would apply to the member firm.[23] On the other hand, if the member firm solicits a government entity on behalf of an affiliated investment adviser, such activity would not cause the firm to be a municipal advisor. Under such circumstances, the member firm would be a "covered member" subject to the requirements of proposed Rule 2030.[24]

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[22] See Exchange Act Section 15B(e)(9) and Rule 15Ba1-1(n) thereunder (defining "solicitation of a municipal entity or obligated person" to mean "a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser . . . that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.")

[23] On August 18, 2014, the MSRB issued a Regulatory Notice requesting comment on draft amendments to MSRB Rule G-37, on political contributions made by brokers, dealers and municipal securities dealers and prohibitions on municipal securities business, to extend the rule to cover municipal advisors. See MSRB Regulatory Notice 2014-15 (August 2014). MSRB Rule G-37 was approved by the Commission in 1994 and, since that time, has prohibited brokers, dealers and municipal securities dealers engaging in municipal securities business from participating in pay-to-play practices. See Securities Exchange Act Release No. 33868 (April 7, 1994), 59 FR 17621 (April 13, 1994) (Order Approving File No. SR-MSRB-94-2).

[24] FINRA notes that a person that is registered under the SEA as a broker-dealer and municipal advisor, and under the Advisers Act as an investment adviser could potentially be a "regulated person" for purposes of the SEC Pay-to-Play Rule. Such a regulated person would be subject to the rules that apply to the services the regulated person is performing. See also supra note 23 (noting that brokers, dealers and municipal securities dealers engaging in municipal securities business are subject to MSRB Rule G-37).

2. Investment Advisers

The proposed 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 Section 203(b)(3) of the Advisers Act for foreign private advisers, or that is an exempt reporting adviser under Advisers Act Rule 204-4(a).[25] Thus, it would not apply to member firms acting on behalf of advisers that are registered with state securities authorities instead of the SEC, or advisers that are unregistered in reliance on exemptions other than Section 203(b)(3) of the Advisers Act. The proposed rule's definition of "investment adviser" is consistent with the definition of "investment adviser" in the SEC Pay-to-Play Rule.[26]

3. Official of a Government Entity

An official of a government entity would include an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.[27] Government

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

26 See SEC Pay-to-Play Rule 206(4)-5(a)(1). FINRA notes that, consistent with the SEC Pay-to-Play Rule, the proposed rule would not apply to state-registered investment advisers as few of these smaller firms manage public pension plans or other similar funds. See also infra note 98 and accompanying text.

27 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(8) defines an "official" to mean "any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (A) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (B) Has authority to appoint any

entities would include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b),[28] 457,[29] and 529 plans.[30]

Thus, the two-year time out would be triggered by contributions, not only to elected officials who have legal authority to hire the adviser, but also to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser. As noted in the SEC Pay-to-Play Rule Adopting Release, a person appointed by an elected official is likely to be subject to that official's influences and recommendations. It is the scope of authority of the particular office of an official, not the influence actually exercised by the individual that would determine whether the individual has influence over the awarding of an investment advisory contract under the definition.[31]

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person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity."

28 A 403(b) plan is a tax-deferred employee benefit retirement plan established under Section 403(b) of the Internal Revenue Code of 1986 (26 U.S.C. 403(b)).

29 A 457 plan is a tax-deferred employee benefit retirement plan established under Section 457 of the Internal Revenue Code of 1986 (26 U.S.C. 457).

30 A 529 plan is a "qualified tuition plan" established under Section 529 of the Internal Revenue Code of 1986 (26 U.S.C. 529). Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(6) defines a "government entity" to mean "any state or political subdivision of a state, including: (A) Any agency, authority or instrumentality of the state or political subdivision; (B) A pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including but not limited to a "defined benefit plan" as defined in Section 414(j) of the Internal Revenue Code, or a state general fund; (C) A plan or program of a government entity; and (D) Officers, agents or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity."

31 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41029 (discussing the terms "official" and "government entity").

4. Contributions

The proposed rule's time out provisions would be triggered by contributions made by a covered member or any of its covered associates. A contribution would include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing the election for a federal, state or local office, including any payments for debts incurred in such an election. It would also include transition or inaugural expenses incurred by a successful candidate for state or local office.[32] Consistent with the SEC Pay-to-Play Rule, FINRA would not consider a donation of time by an individual to be a contribution, provided the covered member has not solicited the individual's efforts and the covered member's resources, such as office space and telephones, are not used.[33] Similarly, FINRA would not consider a charitable donation made by a covered member to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code,[34] or its equivalent in a foreign

[32] Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(1) defines a "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."

[33] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030. The SEC also noted that a covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the adviser is not otherwise paying the employee's salary (e.g., an unpaid leave of absence). See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030 n.157. FINRA would take a similar position in interpreting the proposed rule.

[34] Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. 501(c)(3)) contains a list of charitable organizations that are exempt from Federal income tax.

jurisdiction, at the request of an official of a government entity to be a contribution for purposes of the proposed rule.[35]

5. Covered Associates

As stated in the SEC Pay-to-Play Rule Adopting Release, contributions made to influence the selection process are typically made not by the firm itself, but by officers and employees of the firm who have a direct economic stake in the business relationship with the government client.[36] Accordingly, consistent with the SEC Pay-to-Play Rule, under the proposed rule, contributions by each of these persons, which the proposed rule describes as "covered associates," would trigger the two-year time out.[37]

Contributions by an executive officer of a covered member would trigger the two-year time out. As discussed in Item II.C below, commenters requested that FINRA define the term "executive officer" for purposes of the proposed pay-to-play rule. Accordingly, consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(5) defines an "executive officer of a covered member" to mean: "(A) The president; (B) Any vice

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35 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030 (discussing the scope of the term "contribution" under the SEC Pay-to-Play Rule). Note, however, proposed Rule 2030(e) providing that it shall be a violation of Rule 2030 for any covered member or any of its covered associates to do anything indirectly that, if done directly, would result in a violation of the rule.

36 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41031.

37 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(2) defines a "covered associate" to mean: "(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 of a covered member who supervises, directly or indirectly, the government entity distribution or solicitation activities of a person in subparagraph (B) above; and (D) Any political action committee controlled by a covered member or a covered associate."

president in charge of a principal business unit, division or function (such as sales, administration or finance); (C) Any other officer of the covered member who performs a policy-making function; or (D) Any other person who performs similar policy-making functions for the covered member." Whether a person is an executive officer would depend on his or her function or activities and not his or her title. For example, an officer who is a chief executive of a covered member but whose title does not include "president" would nonetheless be an executive officer for purposes of the proposed rule.

In addition, a covered associate would include a political action committee, or PAC, controlled by the covered member or any of its covered associates as a PAC is often used to make political contributions.[38] Under the proposed rule, FINRA would consider a covered member or its covered associates to have "control" over a PAC if the covered member or covered associate has the ability to direct or cause the direction of governance or operations of the PAC.

6. "Look Back"

Consistent with the SEC Pay-to-Play Rule, the proposed rule would attribute to a covered member contributions made by a person within two years (or, in some cases, six months) of becoming a covered associate. This "look back" would apply to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the proposed rule. A person would become a "covered associate" for purposes of the proposed rule's "look back" provision at the time he or she is hired or promoted to a position that meets the definition of a "covered associate."

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[38] See id.

Thus, when an employee becomes a covered associate, the covered member must "look back" in time to that employee's contributions to determine whether the time out applies to the covered member. If, for example, the contributions were made more than two years (or, pursuant to the exception described below for new covered associates, six months) prior to the employee becoming a covered associate, the time out has run. If the contribution was made less than two years (or six months, as applicable) from the time the person becomes a covered associate, the proposed rule would prohibit the covered member that hires or promotes the contributing covered associate from receiving compensation for engaging in distribution or solicitation activities on behalf of an investment adviser from the hiring or promotion date until the two-year period has run.

In no case would the prohibition imposed be longer than two years from the date the covered associate made the contribution. Thus, if, for example, the covered associate becomes employed (and engages in solicitation activities) one year and six months after the contribution was made, the covered member would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. This "look back" provision, which is consistent with the SEC Pay-to-Play Rule, is designed to prevent covered members from circumventing the rule by influencing the selection process by hiring persons who have made political contributions.[39]

[39] Similarly, consistent with the SEC Pay-to-Play Rule, to prevent covered members from channeling contributions through departing employees, covered members must "look forward" with respect to covered associates who cease to qualify as covered associates or leave the firm. The covered associate's employer at the time of the contribution would be subject to the proposed rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate or remains employed by the covered member. Thus, dismissing a covered associate would not relieve the covered member from the two-year time

B. Prohibition on Soliciting and Coordinating Contributions

Proposed Rule 2030(b) would prohibit a covered member or covered associate from coordinating or soliciting[40] any person or 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[41] to a political party of a state or locality of a government entity

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out. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41033 (discussing the "look back" in that rule).

40 Proposed Rule 2030(g)(11)(B) defines the term "solicit" with respect to a contribution or payment as "to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment." This provision is consistent with a similar provision in the SEC Pay-to-Play Rule. See SEC Pay-to-Play Rule 206(4)-5(f)(10)(ii). Consistent with the SEC Pay-to-Play Rule, whether a particular activity involves a solicitation or coordination of a contribution or payment for purposes of the proposed rule would depend on the facts and circumstances. A covered member that consents to the use of its name on fundraising literature for a candidate would be soliciting contributions for that candidate. Similarly, a covered member that sponsors a meeting or conference which features a government official as an attendee or guest speaker and which involves fundraising for the government official would be soliciting contributions for that government official. Expenses incurred by the covered member for hosting the event would be a contribution by the covered member, thereby triggering the two-year ban on the covered member receiving compensation for engaging in distribution or solicitation activities with the government entity over which that official has influence. Such expenses may include, but are not limited to, the cost of the facility, the cost of refreshments, any expenses paid for administrative staff, and the payment or reimbursement of any of the government official's expenses for the event. The de minimis exception under proposed Rule 2030(c)(1) would not be available with respect to these expenses because they would have been incurred by the firm, not by a natural person. See also SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043 n.328, 329 (discussing the term "solicit" with respect to a contribution or payment).

41 Consistent with the SEC Pay-to-Play Rule, proposed Rule 2030(g)(9) defines the term "payment" to mean "any gift, subscription, loan, advance or deposit of money or anything of value." This definition 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). Consistent with the SEC Pay-to-Play

with which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser. This provision is modeled on a similar provision in the SEC Pay-to-Play Rule[42] and is intended to prevent covered members or covered associates from circumventing the proposed rule's prohibition on direct contributions to certain elected officials such as by "bundling" a large number of small employee contributions to influence an election, or making contributions (or payments) indirectly through a state or local political party.[43]

In addition, as discussed in Item II.C below, in response to a request for clarification from a commenter regarding the application of this provision of the proposed rule, FINRA notes that, consistent with guidance provided by the SEC in connection with SEC Pay-to-Play Rule 206(4)-5(a)(2), a direct contribution to a political party by a covered member or its covered associates would not violate the proposed rule unless the contribution was a means for the covered member 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).

Rule, FINRA is including the broader term "payments," as opposed to "contributions," to deter a covered member from circumventing the proposed rule's prohibitions by coordinating indirect contributions to government officials by making payments to political parties. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043 n.331 and accompanying text (discussing a similar approach with respect to restrictions on soliciting and coordinating contributions and payments).

[42] See SEC Pay-to-Play Rule 206(4)-5(a)(2).

[43] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043 (discussing restrictions on soliciting and coordinating contributions and payments).

C. Direct or Indirect Contributions or Solicitations

Proposed Rule 2030(e) further provides that it shall be a violation of Rule 2030 for any covered member or any of its covered associates to do anything indirectly that, if done directly, would result in a violation of the rule. This provision is consistent with a similar provision in the SEC Pay-to-Play Rule[44] and would prevent a covered member or its covered associates from funneling payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the covered member as a means to circumvent the proposed rule.[45] In addition, as discussed in Item II.C below, in response to a request for clarification from a commenter regarding the application of this provision of the proposed rule, FINRA notes that, consistent with guidance provided by the SEC in connection with SEC Pay-to-Play Rule 206(4)-5(d), proposed Rule 2030(e) would require a showing of intent to circumvent the rule in order for such persons to trigger the two-year time out.

D. Covered Investment Pools

Proposed Rule 2030(d)(1) provides that a covered member that engages in distribution or solicitation activities with a government entity on behalf of a covered

44 See SEC Pay-to-Play Rule 206(4)-5(d).

45 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 (discussing direct and indirect contributions or solicitations). This provision would also cover, for example, situations in which contributions by a covered member are made, directed or funded through a third party with an expectation that, as a result of the contributions, another contribution is likely to be made by a third party to "an official of the government entity," for the benefit of the covered member. Contributions made through gatekeepers thus would be considered to be made "indirectly" for purposes of the rule.

investment pool[46] in which a government entity invests or is solicited to invest shall be treated as though the covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool directly.[47] Proposed Rule 2030(d)(2) 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.[48]

Proposed Rule 2030(d) is modeled on a similar prohibition in the SEC Pay-to-Play Rule[49] and would apply the prohibitions of the proposed rule to situations in which

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46 Consistent with the SEC Pay-to-Play Rule, proposed 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." Thus, the definition includes such unregistered pooled investment vehicles as hedge funds, private equity funds, venture capital funds, and collective investment trusts. It also includes registered pooled investment vehicles, such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.

47 Consistent with the SEC Pay-to-Play Rule, under the proposed rule, if a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year time out is made, the covered member must forgo any compensation related to the assets invested or committed by the government entity in the covered investment pool. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41047.

48 As discussed in Item II.C below, FINRA has added proposed Rule 2030(d)(2) in response to comments on the Notice to clarify, for purposes of the proposed rule, the relationship between an investment adviser to a covered investment pool and a government entity that invests in the covered investment pool.

49 See SEC Pay-to-Play Rule 206(4)-5(c).

an investment adviser manages assets of a government entity through a hedge fund or other type of pooled investment vehicle. Thus, 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 as a funding vehicle or investment option in a government-sponsored plan, such as a "529 plan."[50]

E. Exceptions and Exemptions

As discussed in more detail below, the proposed rule contains exceptions that are modeled on similar exceptions in the SEC Pay-to-Play Rule for de minimis contributions, new covered associates and returned contributions.[51]

In addition, proposed Rule 2030(f) includes an exemptive provision for covered members that is modeled on the exemptive provision in the SEC Pay-to-Play Rule[52] that would allow covered members to apply to FINRA for an exemption from the proposed rule's two-year time out. Under this provision, FINRA would be able to exempt covered members from the proposed rule's time out requirement where the covered member discovers contributions that would trigger the compensation ban after they have been made, and when imposition of the prohibition would be unnecessary to achieve the rule's intended purpose. This provision would provide covered members with an additional avenue by which to seek to cure the consequences of an inadvertent violation by the covered member or its covered associates that falls outside the limits of one of the

50 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 (discussing the applicability of the SEC Pay-to-Play Rule to covered investment pools).

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

52 See SEC Pay-to-Play Rule 206(4)-5(e).

proposed rule's exceptions. In determining whether to grant an exemption, FINRA would take into account the varying facts and circumstances that each application presents.

1. De Minimis Contributions

Proposed Rule 2030(c)(1) would except from the rule's restrictions contributions made by a covered associate that is a natural person to government entity officials for whom the covered associate was entitled to vote[53] at the time of the contributions, provided the contributions do not exceed $350 in the aggregate to any one official per election. If the covered associate was not entitled to vote for the official at the time of the contribution, the contribution must not exceed $150 in the aggregate per election. Consistent with the SEC Pay-to-Play Rule, under both exceptions, primary and general elections would be considered separate elections.[54] These exceptions are based on the theory that such contributions are typically made without the intent or ability to influence the selection process of the investment adviser.

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[53] Consistent with the SEC Pay-to-Play Rule, for purposes of proposed Rule 2030(c)(1), a person would be "entitled to vote" for an official if the person's principal residence is in the locality in which the official seeks election. For example, if a government official is a state governor running for re-election, any covered associate who resides in that state may make a de minimis contribution to the official without causing a ban on the covered member being compensated for engaging in distribution or solicitation activities with that government entity on behalf of an investment adviser. If the government official is running for president, any covered associate in the country would be able to contribute the de minimis amount to the official's presidential campaign. See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034 (discussing the applicability in the SEC Pay-to-Play Rule of the exception for de minimis contributions).

[54] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034.

2. New Covered Associates

Proposed Rule 2030(c)(2) would provide an exception from the proposed rule's restrictions for covered members if a natural person made a contribution more than six months prior to becoming a covered associate of the covered member unless the covered associate engages in, or seeks to engage in, distribution or solicitation activities with a government entity on behalf of the covered member. This provision is consistent with a similar provision in the SEC Pay-to-Play Rule.[55] As stated in the SEC Pay-to-Play Rule Adopting Release, the potential link between obtaining advisory business and contributions made by an individual prior to his or her becoming a covered associate who is uninvolved in distribution or solicitation activities is likely more attenuated than for a covered associate who engages in distribution or solicitation activities and, therefore, should be subject to a shorter look-back period.[56] This exception is also intended to balance the need for covered members to be able to make hiring decisions with the need to protect against individuals marketing to prospective employers their connections to, or influence over, government entities the employer might be seeking as clients.[57]

3. Certain Returned Contributions

Proposed Rule 2030(c)(3) would provide an exception from the proposed rule's restrictions for covered members if the restriction is due to a contribution made by a covered associate and: (1) the covered member discovered the contribution within four

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[55] See SEC Pay-to-Play Rule 206(4)-5(b)(2).

[56] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034 (discussing the applicability of the "look back" in the SEC Pay-to-Play Rule).

[57] See id.

months of it being made; (2) the contribution was less than $350; and (3) the contribution is returned within 60 days of the discovery of the contribution by the covered member.

Consistent with the SEC Pay-to-Play Rule, this exception would allow a covered member to cure the consequences of an inadvertent political contribution to an official for whom the covered associate is not entitled to vote. As the SEC stated in the SEC Pay-to-Play Rule Adopting Release, the exception is limited to the types of contributions that are less likely to raise pay-to-play concerns.[58] The prompt return of the contribution provides an indication that the contribution would not affect a government entity official's decision to award business. The 60-day limit is designed to give contributors sufficient time to seek the contribution's return, but still require that they do so in a timely manner. In addition, the relatively small amount of the contribution, in conjunction with the other conditions of the exception, suggests that the contribution was unlikely to have been made for the purpose of influencing the selection process. Repeated triggering contributions suggest otherwise. Thus, the proposed rule would provide that covered members with 150 or fewer registered representatives would be able to rely on this exception no more than two times per calendar year. All other covered members would be permitted to rely on this exception no more than three times per calendar year. In addition, a covered member would not be able to rely on an exception more than once with respect to contributions by the same covered associate regardless of the time period. These limitations are consistent with similar provisions in the SEC Pay-to-Play Rule.[59]

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[58] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41035.

[59] See SEC Pay-to-Play Rule 206(4)-5(b)(3). The SEC Pay-to-Play Rule includes different allowances for larger and smaller investment advisers based on the number of employees they report on Form ADV.

Proposed Recordkeeping Requirements

Proposed Rule 4580 would require covered members that engage in distribution or solicitation activities with a government entity on behalf of any investment adviser that provides or is seeking to provide investment advisory services to such government entity to maintain books and records that would allow FINRA to examine for compliance with its pay-to-play rule. This provision is consistent with similar recordkeeping requirements imposed on investment advisers in connection with the SEC Pay-to-Play Rule.[60] The proposed rule would require covered members to maintain a list or other record of:

- the names, titles and business and residence addresses of all covered associates;
- the name and business address of each investment adviser on behalf of which the covered member has engaged in distribution or solicitation activities with a government entity within the past five years (but not prior to the rule's effective date);
- the name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities for compensation[61] on behalf of an investment adviser, or which are or were investors in any covered investment pool on behalf of which the covered member has engaged in distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered

60 See Advisers Act Rule 204-2(a)(18) and (h)(1).

61 As discussed in Item II.C below, FINRA has added "for compensation" to proposed Rule 4580(a)(3) to clarify that, consistent with the SEC recordkeeping requirements, FINRA's proposed recordkeeping requirements would apply only to government entities that become clients.

investment pool, within the past five years (but not prior to the rule's effective date); and

- 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.

The proposed rule would require that the direct and indirect contributions or payments made by the covered member or any of its covered associates be listed in chronological order and indicate the name and title of each contributor and each recipient of the contribution or payment, as well as the amount and date of each contribution or payment, and whether the contribution was the subject of the exception for returned contributions in proposed Rule 2030.

Effective Date

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. FINRA intends to establish an effective date that is no sooner than 180 days following publication of the Regulatory Notice announcing Commission approval of the proposed rule change, and no later than 365 days following Commission approval of the proposed rule change. This transition period will provide members firms with time to identify their covered associates and government entity clients and to modify their compliance programs to address new obligations under the rules.

Proposed Rule 2030(a)'s prohibition on 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 is made to the government entity, will not be triggered by contributions made prior to the effective date. Similarly, the prohibition will not apply to contributions made prior to the effective date by new covered associates to which the two years or, as applicable, six months "look back" applies.

As of the effective date, member firms must begin to maintain books and records in compliance with proposed Rule 4580. Members firms will not be required, however, to look back for the five years prior to the effective date of the proposed rule to identify investment advisers and government entity clients in accordance with proposed Rule 4580(a)(2) and (a)(3).

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[62] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

FINRA believes that the proposed rule change establishes a comprehensive regime to allow member firms to continue to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers following the compliance date for the SEC's ban on third party solicitations while

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62 15 U.S.C. 78o-3(b)(6).

deterring member firms from engaging in pay-to-play practices. In the absence of a FINRA pay-to-play rule, covered members will be prohibited from receiving compensation for engaging in distribution and solicitation activities with government entities on behalf of investment advisers. FINRA believes that establishing a pay-to-play rule modeled on the SEC Pay-to-Play Rule is a more effective regulatory response to the concerns identified by the SEC regarding third-party solicitations than an outright ban on such activity. At the same time, FINRA believes that the proposed two-year time out will deter member firms from engaging in pay-to-play practices and, thereby, protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

As discussed above, FINRA published the Notice to request comment on the proposed rule change.[63] The Notice included an analysis of the economic impacts of the proposed rule change and requested comment regarding the analysis. The assessment below includes a summary of the comments received regarding the economic impact of the proposed rule change as set forth in the Notice as well as FINRA's responses to the comments.[64]

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[63] See supra note 3.

[64] All references to commenters are to comment letters as listed in Exhibit 2b and as further discussed in Item II.C of this filing.

Economic Impact Assessment

A. Need for the Rule

As discussed above, 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." 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. Thus, FINRA must propose its own pay-to-play rule to enable member firms to continue to engage in distribution and solicitation activities for compensation with government entities on behalf of investment advisers.

B. Regulatory Objective

The proposed rule change would 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. FINRA aims to enable member firms to continue to engage in such activities for compensation while at the same time deterring member firms from engaging in pay-to-play practices.

C. Economic Baseline

The baseline used to evaluate the impact of the proposed rule change is the regulatory framework under the SEC Pay-to-Play Rule and the MSRB pay-to-play rules.[65] In the absence of the proposed rules, some member firms currently engaging in distribution or solicitation activities with government entities on behalf of investment advisers may not be able to receive payments from investment advisers for engaging in such activities. Since a "regulated person" also includes SEC-registered investment advisers and SEC-registered municipal advisors that would be subject to MSRB pay-to-play rules, member firms dually-registered with the SEC as investment advisers or municipal advisors may be able to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers.[66]

The member firms that would have to cease their distribution or solicitation activities for compensation with government entities on behalf of investment advisers may bear direct losses as a result of the loss of this business. In addition, the absence of a FINRA pay-to-play rule that the SEC finds by order is substantially equivalent to or more stringent than the SEC Pay-to-Play Rule may impact investment advisers and public pension plans.

Specifically, without such a rule, there could be a decrease in the number of third-party solicitors which may reduce the competition in the market for solicitation services. Some investment advisers may need to search for and hire new solicitors as a result of the absence of a FINRA pay-to-play rule to continue their solicitation activities. Due to the potentially limited capacity of third-party solicitors, investment advisers may encounter difficulties in retaining solicitors or delays in solicitation services. These changes would

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[65] See supra note 23 (discussing MSRB Rule G-37).

[66] See supra note 24 (noting that a regulated person that is registered under the SEA as a broker-dealer and municipal advisor, and under the Advisers Act as an investment adviser would be subject to the rules that apply to the services the regulated person is performing).

likely increase the costs to investment advisers that rely on third-party solicitors to obtain government clients.

To the extent that higher costs may reduce the number of investment advisers competing for government business, public pension plans may face more limited investment opportunities. In such an instance, there may be an opportunity cost to a government entity either as it may not invest its assets optimally, or when seeking capital due to limitations on its access to funding.

D. Economic Impacts

1. Benefits

The proposed rule change would enable member firms to continue to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers within the regulatory boundaries of the proposed rule change. The proposed rule change would prevent a potentially harmful disruption in the member firms' solicitation business, and accordingly may help member firms avoid some of the likely losses associated with the absence of such a rule change. The proposed rule change may also help promote competition by allowing more third-party solicitors to participate in the market for solicitation services, which may in turn reduce costs to investment advisers and improve competition for advisory services.

The proposed rule change is intended to establish a comprehensive regime to allow member firms to continue to engage in distribution or solicitation activities with government entities on behalf of investment advisers while deterring member firms from engaging in pay-to-play practices. FINRA believes the proposed rules would curb fraudulent conduct resulting from pay-to-play practices and, therefore, help promote fair competition in the market and protect public pension funds and investors. FINRA also believes the proposed rules would likely reduce the search costs of government entities and increase their ability to efficiently allocate capital, and thereby would promote capital formation.

2. Costs

FINRA recognizes that covered members that engage in distribution or solicitation activities with government entities on behalf of investment advisers would incur costs to comply with the proposed rules on an initial and ongoing basis. Member firms would need to establish and maintain policies and procedures to monitor contributions the firm and its covered associates make and to ensure compliance with the proposed requirements. In addition, member firms that wish to engage in distribution or solicitation activities with government entities may face hiring constraints as a result of the two-year (or, in some cases, six months) "look back" provision.[67]

The compliance costs would likely vary across member firms based on a number of factors such as the number of covered associates, business models of members firms and the extent to which their compliance procedures are automated, whether the covered member is (or is affiliated with) an investment adviser subject to the SEC Pay-to-Play Rule, and whether the covered member is a registered municipal securities dealer and thus subject to MSRB pay-to-play rules.[68] A small covered member with fewer covered associates may expend fewer resources to comply with the proposed rules than a large

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[67] FINRA notes, however, the availability of the exemptive provision in proposed Rule 2030(f) that would allow covered members to apply to FINRA for an exemption from the proposed rule's two-year time out.

[68] See supra note 23 (discussing MSRB Rule G-37).

covered member. Covered members subject to (or affiliated with entities subject to) the SEC Pay-to-Play Rule or MSRB pay-to-play rules may be able to borrow from or build upon compliance procedures already in place. For example, FINRA estimates that approximately 400 member firms are currently subject to the MSRB pay-to-play rules.

The potential burden arising from compliance costs associated with the proposed rules can be initially gauged from the SEC's cost estimates for the SEC Pay-to-Play Rule. The SEC has estimated that investment advisers would spend between 8 and 250 hours to establish policies and procedures to comply with the SEC Pay-to-Play Rule.[69] The SEC further estimated that ongoing compliance would require between 10 and 1,000 hours annually.[70] The SEC estimated compliance costs for firms of different sizes. The SEC assumed that a "smaller firm" would have fewer than five covered associates that would be subject to the SEC Pay-to-Play Rule, a "medium firm" would have between five and 15 covered associates, and a "larger firm" would have more than 15 covered associates.[71] The SEC estimated that the initial compliance costs associated with the SEC Pay-to-Play Rule would be approximately $2,352 per smaller firm, $29,407 per medium firm, and $58,813 per larger firm.[72] It also estimated that the annual, ongoing compliance expenses would be approximately $2,940 per smaller firm, $117,625 per medium firm, and $235,250 per larger firm.[73]

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[69] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41056.

[70] See id.

[71] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41055.

[72] See supra note 69.

[73] See id.

In addition, the SEC estimated the costs for investment advisers to engage outside legal services to assist in drafting policies and procedures. It estimated that 75 percent of larger advisory firms, 50 percent of medium firms, and 25 percent of smaller firms subject to the SEC Pay-to-Play Rule would engage such services.[74] The estimated cost included fees for approximately 8 hours of outside legal review for a smaller firm, 16 hours for a medium firm and 40 hours for a larger firm, at a rate of $400 per hour.[75]

The SEC estimated that the recordkeeping requirements of the SEC Pay-to-Play Rule would increase an investment adviser's burden by approximately 2 hours per year,[76] which would cost the adviser $118 per year based on the SEC's assumption of a compliance clerk's hourly rate of $59.[77] In addition, the SEC estimated that some small and medium firms would incur one-time start-up costs, on average, of $10,000, and larger firms would incur, on average, $100,000 to establish or enhance current systems to assist in their compliance with the recordkeeping requirements.[78]

In the Notice, FINRA requested comment on the economic impacts of the proposed rule change as set forth in the Notice, including on whether the proposed rule change would impose similar compliance costs on member firms as the SEC estimated for investment advisers. Several commenters raised cost and compliance burden concerns in connection with the disclosure requirements set forth in the Notice, stating

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74 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41057.

75 See id.

76 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41063.

77 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41061 n.541.

78 See supra note 76.

among other things, that the disclosure requirements are "overly burdensome and create difficult compliance challenges"[79] and that FINRA's cost estimates in the Notice "do not accurately reflect the true compliance costs associated with the Proposed Rules, and particularly the costs associated with the disclosure requirements . . . ."[80]

Monument Group stated that the vast majority of independent placement agents that would be subject to the proposed rules are small businesses, many of which are minority- or women-owned. Monument Group stated that these firms operate with focused staff and no revenues from other lines of business. Accordingly, Monument Group stated that incremental regulatory requirements that have little impact on larger firms can create significant resource and cost issues for these smaller firms. Specifically, Monument Group stated that the disclosure requirements would place significant and unique burdens on independent third-party private fund placement agents. Another commenter, 3PM, stated that the proposed rule change would add a new and significant burden on small firms in terms of the disclosure and recordkeeping requirements. 3PM also stated that not only would small firms be impacted by cost, but also by their limited personnel resources who would have to take on additional responsibilities to comply with the proposed rule change.

Monument Group requested that FINRA consider the already existing state, municipal and local lobbying registration, disclosure and reporting requirements and pay-to-play regimes in calculating the cost and competitive impact of the proposed rule change. Monument Group stated that the proposed rule change disproportionately affects

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79 Monument Group.

80 SIFMA.

FINRA-registered placement agents (as compared with other broker-dealers) and has the largest economic and anti-competitive effect on small independent firms.

As discussed above and in more detail in Item II.C below, after considering the comments, FINRA has determined not to propose a disclosure requirement for government distribution and solicitation activities at this time. FINRA believes that this determination will reduce substantially the cost and compliance burden concerns raised by commenters regarding the proposed rule change. FINRA however may consider a disclosure requirement for government distribution and solicitation activities as part of a future rulemaking and would consider the economic impact of any such revised proposed disclosure requirement as part of that rulemaking.

Although FINRA has determined to retain a recordkeeping requirement, FINRA notes that, in response to commenter concerns to the Notice regarding the significant costs associated with maintaining lists of unsuccessful solicitations,[81] FINRA has modified the proposed rule such that covered members would only be required to maintain lists of government entities that become clients.[82]

Since the scope of the proposed rule after the modifications is substantially equivalent to the SEC Pay-to-Play Rule, FINRA believes that the SEC's cost estimates serve as a reasonable reference for the potential compliance costs on member firms. In response to the question on the costs of engaging outside legal services to assist in drafting policies and procedures to comply with the proposed rule, 3PM estimated that the majority of member firms would spend between $1,500 and $2,500 or approximately

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81 See, e.g., 3PM.

82 See proposed Rule 4580(a)(3).

five to 10 hours of a professional consultant's time. In addition, 3PM estimated that a member firm would exert approximately 10 to 20 additional hours of compliance oversight in connection with the proposed rule each year. These estimates are slightly lower than the SEC's estimates discussed above.

The proposed rule is not expected to have competitive effects among member firms engaging in distribution or solicitation activities, since all member firms will be subject to the same prohibitions. Moreover, because the restrictions imposed by the proposed rule are substantially equivalent to the restrictions imposed by the SEC Pay-to-Play Rule, the proposed rule is not expected to create an uneven playing field between member firms and investment advisers. There may be a potential impact on the competition between member firms and municipal advisors depending on the differences between the proposed rule and the finalized MSRB rules regulating similar activities of municipal advisors.[83]

E. Regulatory Alternatives

Since the SEC requires that FINRA impose "substantially equivalent or more stringent restrictions" on member firms that wish to act as "regulated persons" than the SEC Pay-to-Play Rule imposes on investment advisers, FINRA believes it is appropriate (and achieves the right balance between the costs and benefits) to model the proposed rule change on the SEC Pay-to-Play Rule rather than impose a regulatory alternative, including a more stringent regulatory alternative, on such member firms.

83 See supra note 23.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 14-50 (November 2014) ("Notice"). FINRA received 10 comment letters in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached as Exhibit 2b.[84] Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.

Most commenters expressed appreciation or support for FINRA's decision to propose a pay-to-play rule, noting the potential disruption of an SEC ban on third party solicitations if FINRA were not to propose and adopt a pay-to-play rule. The commenters raised, however, a number of concerns with the proposed pay-to-play rule, as well as the related proposed disclosure and recordkeeping requirements. A summary of the comments and FINRA's responses are discussed below.[85]

First Amendment Concerns

CCP expressed First Amendment concerns with the proposed rule change. Among other things, CCP raised vagueness and over-breadth concerns with a number of the provisions in the proposed rule change,[86] and asserted that the prohibition on

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[84] All references to commenters are to the comment letters as listed in Exhibit 2b.

[85] Comments that speak to the economic impacts of the proposed rule change are addressed in Item II.B above.

[86] See CCP (discussing, among other things, the proposed definitions of the terms "official of a government entity," "solicit" and "contribution," as well as the provision prohibiting any covered member or any of its covered associates from doing anything indirectly that, if done directly, would result in a violation of the proposed pay-to-play rule).

soliciting and coordinating contributions is a "grave infringement of the basic 'right to associate for the purpose of speaking.'"

In light of CCP raising these constitutional concerns, FINRA notes that the proposed pay-to-play rule does not impose any restrictions on making independent expenditures, ban political contributions, or attempt to regulate State and local elections. FINRA acknowledges that the two-year time out provision may affect the propensity of covered members and their covered associates to make political contributions.[87] As discussed in the Notice and as recognized by CCP, however, establishing requirements to regulate the activities of member firms that engage in distribution or solicitation activities with government entities on behalf of investment advisers is a more effective response to the requirements of the SEC Pay-to-Play Rule than an outright ban on such activity. If FINRA were not to have a pay-to-play rule, the result would be a ban on member firms soliciting government entities for investment advisory services for compensation on behalf of investment advisers.

Moreover, for an investment adviser and its covered associates to provide or agree to provide, directly or indirectly, payment to a member firm to solicit a government entity for investment advisory services on behalf of the investment adviser, 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

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[87] CCP requested that FINRA state explicitly whether the proposed rule would permit contributions in support of independent expenditures. FINRA notes that, consistent with the SEC Pay-to-Play Rule, the proposed rule would not in any way impinge on a wide range of expressive conduct in connection with elections. For example, the rule would not impose any restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches, and other conduct. See also SEC Pay-to-Play Adopting Release, 75 FR 41018, 41024 (discussing independent expenditures).

advisers and that FINRA's rule is consistent with the objectives of the SEC Pay-to-Play Rule. CCP suggested alternative approaches to the proposed pay-to-play rule that it argued would be "less restrictive," but FINRA does not believe that CCP's suggested less restrictive alternatives would meet the SEC's requirements. Accordingly, FINRA has crafted its proposal such that it is substantially similar to the SEC's Pay-to-Play Rule.[88]

FINRA notes that the SEC modeled the SEC Pay-to-Play Rule on similarly designed MSRB Rule G-37, which the United States Court of Appeals for the District of Columbia Circuit upheld against a First Amendment challenge in Blount v. SEC.[89] As stated in the SEC Pay-to-Play Rule Adopting Release, the Blount opinion served as an important guidepost in helping the SEC shape the SEC Pay-to-Play Rule.[90] Similar to MSRB Rule G-37 and the SEC Pay-to-Play Rule, FINRA believes it has closely drawn its proposal to accomplish the goal of preventing quid pro quo arrangements while avoiding unnecessary burdens on the protected speech and associational rights of covered members and their covered associates. This analysis is further supported by the Court of Appeals for the District of Columbia Circuit's recent unanimous en banc decision in Wagner v. FEC, which relied on Blount to uphold against a First Amendment challenge a law barring campaign contributions by federal contractors.[91] As detailed below, the

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[88] In addition, FINRA notes that, to the extent there are interpretive questions regarding the application and scope of the provisions and terms used in its pay-to-play rule, FINRA will work with the industry to understand the interpretive questions and provide additional guidance where warranted.

[89] 61 F.3d 938 (D.C. Cir. 1995), cert. denied, 517 U.S. 1119 (1996).

[90] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41023.

[91] Wagner v. FEC, No. 13-5162, 2015 U.S. App LEXIS 11625 (D.C. Cir. July 7, 2015).

proposed rule is closely drawn in terms of the conduct it prohibits, the persons who are subject to its restrictions, and the circumstances in which it is triggered.

Proposed Pay-to-Play Rule

A. Two-Year Time Out

Consistent with the Notice, proposed Rule 2030(a) 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 make a contribution to an official of the government entity. NASAA stated that member firms should be prohibited from engaging in distribution or solicitation activities on behalf of an investment adviser directed at any government entity for a period of four years following any qualifying contribution by the member firm. In addition, NASAA stated that if a member firm has engaged in solicitation or distribution activities with a government entity on behalf of an investment adviser, the member firm should be prohibited from making any qualifying contributions to that government entity for a period of four years following the conclusion of the solicitation or distribution activities. FINRA has declined to make NASAA's suggested changes. 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.

1. Government Entity

Government entities would include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b),[92] 457,[93] and 529[94] plans. CAI urged FINRA or the SEC to provide additional guidance as to the criteria for determining whether an entity is an "instrumentality" under the proposed rule. CAI noted that its members have struggled to understand the contours of this term in the context of the SEC Pay-to-Play Rule. As stated in the Notice and above, the definition of a "government entity" is consistent with the definition of that term in the SEC Pay-to-Play Rule. The SEC has not provided additional guidance regarding the meaning of the term "instrumentality" in connection with its Rule. Thus, at this time, FINRA declines to provide additional guidance as part of the proposed rule. FINRA recognizes, however, the concerns raised by CAI and will continue to discuss with the industry interpretive questions relating to the proposed rule change.

2. Solicitation

Consistent with the Notice, the proposed pay-to-play rule defines the term "solicit" to mean, with respect to investment advisory services, "to communicate, directly or indirectly, for the purpose of obtaining or retaining 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."[95] CAI sought confirmation that the proposed rule would not apply when a covered member communicates with a third party and has no intent to obtain a client for,

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[92] See supra note 28.

[93] See supra note 29.

[94] See supra note 30.

[95] Proposed Rule 2030(g)(11).

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).

As stated in the Notice and above, the determination of whether a particular communication is a solicitation for investment advisory services or a contribution or payment would be dependent upon the specific facts and circumstances relating to such communication. As a general proposition, if there is no intent to obtain a client for, or refer a client to, an investment adviser (in the context of investment advisory services) or to obtain or arrange a contribution or payment (in the context of contributions to officials of government entities and payments to political parties), FINRA would not consider the communication to be a solicitation.[96]

3. 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 Section 203(b)(3) of the Advisers Act for foreign private advisers, or that is an exempt reporting adviser under Advisers Act Rule 204-4(a).[97] NASAA and 3PM suggested that FINRA expand the definition of "investment adviser" to include state-registered investment advisers, stating, among other things, that it would further reduce the disruptions created by pay-to-play schemes. 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. FINRA notes

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96 See supra notes 18 and 40.

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

that the SEC declined to make a similar change to its proposed rule, stating that it is their understanding that few of these smaller firms manage public pension plans or other similar funds.[98]

4. Covered Associates/Executive Officers

A "covered associate" includes any general partner, managing member or executive officer of a covered member, or other individual with a similar status or function.[99] SIFMA requested that FINRA define the term "executive officer" for purposes of the proposed rule. Consistent with the SEC Pay-to-Play Rule and for purposes of the FINRA pay-to-play rule only, FINRA has added proposed Rule 2030(g)(5) to define an "executive officer of a covered member" to mean: "(A) The president; (B) Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance); (C) Any other officer of the covered member who performs a policy-making function; or (D) Any other person who performs similar policy-making functions for the covered member."

A covered associate also would include a PAC controlled by the covered member or any of its covered associates. FSI asserted that the restrictions on PAC contributions, and the definition of "control" with respect to covered associates are vague and potentially over-broad. For example, FSI stated that "[i]t is unclear whether an employee or executive of a member firm that holds a position on a PAC board of directors or other advisory committee would have 'control' of the PAC under the Proposed Rules. It would also cover PACs that are not connected to the employee or executive's member firm." As

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[98] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41026.

[99] See supra note 37 (defining the term "covered associate").

stated in the Notice and above, FINRA would consider a covered member or its covered associates to have "control" over a PAC if the covered member or covered associate has the ability to direct or cause the direction of governance or operations of the PAC. This position is consistent with the position taken by the SEC in connection with the SEC Pay-to-Play Rule.[100]

5. Distribution

a. Inclusion of Distribution Activities

Consistent with the Notice, proposed Rule 2030(a) 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 makes a contribution to an official of the government entity. Some commenters questioned the meaning of the term "distribution" in the context of the proposed rule. For example, SIFMA stated that it is their understanding "that the phrase 'distribution and solicitation,' as used in the SEC Pay-to-Play Rule, is interpreted to mean 'the solicitation of investment advisory services.'" CAI stated that "[s]ince 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, [it] strongly recommends that FINRA eliminate each and every reference to the word 'distribution' throughout the Notice and the Proposed Rules . . . . [I]t is not clear what activity the term 'distribution' is meant to cover that is not captured by the term 'solicitation.'"

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

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[100] See SEC Pay-to-Play Adopting Release, 75 FR 41018, 41032 (discussing PACs).

person to solicit a government entity for investment advisory services on behalf of the investment adviser unless the person is a "regulated person."[101] 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.[102] Thus, the SEC Pay-to-Play Rule requires FINRA to have a rule that prohibits member firms from engaging in distribution (as well as solicitation) activities if political contributions have been made.

Language in the SEC Pay-to-Play Rule Adopting Release further supports the inclusion of distribution activities by broker-dealers in a FINRA pay-to-play rule. For example, when discussing comments related to its proposed ban on using third parties to solicit government business, the SEC addressed commenters' concerns that the provision would interfere with traditional distribution arrangements of mutual funds and private funds by broker-dealers, by clarifying under what circumstances distribution payments would violate the SEC's Pay-to-Play Rule.[103]

Based on the SEC's definition of "regulated person" as well as its discussion regarding the treatment of distribution fees paid pursuant to a 12b-1 plan, FINRA believes its proposed rule must apply to member firms engaging in distribution activities.

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[101] See SEC Pay-to-Play Rule 206(4)-5(a)(2).

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

[103] See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41040 n.298 (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.")

Accordingly, FINRA has not revised the proposed rule to remove references to the term "distribution."[104]

b. Scope of Distribution Activities

ICI requested confirmation that, with respect to mutual funds, the proposed rule would be triggered only when a member firm solicits a government entity to include a mutual fund in a government entity's plan or program and not when the member is selling mutual fund shares to a government entity. FSI asked for clarification with respect to the treatment of traditional brokerage activities by a financial advisor as "distribution or solicitation activities" in the context of government entity plans.

As discussed above, the proposed pay-to-play rule would apply to distribution activities by covered members. FINRA notes, however, that based on the definition of a "covered investment pool," the proposed rule would not apply to distribution activities related to registered investment companies that are not investment options of a government entity's plan or program.[105] Thus, the proposed rule would apply to distribution activities involving unregistered pooled investment vehicles such as hedge funds, private equity funds, venture capital funds, and collective investment trusts, and registered pooled investment vehicles such as mutual funds, but only if those registered

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[104] In addition, FINRA notes that many of the concerns raised by commenters in connection with including distribution activities in the proposed rule related to the additional burden associated with the proposed disclosure requirements and such activities. As discussed further below, FINRA has determined not to propose a disclosure rule relating to government distribution and solicitation activities.

[105] Proposed 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."

pools are an investment option of a participant-directed plan or program of a government entity.[106]

CAI requested clarification that "compensation" in the context of covered investment pools 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 pool." Consistent with the SEC Pay-to-Play Rule, to the extent the mutual fund distribution fees are paid by the fund pursuant to a 12b-1 plan, such payments would not be prohibited under the proposed rule as they would not constitute payments by the fund's investment adviser. If, however, the adviser pays for the fund's distribution out of its "legitimate profits," the proposed rule would generally be implicated.[107] For private funds, third parties are often compensated by the investment adviser or its affiliated general partner. Thus, such payments would be

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106 Although the proposed rule would not apply to distribution activities relating to all registered pooled investment vehicles, FINRA notes the language of proposed Rule 2030(e) that "[i]t shall be a violation of this 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."

107 For a discussion of a mutual fund adviser's ability to use "legitimate profits" for fund distribution, see Investment Company Act of 1940 Release No. 11414 (October 28, 1980), 45 FR 73898 (November 7, 1980) (Bearing of Distribution Expenses by Mutual Funds) (explaining, in the context of the prohibition on the indirect use of fund assets for distribution, unless pursuant to a 12b-1 plan, "[h]owever, under the rule there is no indirect use of fund assets if an adviser makes distribution related payments out of its own resources . . . . Profits which are legitimate or not excessive are simply those which are derived from an advisory contract which does not result in a breach of fiduciary duty under section 36 of the [Investment Company] Act.").

subject to the proposed rule. In addition, FINRA notes that structuring such a payment to come from the private fund for purposes of evading the rule would violate the rule.[108]

B. Prohibitions as Applied to Covered Investment Pools

1. General

In the Notice, proposed Rule 2390(e) (now proposed as Rule 2030(d)) provided that a covered member that engages in distribution or solicitation activities with a government entity on behalf of an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though the covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser directly. CAI raised concerns regarding the application of the prohibitions of the proposed rule to covered investment pools stating, among other things, "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." CAI reasoned that "[t]here is no basis for this notion given the [SEC] staff's interpretation in the Mayer Brown no-action letter and the Goldstein case . . . , as well as the lack of any relationship between the selling firm and the investment adviser."[109]

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108 See also SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41040 n.298 and accompanying text. CAI also asked FINRA to consider afresh the SEC's position in its Pay-to-Play Rule that payments originating with an investment adviser should be treated as a payment for solicitation, regardless of the purpose or context for the payment. As discussed above, for purposes of the proposed rule, FINRA is taking a position consistent with the SEC's position in its Pay-to-Play Rule.

109 See Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) and Mayer Brown LLP, SEC No-Action Letter ("Mayer Brown letter"), available at https://www.sec.gov/divisions/investment/noaction/2008/mayerbrown072808-206.htm#P15_323. In Goldstein, the court held that the SEC's "Hedge Fund

After considering CAI's concerns, FINRA has modified the language of the proposed rule to recognize the relationship between the selling member and the covered investment pool, but also to clarify that for purposes of the proposed rule, a covered member engaging in distribution or solicitation activities on behalf of a covered investment pool in which a government entity invests or is solicited to invest shall be treated as though the covered member was engaging in, or seeking to engage in, distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool directly.[110]

As stated in the Notice, proposed Rule 2390(e) (now proposed as Rule 2030(d)) was modeled on a similar provision in the SEC Pay-to-Play Rule, Rule 206(4)-5(c),[111]

Rule," which would have given the SEC greater oversight over hedge funds, was invalid because it was arbitrary and in conflict with the purpose of the underlying statute in which the new rule was included. The court concluded that hedge fund investors are not clients of fund advisers for the purpose of the Adviser's Act registration requirement.

In the Mayer Brown letter, SEC staff stated 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 letter distinguishes between a person referring other persons to the adviser where the adviser manages only investment pools and is not seeking to enter into advisory relationships with these other persons (but rather the other persons will be investors or prospective investors in one or more of the investment pools managed by the adviser), versus referring other persons as prospective advisory clients. The letter notes that whether the rule applies will depend on the facts and circumstances.

110 See proposed Rule 2030(d).

111 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."

and was 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.[112] As noted by CAI, however, FINRA recognizes that without a provision corresponding more closely to SEC Pay-to-Play Rule 206(4)-5(c), there is nothing in the proposed rule that deems an investment adviser to a covered investment pool to have a direct investment advisory relationship with government entities investing in the pool. CAI noted that: "Without such a provision, proposed rule 2390(e) would not apply the two year time out restriction in proposed rule 2390(a) to advisers to [covered investment pools]. This is because proposed Rule 2390(a) would only apply where an investment adviser 'provides or is seeking to provide investment advisory services to such government entity.'"

Accordingly, FINRA has modified the proposed rule to include proposed Rule 2030(d)(2) that provides that for purposes of the proposed rule "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."

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112 In adopting this provision, the SEC noted a commenter's questioning of its authority to apply the rule in the context of covered investment pools in light of the opinion of the Court of Appeals for the District of Columbia Circuit in the Goldstein case. See supra note 109. The SEC 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.

2. Two-Tiered Investment Products

CAI sought confirmation from FINRA that the proposed pay-to-play rule would not apply in the context of two-tiered investment products, such as variable annuities. CAI asserted, among other things, that "[o]rdinarily, 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." CAI requested clarification 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. FINRA notes that the SEC did not exclude specific products from the SEC Pay-to-Play Rule and, therefore, FINRA has determined not to exclude specific products from its proposed rule.

C. Disgorgement

In the Notice, 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 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.

NASAA expressed support for FINRA's inclusion of a disgorgement provision for violations of the proposed rule. Most commenters, however, opposed the requirement.[113] SIFMA stated that "[w]hile disgorgement is the almost universal remedy for violations of various pay-to-play rules, . . . making application of the remedy mandatory could have the deleterious effect of dissuading covered members from voluntary disgorgement of fees where such members discover pay-to-play violations themselves." ICI stated that "including disgorgement as a penalty is not necessary given that the SEC and FINRA both have full authority to require disgorgement of fees, and indeed, disgorgement has been the penalty universally applied (along with additional penalties) in enforcement actions under existing pay-to-play rules, such as MSRB Rule G-37 and SEC Rule 206(4)-5."

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

D. Prohibition on Soliciting and Coordinating Contributions

Consistent with the Notice, proposed Rule 2030(b) would prohibit a covered member or covered associate from coordinating or soliciting any person or 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. As stated in

[113] See, e.g., SIFMA, CAI and ICI.

the Notice and above, this provision is modeled on a similar provision in the SEC Pay-to-Play Rule.[114]

CAI sought confirmation that the proposed prohibition on soliciting and coordinating contributions would 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. Similar to guidance provided in the context of SEC Pay-to-Play Rule 206(4)-5(a)(2), FINRA notes that a direct contribution to a political party by a covered member or its covered associates would not violate the proposed rule unless the contribution was a means for the covered member 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).[115]

E. Direct or Indirect Contributions or Solicitations

Consistent with the Notice, proposed Rule 2030(e) provides that it shall be a violation of the proposed pay-to-play 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 the rule. CAI requested that FINRA incorporate a knowledge and support requirement into this provision of the proposed 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. As stated in the Notice and above, this provision is modeled on SEC Pay-to-Play Rule 206(4)-5(d). Consistent with guidance provided by the SEC in

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[114] See SEC Pay-to-Play Rule 206(4)-5(a)(2).

[115] See also SEC Pay-to-Play Adopting Release, 75 FR 41018, 41044 n.337.

connection with that provision, FINRA has clarified that it would require a showing of intent to circumvent the rule for a covered member or its covered associates funneling payments through a third party to trigger the two-year time out.[116]

F. Exceptions

In the Notice, FINRA included exceptions to the prohibition in the proposed pay-to-play rule for de minimis contributions and returned contributions. CAI and CCP stated that they believe that the $350 and $150 de minimis contribution limits are unreasonably low. CAI stated that it believes the $350 amount for returned contributions is unnecessary because "[i]f 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."

FINRA has determined not to modify the proposed exceptions. As stated in the Notice and above, the exceptions are modeled on similar exceptions in the SEC Pay-to-Play Rule for de minimis contributions and returned contributions.[117] Moreover, FINRA believes that it is necessary to keep the amounts at the levels as proposed in the Notice to meet the requirement in the SEC Pay-to-Play Rule that the restrictions in FINRA's rule must be substantially equivalent to, or more stringent than, the restrictions in the SEC Pay-to-Play Rule.

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116 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 n.340.

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

Proposed Recordkeeping Requirements

A. Unsuccessful Solicitations

Proposed Rule 4580 would require covered members that engage in distribution or solicitation activities with a government entity on behalf of any investment adviser that provides or is seeking to provide investment advisory services to such government entity to maintain books and records that would allow FINRA to examine for compliance with its proposed pay-to-play rule. SIFMA requested that FINRA not extend the recordkeeping requirements to unsuccessful solicitations where the covered member does not receive compensation because maintaining such records would impose significant costs on covered members with little corresponding benefit.[118]

FINRA intends that the recordkeeping requirements of proposed Rule 4580 be consistent with similar recordkeeping requirements imposed on investment advisers in connection with the SEC Pay-to-Play Rule.[119] The SEC does not require investment advisers to maintain lists of government entities that do not become clients.[120] Accordingly, FINRA has added the term "for compensation" to proposed Rule 4580(a)(3) to clarify that the proposed Rule would not apply to unsuccessful solicitations.

B. Indirect Contributions

Consistent with the Notice, proposed Rule 4580(a)(4) would require a covered member 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,

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118 See also CAI, 3PM and FSI (requesting that FINRA not apply the proposed recordkeeping requirements to unsuccessful solicitations of government entities).

119 See Advisers Act Rule 204-2(a)(18) and (h)(1).

120 See SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41050.

or direct or indirect payments to a political party of a state or political subdivision thereof or to a PAC. 3PM requested that FINRA eliminate the requirement to maintain a list of indirect contributions, arguing that "requiring firms to . . . track and monitor indirect contributions could become extremely time consuming and costly for firms." CAI asserted that not all payments to political parties or PACs should have to be maintained. Instead, CAI stated that only payments to political parties or PACs where the covered member or 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.

As stated in the Notice and above, the proposed recordkeeping requirements are intended to allow FINRA to examine for compliance with its proposed pay-to-play rule. Thus, the reference to indirect contributions in proposed Rule 4580(a)(4) is intended to include records of contributions or payments a covered member solicits or coordinates another person or PAC to make under proposed Rule 2030(b) (Prohibition on Soliciting and Coordinating Contributions).[121] In addition, 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 political parties or PACs as such

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[121] This interpretation is consistent with the SEC's interpretation of a similar provision in Advisers Act Rule 204-2(a)(18)(i).

records would assist FINRA in identifying situations that might suggest an intent to circumvent the rule.[122]

Proposed Disclosure Requirements

In the Notice, FINRA proposed Rule 2271 to require a covered member engaging in distribution or solicitation activities for compensation with a government entity on behalf of one or more investment advisers to make specified disclosures to the government entity regarding each investment adviser. Several commenters raised concerns regarding the proposed disclosure requirements.[123] For example, commenters raised concerns regarding the scope and timing of the disclosure requirements[124] and that the requirements would be duplicative of existing federal and state investor protection-related disclosure requirements.[125] In addition, commenters raised concerns regarding the

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122 ICI stated that if FINRA applies the requirements of proposed Rule 4580(a)(4) to a member firm holding an omnibus account on behalf of another broker-dealer that solicited a government entity, and the omnibus dealer is unaware of the broker-dealer's solicitation activities, the omnibus dealer will likely be unable to maintain records required by proposed Rule 4580. As a potential way in which to address this concern, ICI referenced an SEC staff no-action relief letter that addresses a similar concern regarding the recordkeeping requirements related to the SEC Pay-to-Play Rule. See ICI referencing Investment Company Institute, SEC No-Action Letter dated September 12, 2011, available at http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204-incoming.pdf. FINRA recognizes the concern raised by ICI and will address interpretive questions as needed regarding the application of the proposed recordkeeping requirements to covered members holding omnibus accounts on behalf of other broker-dealers that engage in distribution or solicitation activities with government entities.

123 See, e.g., SIFMA, Monument Group, ICI, IAA, FSI, CAI and 3PM.

124 See, e.g., SIFMA, Monument Group, ICI, IAA, CAI and 3PM.

125 See, e.g., SIFMA, Monument Group and FSI.

costs and compliance burdens associated with the proposed disclosure requirements.[126]

After considering the comments, FINRA has determined not to propose a disclosure rule at this time. FINRA will continue to consider whether such a rule would be appropriate. If FINRA determines to propose a disclosure rule at a later date, it would do so pursuant to FINRA's notice and comment rulemaking process.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or

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126 See, e.g., SIFMA, Monument Group and 3PM.

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2015-056 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Robert W. Errett, Deputy Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2015-056. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2015-056 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[127]

Robert W. Errett
Deputy Secretary

[127] 17 CFR 200.30-3(a)(12).

Exhibit 2a

Regulatory Notice 14-50

Political Contributions

FINRA Requests Comment on a Proposal to Establish a "Pay-to-Play" Rule

Comment Period Expires: December 15, 2014

Executive Summary

FINRA is requesting comment on a proposal to establish "pay-to-play"[1] and related rules that would regulate the activities of member firms that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers that provide or are seeking to provide investment advisory services to such government entities within two years after a contribution to an official of the government entity is made by the member firm or a covered associate. This proposal responds to Rule 206(4)-5 under the Investment Advisers Act of 1940 (Advisers Act), which includes a provision that, upon its compliance date, will prohibit 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 for investment advisory services on behalf of the investment adviser unless the member firm is subject to a FINRA pay-to-play rule. Specifically, FINRA is seeking comment on three proposed new rules: Rule 2271 (Disclosure Requirement for Government Distribution and Solicitation Activities); Rule 2390 (Engaging in Distribution and Solicitation Activities with Government Entities); and Rule 4580 (Books and Records Requirements for Government Distribution and Solicitation Activities).

The text of the proposed rule can be found at *www.finra.org/notices/14-50*.

Questions concerning this *Notice* should be directed to Victoria L. Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104.

November 2014

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Government Securities
- Legal
- Municipal
- Registered Representatives
- Senior Management

Key Topics

- Disclosure
- Political Contributions
- Recordkeeping

Referenced Rules & Notices

- Advisers Act Rule 204-2
- Advisers Act Rule 204-4
- Advisers Act Rule 206(4)-3
- Advisers Act Rule 206(4)-5
- MSRB Regulatory Notice 2014-15
- MSRB Rule G-37
- SEA Rule 15Ba1-1

FINRA®

Financial Industry Regulatory Authority

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by December 15, 2014.

Comments must be submitted through one of the following methods:

- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

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

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this Notice will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[2]

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).[3]

Background & Discussion

In July 2010, the SEC adopted Advisers Act Rule 206(4)-5 addressing pay-to-play practices by investment advisers (the SEC Pay-to-Play Rule).[4] The SEC Pay-to-Play Rule prohibits an investment adviser from providing advisory services for compensation to a government entity for two years after the adviser or its covered associates make a contribution to an official of the government entity, unless an exception or exemption applies. In addition, it prohibits an investment adviser from soliciting from others, or coordinating, contributions to government entity officials or payments to political parties where the adviser is providing or seeking to provide investment advisory services to a government entity.

The SEC Pay-to-Play Rule also 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." 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 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] This SEC ban on third party solicitations will be effective nine months after the compliance date of a final rule adopted by the SEC by which municipal advisors must register under the SEA.[6] The SEC adopted such a final rule on September 20, 2013, with a compliance date of July 1, 2014.[7]

Based on this regulatory framework, FINRA is proposing a pay-to-play rule, Rule 2390, modeled on the SEC Pay-to-Play Rule that would impose substantially equivalent or more stringent restrictions on member firms engaging in distribution or solicitation activities than the SEC Pay-to-Play Rule imposes on investment advisers. FINRA is also proposing rules that would impose recordkeeping and disclosure requirements on member firms in connection with political contributions.[8]

The proposed rules would 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. FINRA believes that establishing requirements for member firms that are modeled on the SEC's Pay-to-Play-Rule is a more effective regulatory response to the concerns the SEC identified in the SEC Pay-to-Play Rule Adopting Release regarding third-party solicitations than an outright ban on such activity. For example, in the SEC Pay-to-Play Rule Adopting Release, the SEC stated that solicitors[9] or "placement agents"[10] have played a central role in actions that it and other authorities have brought involving pay-to-play schemes.[11] The SEC noted that in several instances, advisers allegedly made significant payments to placement agents and other intermediaries in order to influence the award of advisory contracts.[12] The SEC also acknowledged the difficulties that advisers face in monitoring or controlling the activities of their third-party solicitors.[13] Accordingly, the proposed rules are intended to 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.[14]

Proposed Pay-to-Play Rule

A. Two-Year Time Out

Proposed Rule 2390(a) would prohibit a covered member from engaging in distribution or solicitation[15] 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 the two years after the contribution is made). As discussed in more detail below, the terms and scope of this prohibition are modeled on the SEC Pay-to-Play Rule.[16]

The proposed rule would not ban or limit the amount of political contributions a covered member or its covered associates could make. Instead, it 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 make a contribution to an official of the government entity. Consistent with the two-year time out in the SEC Pay-to-Play Rule, the two-year time out in the proposed rule is intended to discourage covered members from participating in pay-to-play practices by requiring a cooling-off period during which the effects of a political contribution on the selection process can be expected to dissipate.

1. Covered Members

Proposed Rule 2390(h)(4) defines a "covered member" to mean "any member except when that member is engaging in activities that would cause the member to be a municipal advisor as defined in Exchange Act Section 15B(e)(4), SEA Rule 15Ba1-1(d)(1) through (4) and other rules and regulations thereunder." As noted above, the SEC Pay-to-Play Rule includes within its definition of "regulated person" SEC-registered municipal advisors, subject to specified conditions.[17] Specifically, the SEC Pay-to-Play Rule prohibits an investment adviser from providing or agreeing to provide, directly or indirectly, payment to an SEC-registered municipal advisor unless the municipal advisor is subject to a Municipal Securities Rulemaking Board (MSRB) pay-to-play rule.[18]

A member firm that solicits a government entity for investment advisory services on behalf of an unaffiliated investment adviser may be required to register with the SEC as a municipal advisor as a result of such activity.[19] Under such circumstances, MSRB rules applicable to municipal advisors, including any pay-to-play rule adopted by the MSRB, would apply to the member firm.[20] On the other hand, if the member firm solicits a government entity on behalf of an affiliated investment adviser, such activity would not cause the firm to be a municipal advisor. Under such circumstances, the member firm would be a "covered member" subject to the requirements of the proposed rule.[21]

2. Investment Advisers

The proposed 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 Section 203(b)(3) of the Advisers Act for foreign private advisers, or that is an exempt reporting adviser under Advisers Act Rule 204-4(a).[22] The proposed rule's definition of "investment adviser" is consistent with the definition of "investment adviser" in the SEC Pay-to-Play Rule.[23] Thus, it would not apply to member firms acting on behalf of advisers that are registered with state securities authorities instead of the SEC, or advisers that are unregistered in reliance on exemptions other than Section 203(b)(3) of the Advisers Act.

3. Official of a Government Entity

An official of a government entity would include an incumbent, candidate or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser.[24] Government entities would include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds, including participant-directed plans such as 403(b),[25] 457,[26] and 529 plans.[27]

Thus, the two-year time out would be triggered by contributions, not only to elected officials who have legal authority to hire the adviser, but also to elected officials (such as persons with appointment authority) who can influence the hiring of the adviser. As noted in the SEC Pay-to-Play Rule Adopting Release, a person appointed by an elected official is likely to be subject to that official's influences and recommendations. It is the scope of authority of the particular office of an official, not the influence actually exercised by the individual that would determine whether the individual has influence over the awarding of an investment advisory contract under the definition.[28]

4. Contributions

The proposed rule's time out provisions would be triggered by contributions made by a covered member or any of its covered associates. A contribution would include a gift, subscription, loan, advance, deposit of money, or anything of value made for the purpose of influencing the election for a federal, state or local office, including any payments for debts incurred in such an election. It would also include transition or inaugural expenses incurred by a successful candidate for state or local office.[29] Consistent with the SEC Pay-to-Play Rule, FINRA would not consider a donation of time by an individual to be a contribution, provided the covered member has not solicited the individual's efforts and the covered member's resources, such as office space and telephones, are not used.[30] Similarly, FINRA would not consider a charitable donation made by a covered member to an organization that qualifies for an exemption from federal taxation under the Internal Revenue Code,[31] or its equivalent in a foreign jurisdiction, at the request of an official of a government entity to be a contribution for purposes of the proposed rule.[32]

5. **Covered Associates**

As stated in the SEC Pay-to-Play Rule Adopting Release, contributions made to influence the selection process are typically made not by the firm itself, but by officers and employees of the firm who have a direct economic stake in the business relationship with the government client.[33] Accordingly, consistent with the SEC Pay-to-Play Rule, under the proposed rule, contributions by each of these persons, which the proposed rule describes as "covered associates," would trigger the two-year time out.[34]

In addition, a covered associate would include a political action committee, or PAC, controlled by the covered member or any of its covered associates as a PAC is often used to make political contributions.[35] Under the proposed rule, FINRA would consider a covered member or its covered associates to have "control" over a PAC if the covered member or covered associate has the ability to direct or cause the direction of governance or operations of the PAC.

6. **"Look Back"**

Consistent with the SEC Pay-to-Play Rule, the proposed rule would attribute to a covered member contributions made by a person within two years (or, in some cases, six months) of becoming a covered associate. This "look back" would apply to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the proposed rule. A person would become a "covered associate" for purposes of the proposed rule's "look back" provision at the time he or she is hired or promoted to a position that meets the definition of a "covered associate."

Thus, when an employee becomes a covered associate, the covered member must "look back" in time to that employee's contributions to determine whether the time out applies to the covered member. If, for example, the contributions were made more than two years (or, pursuant to the exception described below for new covered associates, six months) prior to the employee becoming a covered associate, the time out has run. If the contribution was made less than two years (or six months, as applicable) from the time the person becomes a covered associate, the proposed rule would prohibit the covered member that hires or promotes the contributing covered associate from receiving compensation for engaging in distribution or solicitation activities from the hiring or promotion date until the two-year period has run.

In no case would the prohibition imposed be longer than two years from the date the covered associate made the contribution. Thus, if, for example, the covered associate becomes employed (and engages in solicitation activities) one year and six months after the contribution was made, the covered member would be subject to the proposed rule's prohibition for the remaining six months of the two-year period. This "look back" provision, which is consistent with the SEC Pay-to-Play Rule, is designed to prevent covered members from circumventing the rule by influencing the selection process by hiring persons who have made political contributions.[36]

B. Disgorgement

If a covered member engages in distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser within two years after a political contribution has been made to an official of the government entity, proposed Rule 2390(b)(1) would make clear that the covered member cannot receive any compensation or other remuneration pertaining to, or arising from, the distribution or solicitation activities from the investment adviser, a covered investment pool advised by the adviser or the government entity.

In addition, proposed Rule 2390(b)(2) would require 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 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. Proposed Rule 2390(b)(3) would prohibit covered members from entering into arrangements with an investment adviser or government entity to recoup the disgorged compensation or other remuneration.

Although the SEC Pay-to-Play Rule does not include a similar "disgorgement" requirement, FINRA believes that such a requirement is appropriate for a violation of its pay-to-play rule and as a means to further discourage pay-to-play practices. In addition, FINRA notes that this disgorgement requirement would be in addition to any other sanctions that may be imposed for a violation of its pay-to-play rule.

C. Prohibition on Soliciting and Coordinating Contributions

Proposed Rule 2390(c) would prohibit a covered member or covered associate from coordinating or soliciting[37] any person or 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[38] 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. This provision is modeled on a similar provision in the SEC Pay-to-Play Rule[39] and is intended to prevent covered members or covered associates from circumventing the proposed rule's prohibition on direct contributions to certain elected officials such as by "bundling" a large number of small employee contributions to influence an election, or making contributions (or payments) indirectly through a state or local political party.[40]

D. Direct or Indirect Contributions or Solicitations

Proposed Rule 2390(f) further provides that it shall be a violation of Rule 2390 for any covered member or any of its covered associates to do anything that, if done directly, would result in a violation of the rule. This provision is consistent with a similar provision in the SEC Pay-to-Play Rule[41] and would prevent a covered member or its covered associates from funneling payments through third parties, including, for example, consultants, attorneys, family members, friends or companies affiliated with the covered member as a means to circumvent the proposed rule.[42]

E. Covered Investment Pools

Proposed Rule 2390(e) provides that a covered member that engages in distribution or solicitation activities with a government entity on behalf of an investment adviser to a covered investment pool[43] in which a government entity invests or is solicited to invest shall be treated as though the covered member was engaging in or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser directly.[44] This provision is modeled on a similar prohibition in the SEC Pay-to-Play Rule[45] and would apply the prohibitions of the proposed rule to an investment adviser that manages assets of a government entity through a hedge fund or other type of pooled investment vehicle. Thus, 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 as a funding vehicle or investment option in a government-sponsored plan, such as a "529 plan."[46]

F. Exceptions and Exemptions

As discussed in more detail below, the proposed rule contains exceptions that are modeled on similar exceptions in the SEC Pay-to-Play Rule for *de minimis* contributions, new covered associates and returned contributions.[47]

In addition, proposed Rule 2390(g) includes an exemptive provision for covered members that is modeled on the exemptive provision in the SEC Pay-to-Play Rule[48] that would allow covered members to apply to FINRA for an exemption from the proposed rule's two-year time out. Under this provision, FINRA would be able to exempt covered members from the proposed rule's time out requirement where the covered member discovers contributions that would trigger the compensation ban after they have been made, and when imposition of the prohibition would be unnecessary to achieve the rule's intended purpose. This provision would provide covered members with an additional avenue by which to seek to cure the consequences of an inadvertent violation by the covered member or its covered associates that falls outside the limits of one of the proposed rule's exceptions. In determining whether to grant an exemption, FINRA would take into account the varying facts and circumstances that each application presents.

1. *De Minimis* Contributions

Proposed Rule 2390(d)(1) would except from the rule's restrictions contributions made by a covered associate to government entity officials for whom the covered associate was entitled to vote[49] at the time of the contributions, provided the contributions do not exceed $350 in the aggregate to any one official per election. If the covered associate was not entitled to vote for the official at the time of the contribution, the contribution must not exceed $150 in the aggregate per election. Consistent with the SEC Pay-to-Play Rule, under both exceptions, primary and general elections would be considered separate elections.[50] These exceptions are based on the theory that such contributions are typically made without the intent or ability to influence the selection process.

2. New Covered Associates

Proposed Rule 2390(d)(2) would provide an exception from the proposed rule's restrictions for covered members if a natural person made a contribution more than six months prior to becoming a covered associate of the covered member unless the covered associate engages in, or seeks to engage in, distribution or solicitation activities with a government entity on behalf of the covered member. This provision is consistent with a similar provision in the SEC Pay-to-Play Rule.[51] As stated in the SEC Pay-to-Play Rule Adopting Release, the potential link between obtaining advisory business and contributions made by an individual prior to his or her becoming a covered associate who is uninvolved in distribution or solicitation activities is likely more attenuated than for a covered associate who engages in distribution or solicitation activities and, therefore, should be subject to a shorter look-back period.[52] This exception is also intended to balance the need for covered members to be able to make hiring decisions with the need to protect against individuals marketing to prospective employers their connections to, or influence over, government entities the employer might be seeking as clients.[53]

3. Certain Returned Contributions

Proposed Rule 2390(d)(3) would provide an exception from the proposed rule's restrictions for covered members if the restriction is due to a contribution made by a covered associate and: (1) the covered member discovered the contribution within four months of it being made; (2) the contribution was less than $350; and (3) the contribution is returned within 60 days of the discovery of the contribution by the covered member.

Consistent with the SEC Pay-to-Play Rule, this exception would allow a covered member to cure the consequences of an inadvertent political contribution to an official for whom the covered associate is not entitled to vote. As the SEC stated in the SEC Pay-to-Play Rule Adopting Release, the exception is limited to the types of contributions that are less likely to raise pay-to-play concerns.[54] The prompt return of the contribution provides an indication that the contribution would not affect a government entity official's decision to award business. The 60-day limit is designed to give contributors sufficient time to seek its return, but still require that they do so in a timely manner. In addition, the relatively small amount of the contribution, in conjunction with the other conditions of the exception, suggests that the contribution was unlikely to have been made for the purpose of influencing the selection process. Repeated triggering contributions suggest otherwise. Thus, the proposed rule would provide that covered members with 150 or fewer registered representatives would be able to rely on this exception no more than two times per calendar year. All other covered members would be permitted to rely on this exception no more than three times per calendar year. In addition, a covered member would not be able to rely on an exception more than once with respect to contributions by the same covered associate regardless of the time period. These limitations are consistent with similar provisions in the SEC Pay-to-Play Rule.[55]

Proposed Disclosure Requirements

Proposed Rule 2271 would require a covered member engaging in distribution or solicitation activities for compensation with a government entity on behalf of one or more investment advisers to make specified disclosures to the government entity regarding each investment adviser. The disclosures must be in writing (which may be electronic) and provided at the time of the initial distribution or solicitation. In addition, the disclosures must include the following information:

- the fact that the covered member is engaging in distribution or solicitation activities on behalf of the investment adviser;
- the name of the investment adviser on whose behalf the covered member is engaging in distribution or solicitation activities;
- the nature of the relationship, including any affiliation, between the covered member and the investment adviser;
- a statement that the covered member will be compensated by the investment adviser for its distribution or solicitation activities and the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the covered member;
- any incremental charges or fees that may be imposed on the government entity as a result of the distribution or solicitation engaged in by the covered member;
- 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
- the existence of the covered member's internal policies with respect to political contributions by covered associates and other associated persons.

Proposed Rule 2271 also would require covered members to update in writing any material changes to the information provided in these disclosures within 10 calendar days of the date of such changes.[56]

Proposed Recordkeeping Requirements

Proposed Rule 4580 would require covered members that engage in distribution or solicitation activities with a government entity on behalf of any investment adviser that provides or is seeking to provide investment advisory services to such government entity to maintain books and records that would allow FINRA to examine for compliance with proposed Rules 2271 and 2390. This provision is consistent with similar recordkeeping requirements imposed on investment advisers in connection with the SEC Pay-to-Play Rule.[57] The proposed rule would require covered members to maintain a list or other record of:

- the names, titles and business and residence addresses of all covered associates;
- the name and business address of each investment adviser on behalf of which the covered member has engaged in distribution or solicitation activities with a government entity within the past five years (but not prior to the rule's effective date);
- the name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities on behalf of an investment adviser within the past five years (but not prior to the rule's effective date); and
- 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.

The proposed rule would require that the direct and indirect contributions or payments made by the covered member or any of its covered associates be listed in chronological order and indicate the name and title of each contributor and each recipient of the contribution or payment, as well as the amount and date of each contribution or payment, and whether the contribution was the subject of the exception for returned contributions in proposed Rule 2390.

Economic Impact Analysis

A. Need for the Rule

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." 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 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. Thus, FINRA must propose its own pay-to-play rule to enable member firms to continue to engage in distribution and solicitation activities for compensation with government entities on behalf of investment advisers.

B. Regulatory Objective

The proposed rules would 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. FINRA aims to enable member firms to continue to engage in such activities for compensation while at the same time deterring member firms from engaging in pay-to-play practices.

C. Economic Baseline

The baseline used to evaluate the impact of the proposed rules is the regulatory framework under the SEC Pay-to-Play Rule and the MSRB pay-to-play rules. In the absence of the proposed rules, some member firms currently engaging in distribution or solicitation activities with government entities on behalf of investment advisers would not be able to receive payments from investment advisers after the SEC's ban on third-party solicitors becomes effective. Since a "regulated person" also includes SEC-registered investment advisers and SEC-registered municipal advisors subject to MSRB pay-to-play rules, member firms dually registered with the SEC as investment advisers or municipal advisors may continue to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers.

The member firms that would have to cease their distribution or solicitation activities for compensation with government entities on behalf of investment advisers may bear direct losses as a result of the loss of this business. In addition, the third-party solicitor ban may impact investment advisers and public pension plans.

Specifically, a decrease in the number of third-party solicitors may reduce the competition in the market for solicitation services. Some investment advisers may need to search for and hire new solicitors as a result of the ban to continue their solicitation activities. Due to limited capacity of third-party solicitors, investment advisers may encounter difficulties in retaining solicitors or delays in solicitation services. These changes would likely increase the costs to investment advisers that rely on third-party solicitors to obtain government clients.

To the extent that higher costs may reduce the number of investment advisers competing for government business, public pension plans may face limited investment opportunities. Allocative efficiency in the market for advisory services may be adversely affected.

D. Economic Impacts

1. Benefits

The proposed rules would enable member firms to continue to engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers within the regulatory boundaries of the proposed rules. By preventing a potentially harmful disruption in the member firms' solicitation business, the proposed rules may help member firms avoid some of the likely losses associated with the SEC's third-party solicitor ban. The proposed rules may also help promote competition and efficiency by allowing more third-party solicitors to participate in the market for solicitation services, which may in turn reduce costs to investment advisers and improve competition for advisory services.

The proposed rules are intended to establish a comprehensive regime to allow member firms to continue to engage in distribution or solicitation activities with government entities on behalf of investment advisers while deterring member firms from engaging in pay-to-play practices. FINRA believes the proposed rules would curb fraudulent conduct resulting from pay-to-play practices and, therefore, help promote fair competition in the advisory market and protect public pension funds and investors.

2. Costs

FINRA recognizes that covered members that engage in distribution or solicitation activities with government entities on behalf of investment advisers would incur costs to comply with the proposed rules on an initial and ongoing basis. Member firms would need to establish and maintain policies and procedures to monitor contributions the firm and its covered associates make and to ensure compliance with the proposed requirements. FINRA is interested in the prevalence of member firms' distribution or solicitation activities with government entities on behalf of investment advisers and requests comment on the number of member firms that would be affected by the proposed rules.

The compliance costs would likely vary across member firms based on a number of factors such as the number of covered associates, business models of members firms and the extent to which their compliance procedures are automated, whether the covered member is (or is affiliated with) a registered investment adviser subject to the SEC Pay-to-Play Rule, and whether the covered member is a registered municipal securities dealer and thus subject to MSRB pay-to-play rules. A small covered member with fewer covered associates may expend fewer resources to comply with the proposed rules than a large covered member. Covered members subject to (or affiliated with entities subject to) the SEC Pay-to-Play Rule or MSRB pay-to-play rules may be able to borrow from or build upon compliance procedures already in place. For example, FINRA estimates that approximately 400 member firms are currently subject to the MSRB pay-to-play rules. FINRA requests comment on the number of member firms that are subject to (or are affiliated with entities subject to) the SEC Pay-to-Play Rule or MSRB pay-to-play rules and the estimated compliance costs for these member firms.

The potential burden arising from compliance costs associated with the proposed rules can be initially gauged from the SEC's cost estimates for the SEC Pay-to-Play Rule. The SEC has estimated that investment advisers would spend between 8 and 250 hours to establish policies and procedures to comply with the SEC Pay-to-Play Rule.[58] The SEC further estimated that ongoing compliance would require between 10 and 1,000 hours annually.[59] The SEC estimated compliance costs for firms of different sizes. The SEC assumed that a "smaller firm" would have fewer than five covered associates that would be subject to the SEC Pay-to-Play Rule, a "medium firm" would have between five and 15 covered associates, and a "larger firm" would have more than 15 covered associates.[60] The SEC estimated that the initial compliance costs associated with the SEC Pay-to-Play Rule would be approximately $2,352 per smaller firm, $29,407 per medium firm, and $58,813 per larger firm.[61] It also estimated that the annual, ongoing compliance expenses would be approximately $2,940 per smaller firm, $117,625 per medium firm, and $235,250 per larger firm.[62] FINRA encourages comment on whether the affected members are similar to investment advisers in size, number of covered associates and other characteristics related to compliance. FINRA also requests comment on whether the proposed rules would impose similar compliance costs to member firms as the SEC estimated for investment advisers.

In addition, the SEC estimated the costs for investment advisers to engage outside legal services to assist in drafting policies and procedures. It estimated that 75 percent of larger advisory firms, 50 percent of medium firms, and 25 percent of smaller firms subject to the SEC Pay-to-Play Rule would engage such services.[63] The estimated cost included fees for approximately 8 hours of outside legal review for a smaller firm, 16 hours for a medium firm and 40 hours for a larger firm, at a rate of $400 per hour.[64] FINRA requests comment on the number of member firms that would engage similar legal services and the magnitude of the associated costs. FINRA also requests comment on whether some of the other costs estimated by the SEC, such as the cost to retain legal counsel to determine with certainty who could be a covered government official and the cost to apply for an exemption, would apply to member firms.

The SEC estimated that the recordkeeping requirements of the SEC Pay-to-Play Rule would increase an investment adviser's burden by approximately 2 hours per year,[65] which would cost the adviser $118 per year based on the SEC's assumption of a compliance clerk's hourly rate of $59.[66] In addition, the SEC estimated that some small and medium firms would incur one-time start-up costs, on average, of $10,000, and larger firms would incur, on average, $100,000 to establish or enhance current systems to assist in their compliance with the recordkeeping requirements.[67] FINRA preliminarily believes that the proposed recordkeeping requirements would impose an ongoing burden greater than 2 hours per year. Commenters are encouraged to provide cost estimates for compliance with the proposed recordkeeping requirements.

FINRA also requests public comment on compliance costs associated with the proposed disclosure requirements. The costs may be lower than the costs imposed by MSRB Rule G-37, which requires quarterly reports.

Since member firms that are dually registered as investment advisers (and thus subject to the SEC Pay-to-Play Rule) or municipal securities dealers or municipal advisors (and thus subject to the MSRB pay-to-play rules) should already have pay-to-play compliance policies and procedures in place, FINRA expects these member firms to provide useful information on compliance cost estimates through the public comment process. FINRA staff will estimate the compliance costs associated with the proposed rules to member firms based on information obtained through the process.

The proposed rules would also impose costs on FINRA. FINRA would need to develop policies and procedures to regulate the activities of member firms that engage in distribution and solicitation activities with government entities on behalf of investment advisers. FINRA needs to establish a regulatory infrastructure to manage regulatory processes, including regulatory support to members and potential challenges to its decisions. It would also need to train its staff about the pay-to-play practices in order to conduct effective regulatory reviews.

FINRA preliminarily estimates that it would spend approximately 150 hours to develop and train staff on policies and procedures to implement the proposed rules. FINRA expects to examine a member firm periodically on a one-, two-, three- or four-year cycle based upon, among other factors, FINRA's risk assessment of the member firm. The average frequency of an examination is estimated to be 3.29 years. Based on its experience with MSRB Rule G-37, FINRA estimates that an examiner would spend between 16 to 24 hours and up to 100 hours to examine a member firm's compliance with the proposed rules. In addition, FINRA is estimated to spend approximately one hour per examination to provide consultation on the proposed rules to member firms.

3. Competitive Effects

The proposed rules do not cover member firms that are SEC-registered municipal advisors subject to MSRB pay-to-play rules. On August 18, 2014, the MSRB issued a Regulatory Notice requesting comment on proposed MSRB pay-to-play rules applicable to municipal advisors. FINRA recognizes that both its and the MSRB's proposed rules are undergoing the public comment process and subject to modifications, but welcomes comment on any potential competitive impacts to member firms that might arise on the basis of any differences in the application of these rules.

Investment advisers may engage in distribution and solicitation activities with government entities on behalf of other investment advisers. Investment advisers that are FINRA members may be subject to either the proposed rules or the SEC Pay-to-Play Rule depending on the services they are performing. FINRA invites comment on whether any differences between the proposed rules and the SEC Pay-to-Play Rule would have any impact on competition in the market for solicitation services by member firms.

E. Regulatory Alternatives

Since the SEC requires that FINRA imposes "substantially equivalent or more stringent restrictions" on member firms than the SEC Pay-to-Play Rule imposes on investment advisers, FINRA believes it is appropriate to model the proposed rules on the SEC Pay-to-Play Rule.

Request for Comment

FINRA requests comment on all aspects of the proposed rules, including any potential costs and burdens of the proposed rules. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA particularly requests comment on the following questions:

1. The proposed pay-to-play rule is modeled on the SEC Pay-to-Play Rule. Is this approach appropriate or are there alternative models that FINRA should consider that would be as or more effective in deterring pay-to-play practices and also meet the requirement in the SEC Pay-to-Play Rule that FINRA's rules impose substantially equivalent or more stringent restrictions on member firms than the SEC Pay-to-Play Rule imposes on investment advisers?
2. The proposed pay-to-play rule applies to covered members that 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. Could member firms engage in activities with government entities that are not covered by this rule that should be covered? If so, what are those activities and how should FINRA design a pay-to-play rule to cover such activities?
3. FINRA is proposing to interpret and apply the terms in its proposed pay-to-play rule consistent with how the SEC has interpreted the terms in the SEC Pay-to-Play Rule. Is this approach appropriate? Are there terms that require additional clarification or that should be interpreted or applied differently? Are there differences between broker-dealers and investment advisers that would warrant a different interpretation or application of terms in the proposed rule?
4. How prevalent are pay-to-play practices by member firms? What are the effects of such pay-to-play practices on the ability to obtain business from government entities?
5. How prevalent are pay-to-play practices in connection with member firms engaging in distribution or solicitation activities with government entities on behalf of investment advisers that provide or are seeking to provide investment advisory services to the government entity? Would the proposed rules be effective at deterring such practices?

6. Are the proposed recordkeeping requirements appropriately tailored to obtain information that would be relevant for purposes of monitoring for compliance with the proposed rule?
7. Are the proposed disclosure requirements appropriately tailored to provide government entities with the information necessary for the government entity to determine if there are potential conflicts of interest that could influence the selection process by the government entity?
8. What would be the likely effects on competition, efficiency and capital formation of the proposed pay-to-play rule?
9. How many member firms are expected to be impacted by the proposed pay-to-play rule? What is the estimated number of covered associates per member firm?
10. What are the sources and estimates of benefits associated with the proposed pay-to-play rule, proposed disclosure requirements and proposed recordkeeping requirements?
11. What are the sources and estimates of compliance costs associated with the proposed pay-to-play rule, proposed disclosure requirements and proposed recordkeeping requirements? Would the proposed rules impose different costs based on the size or the business model of the member firm?
12. How many member firms would engage outside legal services to assist in drafting policies and procedures to comply with the proposed rules? What are the estimated costs?
13. How many member firms that would be impacted by the proposed pay-to-play rule are subject to (or are affiliated with entities subject to) the SEC Pay-to-Play Rule or MSRB pay-to-play rules? Would the compliance costs associated with the proposed rule be lower for these member firms? What are the estimates of compliance costs?
14. The proposed pay-to-play rule does not cover member firms that are SEC-registered municipal advisors subject to MSRB pay-to-play rules. FINRA recognizes that both its and the MSRB's proposed rules are still undergoing the public comment process and subject to modifications. Would the applicability of the two sets of rules on member firms create any competitive imbalances? What are they? How substantial are they?
15. Would the proposed pay-to-play rule create any competitive imbalances among member firms because some dually registered investment advisers would be subject to the SEC Pay-to-Play Rule while others would be subject to the proposed rule?
16. Are there any other expected economic impacts associated with the proposed rules? What are they, what entities would be impacted, and what are the estimates of those impacts?

Endnotes

1. "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.

2. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.

3. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the Federal Register. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

4. *See* 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 Advisers Act Release No. 3221 (June 22, 2011), 76 FR 42950 (July 19, 2011) (Rules Implementing Amendments to the Investment Advisers Act of 1940); 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).

5. *See* SEC Pay-to-Play Rule 206(4)-5(f)(9). A "regulated person" also includes SEC registered investment advisers and SEC-registered municipal advisors, subject to specified conditions.

6. *See* Advisers Act Release No. 3418 (June 8, 2012), 77 FR 35263 (June 13, 2012).

7. *See* Exchange Act Release No. 70462 (September 20, 2013), 78 FR 67468 (November 12, 2013) (Registration of Municipal Advisors).

8. In connection with the adoption of the SEC Pay-to-Play Rule, the SEC also adopted recordkeeping requirements related to political contributions by investment advisers and their covered associates. *See* Advisers Act Rule 204-2(a)(18) and (h)(1).

9. "Solicitors" typically locate investment advisory clients on behalf of an investment adviser. *See* Advisers Act Release No. 2910 (August 3, 2009), 74 FR 39840, 39853 n.137 (August 7, 2009) (Political Contributions by Certain Investment Advisers).

10. "Placement agents" typically specialize in finding investors (often institutional investors or high net worth investors) that are willing and able to invest in a private offering of securities on behalf of the issuer of such privately offered securities. *See id.*

11. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41037 (discussing the reasons for proposing a ban on using third parties to solicit government business).

12. *See id.*

13. *See id.*

14. In response to a request from SEC staff, FINRA previously indicated its intent to prepare rules for consideration by the SEC that would prohibit its member firms from soliciting advisory business from a government entity on behalf of an adviser unless the member firms comply with requirements prohibiting pay-to-play practices. *See letter* from Andrew J. Donohue, Director, Division of Investment Management,

SEC, to Richard G. Ketchum, Chairman & CEO, FINRA, dated December 18, 2009 (requesting whether FINRA would consider adopting a rule preventing pay-to-play activities by registered broker-dealers acting as legitimate placement agents on behalf of investment advisers). *See also* *letter* from Richard G. Ketchum, Chairman & CEO, FINRA, to Andrew J. Donohue, Director, Division of Investment Management, SEC, dated March 15, 2010 (stating "[w]e believe that a regulatory scheme targeting improper pay to play practices by broker-dealers acting on behalf of investment advisers is... a viable solution to a ban on certain private placement agents serving a legitimate function").

15. Consistent with the SEC Pay-to-Play Rule, proposed Rule 2390(h)(10) defines the term "solicit" to mean "(A) With respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and (B) With respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment." The determination of whether a particular communication would be a solicitation would depend on the facts and circumstances relating to such communication. As a general proposition, any communication made under circumstances reasonably calculated to obtain or retain an advisory client would be considered a solicitation unless the circumstances otherwise indicate that the communication does not have the purpose of obtaining or retaining an advisory client. *See also infra* note 37.

16. *See* SEC Pay-to-Play Rule 206(4)-5(a)(1).

17. *See supra* note 5.

18. *See* SEC Pay-to-Play Rule 206(4)-5(a)(2)(i)(A) and 206(4)-5(f)(9).

19. *See* Exchange Act Section 15B(e)(9) and Rule 15Ba1-1(n) thereunder (defining "solicitation of a municipal entity" to mean "a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser . . . that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.")

20. On August 18, 2014, the MSRB issued a Regulatory Notice requesting comment on draft amendments to MSRB Rule G-37, on political contributions made by brokers, dealers and municipal securities dealers and prohibitions on municipal securities business, to extend the rule to cover municipal advisors. *See* *MSRB Regulatory Notice 2014-15* (August 2014).

21. FINRA notes that a person that is registered under the SEA as a broker-dealer and municipal advisor, and under the Advisers Act as an investment adviser could potentially be a "regulated person" for purposes of the SEC Pay-to-Play Rule. Such a regulated person should follow the rules that apply to the services it is performing.

22. *See* proposed Rule 2390(h)(6).

23. *See* SEC Pay-to-Play Rule 206(4)-5(a)(1).

24. Consistent with the SEC Pay-to-Play Rule, proposed Rule 2390(h)(7) defines an "official" to mean: "any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (A) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (B) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity."

25. A 403(b) plan is a tax-deferred employee benefit retirement plan established under Section 403(b) of the Internal Revenue Code of 1986 (26 U.S.C. 403(b)).

26. A 457 plan is a tax-deferred employee benefit retirement plan established under Section 457 of the Internal Revenue Code of 1986 (26 U.S.C. 457).

27. A 529 plan is a "qualified tuition plan" established under Section 529 of the Internal Revenue Code of 1986 (26 U.S.C. 529). Consistent with the SEC Pay-to-Play Rule, proposed Rule 2390(h)(5) defines a "government entity" to mean "any state or political subdivision of a state, including: (A) Any agency, authority or instrumentality of the state or political subdivision; (B) A pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including but not limited to a "defined benefit plan" as defined in Section 414(j) of the Internal Revenue Code, or a state general fund; (C) A plan or program of a government entity; and (D) Officers, agents or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity."

28. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41029 (discussing the terms "official" and "government entity").

29. Consistent with the SEC Pay-to-Play Rule, proposed Rule 2390(h)(1) defines a "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."

30. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030. The SEC also noted that a covered associate's donation of his or her time generally would not be viewed as a contribution if such volunteering were to occur during non-work hours, if the covered associate were using vacation time, or if the adviser is not otherwise paying the employee's salary (*e.g.*, an unpaid leave of absence). *See id.* at 41030 n. 157. FINRA would take a similar position in interpreting the proposed rule.

31. Section 501(c)(3) of the Internal Revenue Code (26 U.S.C. 501(c)(3)) contains a list of charitable organizations that are exempt from Federal income tax.

32. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41030 (discussing the scope of the term "contribution" under the SEC Pay-to-Play Rule). *But see* proposed Rule 2390(f) providing that it shall be a violation of Rule 2390 for any covered member or any of its covered associates to do anything that, if done directly, would result in a violation of the rule.

33. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41031.

34. Consistent with the SEC Pay-to-Play Rule, proposed Rule 2390(h)(2) defines a "covered associate" as: "(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 of a covered member who supervises, directly or indirectly, the government entity distribution or solicitation activities of a person in subparagraph (B) above; and (D) Any political action committee controlled by a covered member or a covered associate."

35. *See id.*

36. Similarly, consistent with the SEC Pay-to-Play Rule, to prevent covered members from channeling contributions through departing employees, covered members must "look forward" with respect to covered associates who cease to qualify as covered associates or leave the firm. The covered associate's employer at the time of the contribution would be subject to the proposed rule's prohibition for the entire two-year period, regardless of whether the covered associate remains a covered associate or remains employed by the covered member. Thus, dismissing a covered associate would not relieve the covered member from the two-year time out. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41033 (discussing the "look back" in that rule).

37. Proposed Rule 2390(h)(10)(B) defines the term "solicit" with respect to a contribution or payment as "to communicate directly or indirectly, for the purpose of obtaining or arranging a contribution or payment." This provision is consistent with a similar provision in the SEC Pay-to-Play Rule. *See* SEC Pay-to-Play Rule 206(4)-5(f)(10)(ii). Consistent with the SEC Pay-to-Play Rule, whether a particular activity involves a solicitation or coordination of a contribution or payment for purposes of the proposed rule would depend on the facts and circumstances.

38. Consistent with the SEC Pay-to-Play Rule, proposed Rule 2390(h)(8) defines the term "payment" to mean "any gift, subscription, loan, advance or deposit of money or anything of value." This definition 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). Consistent with the SEC Pay-to-Play Rule, FINRA is including the broader term "payments," as opposed to "contributions," to deter a covered member from circumventing the proposed rule's prohibitions by coordinating indirect contributions to government officials by making payments to political parties. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043, n. 331 and accompanying text (discussing a similar approach with respect to restrictions on soliciting and coordinating contributions and payments).

39. *See* SEC Pay-to-Play Rule 206(4)-5(a)(2).

40. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41043 (discussing restrictions on soliciting and coordinating contributions and payments).

41. *See* SEC Pay-to-Play Rule 206(4)-5(d).

42. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 (discussing direct and indirect contributions or solicitations).

43. Consistent with the SEC Pay-to-Play Rule, proposed Rule 2390(h)(3) defines a "covered investment pool" to mean: "(A) Any investment company registered under the Investment Company Act of 1940 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." Thus, the definition includes such unregistered pooled investment vehicles as hedge funds, private equity funds, venture capital funds, and collective investment trusts. It also includes registered pooled investment vehicles, such as mutual funds, but only if those registered pools are an investment option of a participant-directed plan or program of a government entity.

44. Consistent with the SEC Pay-to-Play Rule, under the proposed rule, if a government entity is an investor in a covered investment pool at the time a contribution triggering a two-year time out is made, the covered member must forgo any compensation related to the assets invested or committed by the government entity in the covered investment pool.

45. *See* SEC Pay-to-Play Rule 206(4)-5(c).

46. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41044 (discussing the applicability of the SEC Pay-to-Play Rule to covered investment pools).

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

48. *See* SEC Pay-to-Play Rule 206(4)-5(e).

49. Consistent with the SEC Pay-to-Play Rule, for purposes of proposed Rule 2390(d)(1), a person would be "entitled to vote" for an official if the person's principal residence is in the locality in which the official seeks election. For example, if a government official is a state governor running for re-election, any covered associate who resides in that state may make a *de minimis* contribution to the official without causing a ban on the covered member being compensated for engaging in distribution or solicitation activities with that government entity on behalf of an investment adviser. If the government official is running for president, any covered associate in the country would be able to contribute the *de minimis* amount to the official's presidential campaign. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034 (discussing the applicability in the SEC Pay-to-Play Rule of the exception for *de minimis* contributions).

50. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034.

51. *See* SEC Pay-to-Play Rule 206(4)-5(b)(2).

52. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41034 (discussing the applicability of the "look back" in the SEC Pay-to-Play Rule).

53. *See id.*

54. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41035.

55. *See* SEC Pay-to-Play Rule 206(4)-5(b)(3). The SEC Pay-to-Play Rule includes different allowances for larger and smaller investment advisers based on the number of employees they report on Form ADV.

56. The SEC imposes similar disclosure requirements on solicitors in connection with cash payments by investment advisers to solicitors with respect to solicitation activities. *See* Advisers Act Rule 206(4)-3.

57. *See* Advisers Act Rule 204-2(a)(18) and (h)(i).

58. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41056.

59. *See id.*

60. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41055.

61. *See supra* note 58.

62. *See id.*

63. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41057.

64. *See id.*

65. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41063.

66. *See* SEC Pay-to-Play Rule Adopting Release, 75 FR 41018, 41061.

67. *See supra* note 65.

Exhibit 2b

Alphabetical List of Written Comments

1. William Beatty, North American Securities Administrators Association, Inc. ("NASAA") (December 12, 2014)

2. David T. Bellaire, Financial Services Institute ("FSI") (December 15, 2014)

3. Allen Dickerson, Center for Competitive Politics ("CCP") (December 15, 2014)

4. Molly M. Diggins, Monument Group Inc. ("Monument Group") (December 15, 2014)

5. Donna DiMaria, Third Party Marketers Association ("3PM") (December 22, 2014)

6. Marin E. Gibson, Securities Industry and Financial Markets Association ("SIFMA") (December 22, 2014)

7. Cliff Kirsch and Michael Koffler, Sutherland Asbill & Brennan LLP on behalf of Committee of Annuity Insurers ("CAI") (January 2, 2015)

8. Sanjay Lamba, Investment Adviser Association ("IAA") (December 22, 2014)

9. Lisa Roth, Monahan & Roth, LLC (December 22, 2014)

10. Tamara K. Salmon, Investment Company Institute ("ICI") (December 15, 2014)

Exhibit 2c

NASAA

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December 12, 2014

Submitted electronically to pubcom@finra.org

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

Re: Comments in Response to Regulatory Notice 14-50

Dear Ms. Asquith:

The North American Securities Administrators Association ("NASAA")[1] appreciates the opportunity to offer comments regarding the Financial Industry Regulatory Authority's ("FINRA") Regulatory Notice 14-50 ("The Proposal"), which addresses FINRA's proposed pay-to-play rules. While NASAA supports FINRA's efforts to implement rules designed to curb the disruptive practices related to pay-to-play schemes, NASAA urges FINRA to strengthen its proposed rules.

Investment Adviser Act Rule 206(4)-5 prohibits SEC-registered investment advisers from engaging the services of a third-party to solicit a government entity for advisory business unless such third-party is a "regulated person."[2] The SEC defines regulated person to include SEC-registered broker-dealers that are members of a national securities association whose rules "prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made" and that "such rules impose substantially equivalent or more stringent restrictions" than the SEC rules.[3] The Proposal is FINRA's initial effort to create such rules so that investment advisers can engage FINRA members to solicit government entities.

As the SEC's rule makes clear, any FINRA rule must be equivalent to or more stringent than the SEC's own pay-to-play rule in order for FINRA members to be considered regulated

[1] NASAA is the association of all state, provincial, and territorial securities regulators in North America. Its membership consists of the securities regulators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. Their core mission is protecting investors from fraud and abuse in the offer and sale of securities. Organized in 1919, NASAA is the oldest international organization devoted to investor protection.
[2] 17 CFR 275.206(4)-5
[3] *Id*.

persons. The Proposal satisfies this requirement, as it substantially mirrors the SEC's rule. FINRA, however, should take this opportunity to create more stringent rules for its members.

The Proposal suggests a two-year "cooling off" period in which a FINRA-member firm cannot be paid to engage in solicitation or distribution activities with a government entity on behalf of an SEC-registered—or exempted—investment adviser.[4] While this cooling off period is identical to the cooling off period in the SEC rules, a longer cooling off period would increase the investor protection component of the proposal. Specifically, NASAA suggests that FINRA-member firms be prohibited from engaging in distribution or solicitation activities on behalf of an investment adviser directed at any government entity for a period four years following any qualifying contribution by the FINRA-member firm. Additionally, if a FINRA-member firm has engaged in solicitation or distribution activities with a government entity on behalf of an investment adviser, then that FINRA-member firm should be prohibited from making any qualifying contributions to that government entity for period of four years following the conclusion of the solicitation or distribution activities.

As currently proposed, FINRA Rule 2390 is only applicable to arrangements between SEC-registered, exempt, or exempt reporting advisers and FINRA-member firms due to a limited definition of the term investment adviser. Proposed Rule 2390's definition of investment adviser should be expanded to include state-registered investment advisers. Specifically, Proposed Rule 2390 should be expanded so as to prohibit FINRA-member firms from conducting distribution or solicitation activities with government entities on behalf of state-registered investment advisers if the FINRA-member firm has made any qualifying contributions to the government entity. Expanding the definition of investment adviser in the Proposal to encompass relationships between FINRA-member firms and state-registered investment advisers would further reduce the disruptions created by pay-to-play schemes.

Finally, NASAA supports FINRA's inclusion of disgorgement provisions for violations of the rule. FINRA, however, should include other investment education foundations, such a state securities investor education funds, as possible recipients of disgorgement payments.

The Proposal mirrors the SEC's rules ensuring that FINRA's members can continue to engage in the lucrative business of soliciting government entities on behalf of investment advisers, but FINRA should take this opportunity—by implementing the above suggestions—to create more stringent pay-to-play regulations that increase the underlying investor protection goals of such rules. Should you have any questions regarding the comments in this letter, please do not hesitate to contact Joseph Brady, NASAA Acting Executive Director and General Counsel at jb@nasaa.org or 202-737-0900.

[4] FINRA's proposed definition of investment adviser includes advisers exempt from SEC registration pursuant to Section 203(b)(3) of the Investment Advisers Act of 1940 and exempt reporting advisers, as defined in Rule 204-4(a).

Sincerely,

William Beatty
NASAA President
Washington Securities Administrator

VIA ELECTRONIC MAIL

December 15, 2014

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

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

Dear Ms. Asquith:

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

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

[1] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 100 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Advisor members.
[2] *SEC v. Henry Morris, et al.*, Litigation Release No. 20963 (Mar. 19, 2009).

Background on FSI and its Members

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

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

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

Comments

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

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

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

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

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

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

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

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

FSI member firms have adopted written supervisory procedures to achieve compliance with Rule 206(4)-5 due to the uncertainty that currently exists as to the application of the Rule. This creates a burden upon such entities in a context where there is little to no risk of pay-to-play corruption. The rule has caused some IBD firms to adopt sweeping prohibitions with respect to political contributions. In the IBD channel, financial advisers conduct advisory activity in a de-centralized manner, whether through a corporate entity registered as an adviser or an independently-registered adviser. However, as a matter of practical compliance considerations, given the way the rule is written, FSI's broker-dealers have been forced to apply the rule comprehensively as if financial advisors conduct advisory activity in a centralized manner. As a consequence, many IBDs have had to impose sweeping prohibitions on any political contributions. FSI is concerned that similar requirements imposed by FINRA may lead to additional uncertainty with respect to applying restrictions to independent financial advisors. As a result, we respectfully request that FINRA provide additional guidance with respect to the application of pay-to-play requirements upon independent financial advisors.

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

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

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

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

III. Disclosure Requirements

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

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

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

IV. Books and Records Requirements

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

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

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

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

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

V. Treatment of PAC Contributions

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

1) Contribution to an official of a government entity in respect of which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser; or
2) Payment to a political party of a state or locality of a government entity with which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser."[14]

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

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

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

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

Respectfully submitted,

David T. Bellaire, Esq.
Executive Vice President & General Counsel

December 15, 2014

Via Electronic Submission

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: Regulatory Notice 14-50, Comment on Proposal to Establish a "Pay-to-Play" Rule (Proposed Rules 2271, 2390, and 4580).

Dear Ms. Asquith,

I write on behalf of the Center for Competitive Politics ("CCP"), a § 501(c)(3) organization dedicated to educating the public concerning the benefits of increased freedom and competition in the electoral process. Toward that end, CCP engages in research, scholarship, and outreach to protect and promote the First Amendment political rights of speech, assembly, and petition. CCP also operates a *pro bono* law center that brings legal challenges to state and federal laws and regulations that impose unconstitutional burdens on the exercise of those freedoms.

The Proposed Rules are of particular importance to CCP because, *inter alia*, they limit the ability of covered individuals to make contributions to candidates for public office. The right to financially support candidates is a fundamental liberty secured by the First Amendment.[1]

[1] *Buckley v. Valeo*, 424 U.S. 1, 25 (1976) (right to make contributions to candidates for office "lies at the foundation of a free society").
CCP understands that the First Amendment's protection of political rights serves as a limit on government action. *Columbia Broadcasting System, Inc. v. Democratic Nat'l Com.*, 412 U.S. 94, 114 (1973) (First Amendment "is a restraint on government action, not that of private persons"). Nonetheless, the Securities and Exchange Commission will have to ratify and approve FINRA's rules, thus implicating constitutional liberties. FINRA, FINRA RULEMAKING PROCESS (*available at*: http://www.finra.org/Industry/Regulation/FINRARules/RulemakingProcess/). Accordingly,

We have no doubt that the Proposed Rules are a well-intentioned effort to prevent pay-to-play practices at the state and local levels. And we understand that FINRA is simply making a good faith effort to synchronize its regulations with Rule 206(4)-5, as promulgated by the Securities and Exchange Commission in 2011. Moreover, CCP agrees that "establishing requirements for member firms that are modeled on the SEC's Pay-to-Play Rule is a more effective response…than an outright ban on such activity."[2] Limits on political freedoms are certainly preferable to extinguishing them altogether.[3]

Nonetheless, the Proposed Rules remain vague in important particulars, and cover a wider range of activity than is necessary for the prevention of actual or perceived pay-to-play corruption. We believe that FINRA should more carefully consider recent Supreme Court decisions that impact the justification for campaign contribution limits and revise the Proposed Rules accordingly.

Vagueness Concerns with Proposed Rule 2390

The Supreme Court has explained why laws much at times be struck down as "void for vagueness [because]…[a provision's] prohibitions are not clearly defined."[4]

> First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning.
>
> Second, if arbitrary and discriminatory enforcement is to be prevented, laws must provide explicit standards for those who apply them…
>
> Third…where a vague statute abuts upon sensitive areas of basic First Amendment freedoms, it operates to inhibit the exercise of those freedoms. Uncertain meanings inevitably lead

FINRA should take this early opportunity to consider constitutional questions as part of its deliberations.

[2] Regulatory Notice 14-50 at 3 (Nov. 2014).

[3] *McConnell v. FEC*, 540 U.S. 93, 231 (2003) (striking down ban on contributions by individuals 17 years of age or under).

[4] *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972).

> citizens to steer far wider of the unlawful zone, than if the boundaries of the forbidden areas were clearly marked.[5]

Unfortunately, a number of provisions in Rule 2390 and the accompanying Regulatory Notice pose fundamental vagueness concerns, which are troubling given the associational liberties implicated.

Under Proposed Rule 2390(a), covered members are barred from "engag[ing] 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" for two years "after a contribution to an official of the government entity." Proposed Rule 2390(a). This languages mirrors similarly language in SEC Rule 206(4)-5[6], which is presently being challenged in federal court.[7]

This provision is vague, and the Regulatory Notice's description provides little additional precision. According to the Notice, "[a]n official of a government entity would include an incumbent, candidate[,] or successful candidate for elective office of a government entity if the office is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser or has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment advisor."[8]

The breadth of this definition is, on its face, excessive. The inherent vagueness of "indirect influence" and "indirect responsibility" is self-evident. Moreover, there are no articulated standards sufficient to guide the covered community in determining who is and is not a qualified officeholder (and consequently, which contributions do and do not trigger the ban on business). This vagueness *itself* stifles First Amendment activity by deterring covered members and covered associates from making political contributions.

What is more, the definitions, per the Regulatory Notice, extend to candidates for office—prohibiting contributions simply because someone is running for an office that may not, in fact, have any connection to investment

[5] *Grayned*, 408 U.S. at 108-109 (punctuation altered, citations omitted).
[6] "[I]t shall be unlawful…[f]or any investment advisor…to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the investment adviser or any covered associate within two years after the contribution is made…" 11 C.F.R 275.206(4)-5 (2014).
[7] *New York State Republican Comm., et. al v. SEC*, No. 14-012345 (D.D.C. 2014).
[8] Regulatory Notice at 5. This language is presumably taken verbatim from the SEC's guidance regarding Rule 206(4)-5. 75 Fed. Reg. 41018, 41029 (July 14, 2010).

adviser selection.[9] Even a contribution to a candidate who goes on to lose the election nonetheless triggers sanctions under Rule 2390.

This lack of clarity will inevitably mean that some contributions which would otherwise be made, and which pose little or no risk of pay-to-play corruption, will not be made. This, in and of itself, is a First Amendment harm. The Supreme Court has long held that the freedom of association is “protected not only against heavy-handed frontal attack, but also from being stifled by more subtle governmental influence.”[10]

The definition of “solicit” under Proposed Rule 2390 suffers from similar problems. This definition includes efforts to “communicate, directly or indirectly, for the purpose of obtaining or retaining a client for…an investment adviser” and “communicat[ing], directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.”[11] The spirit of this definition is easily understood—it is intended to avoid *quid pro quo* arrangements for investment advisory contracts. But the concept of an “indirect communication” is nebulous, and worse, uncabined. Indeed, as the hallmark of a communication is the conveyance of information from one person to another, it is not clear what could constitute an “indirect communication.”

The Proposed Rule states that “[n]o covered member shall engage in distribution or solicitation activities with a government entity on behalf of an investment adviser that provides or is seeking to provide investment advisory services” to that government entity “within two years after a [prohibited] contribution.”[12] But it is unclear how the Authority would determine whether an actor is “seeking” to engagement in such activities. Even if this provision were decipherable, it would certainly present significant difficulties of proof. Worse yet, it will deprive regulators of a clear and consistent definition of covered members and associates, a circumstance that may ultimately lead to the perception or reality of selective enforcement.

Similarly, the Regulatory Notice’s explanation as to what constitutes a “contribution” poses significant vagueness problems. Under the Proposed Rule, “[a] contribution would include a gift, subscription, loan, advance, deposit of money, or anything of value made the purpose of influencing the election.”[13] This seems somewhat at odds with the direct text of the Proposed

[9] Regulatory Notice at 5 (“An official of a government entity would include an incumbent, candidate or successful candidate for elective office…”).
[10] *Bates v. City of Little Rock*, 361 U.S. 516, 523 (1958).
[11] Propsoed Rule 2390(h).
[12] Proposed Rule 2390(a).
[13] Regulatory Notice at 5. This provision accords with the Proposed Rule’s definition of payment, at 2390(h)(8), with the exception of the use of the Oxford comma. That definition

Rule, which seems to only anticipate contributions "to an official of the government entity."

Similar language existed in the Federal Election Campaign Act, which was facially challenged in the seminal case of *Buckley v. Valeo*.[14] The *Buckley* Court noted that the vagueness of this definition was mitigated by the Court's decision to limit its application solely to candidates for office and federal political committees—entities whose "major purpose" was express candidate advocacy.[15]

However, the Proposed Rule is not so limited, and it is unclear what FINRA believes might "influence" an election—especially as the Proposed Rule already regulates a good deal of "indirect" activity. In the past, government agencies have interpreted a variety of protected speech as being speech designed to "influence an election." Indeed, the first prosecution brought under the Federal Election Campaign Act—before the narrowing construction to "contribution" was applied by *Buckley*—was brought by the Nixon Justice Department against an organization which, during an election year, advocated the impeachment of the President for, among other things, the expansion of the Vietnam War into Cambodia and Laos.[16] The government argued that the war was a "principal campaign issue", and therefore any discussion of it constituted election activity.

The Regulatory Notice seems to suggest that the Authority reads the Proposed Rule in a similar fashion. If a covered associate or member gave money to an advocacy group that happened to support a similar position to the one held by an "official of a government entity" it could well be interpreted as "influencing" an election. "Such a result would, we think, be abhorrent…[a]ny [covered member or associate] would be wary of" contributing to *any* group which "express[es] any viewpoint" lest it trigger the two-year ban on business.[17] It would be well for the Authority to define contributions more narrowly—to only political contributions made to covered candidates. As the *McCutcheon* Court noted just last Term, regulations that limit contributions "must…target what we have called "*quid pro quo*" corruption or its appearance…the notion of a *direct* exchange of an official act

reads "any gift, subscription, loan, advance or deposit of money or anything of value." In the interest of providing full precision and clarity to the regulated community, CCP recommends the consistent use of the Oxford comma in both the Proposed Rules and accompanying explanations.

[14] 424 U.S. 1 (1976).

[15] *Buckley*, 424 U.S. at 24, n. 24 (noting that "[o]ther courts have given that phrase a narrow meaning to alleviate various problems in other contexts").

[16] *United States v. Nat'l Comm. for Impeachment*, 469 F.2d 1135 (1972).

[17] *Nat'l Comm. for Impeachment*, 469 F.2d at 1142. This is not an unusual reading. *Nat'l Org. for Marriage, Inc. v. McKee*, 649 F.3d 34, 44 (1st Cir. 2011) (applying narrowing construction to "influencing" in Maine campaign finance statute).

for money."[18] Contributions to social welfare groups, which interact with the public on issues of import, should be encouraged, not chilled.

Exacerbating these problems is the Proposed Rule's prohibition on "any covered member or any of its covered associates [doing] anything indirectly that, if done directly, would result in a violation of the Rule."[19] While it is certainly appropriate to prohibit circumvention of otherwise-constitutional rules targeting corruption, this catchall provision—with its now all-too-familiar use of the word "indirectly"—could be read extremely broadly. In practice, it will inevitably be interpreted to reach practically any behavior that could conceivably be covered by the Rule's provisions, a troubling prospect given the penalties involved. Again: how, precisely, does one "indirectly" perform an act?[20]

The vagueness and overbreadth of Proposed Rule 2390 is also compounded by the extensive disclosure and recordkeeping requirements in Proposed Rules 2271 and 4580. Attaching extensive "strings" to the enjoyment of First Amendment liberties can, in practice, squelch them altogether, as Justice O'Connor observed in *FEC v. Massachusetts Citizens for Life*.[21]

In short, Proposed Rule 2390 attempts to obtain universal coverage by employing terms that are both vague and overbroad. This is an approach to regulation that the United States Supreme Court has long decried,[22] and a practice that leaves the present construction of the Proposed Rule suspect to inevitable constitutional challenge.

Proposed Rule 2390(c) Bars Fundamental Political Association

Proposed Rule 2390(c) appears to be an anti-circumvention measure, and flatly prohibits "a covered member or covered associate from coordinating or soliciting any person or PAC to make any payment[23] to a political party of a state or locality of a government entity with which the covered member is

[18] *McCutcheon v. FEC*, 134 S. Ct. 1434, 1441 (2014) (emphasis supplied).
[19] Proposed Rule 2390(f).
[20] *See* Tr. of Oral Argument, *New York State Republican Comm. v. SEC*, *supra* note 7 ("What do you say about the very troubling demonstration that I've had in this case that nobody understands the scope of the SEC's rule because of Subsection (D)'s catch-all language that bars everything under the rule, anything indirectly which, if done directly, would result in a violation of this section…?").
[21] 479 U.S. 238, 265-266 (1986) (observing the "significant burden" imposed on the petitioner comes "from the additional organizational restraints imposed upon it").
[22] *NAACP v. Button*, 371 U.S. 415, 438 (1963) ("[b]road prophylactic rules in the area of free express are suspect. Precision of regulation must be the touchstone in an area so closely touching our most precious freedoms") (citations omitted).
[23] Which is defined similarly to "contribution", as discussed *supra*.

engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser."[24]

Unlike the contribution limits, which generally seem to be targeted at specific individuals who may be able to enter into *quid pro quo* bargains, Proposed Rule 2390(c) bars individuals from simply associating with a political party—even if the political party is not the same as the official's. This is a grave infringement of the basic "right to associate for the purpose of speaking."[25]

This Rule proscribes quite a large amount of political behavior. For example, may a covered associate attend a PAC event—perhaps by buying a $50 ticket—where contributions are solicited by speakers? Would that constitute "coordination"?

How involved may covered associates be with the local branch of their preferred political party under this Rule? May they not pass out literature for other, non-covered official candidates—while happening to also note that the local party could use monetary support? May she help set up for local party events where donations may or may not be solicited by a speaker? What if she does not know if contributions will be solicited? May she suggest that a friend who has maxed out his or her financial support to a local city council candidate also give money to that candidate's party?

Surely there are narrower means of preventing circumvention of the Proposed Rule's contribution limits that do not threaten to quash a covered associate's ability to suggest to a friend that she should, broadly, support the candidates of a particular political party.

The Contribution Limits are Unreasonably Low and Have Not Been Justified

At the outset, CCP notes that the Proposed Rule's contribution limit mirrors the limits impose by SEC Rule 206(4)-5, and does not, as the Municipal Securities Rulemaking Board's recent changes to Rule G-37 did, altogether bar a class of contributions from natural persons.

However, the contribution limit remains notably and unnecessarily low, at just $350 for candidates that a covered associate may vote for, and $150 for other candidates. These two contribution limits apply whether the candidate is running for office in California—which has a population of nearly 40 million—or in the town of New Hope, Pennsylvania—which has a population of 2,518. Such limits evince no effort to tailor the rule to concerns about

[24] Regulatory Notice at 7.
[25] *Rumsfeld v. FAIR*, 547 U.S. 47, 68 (2006); *Buckley*, 424 U.S. at 24 (right to associate is "fundamental").

corruption. The words of Judge Beryl Howell of the United States District Court for the District of Columbia, when speaking of SEC Rule 206(4)-5, are relevant: "the $350 seems like it came out of thin air."[26]

Despite the lack of a record justifying its new contribution limits, the Authority appears to have substituted its judgment for the more considered deliberations of state legislatures. Most of the states have crafted contribution limits in an effort to limit corruption or the appearance of corruption. Some states, such as Oregon or Virginia, do not limit contributions to candidates at all. There is no evidence that states without contribution limits are any more corrupt than states with such limits. FINRA has failed to explain why the campaign finance regulations crafted by state governments to meet the specific circumstances of each state are nevertheless inadequate to address "pay-to-play" concerns.

FINRA Ought to Consider Alternatives to the Proposed Rules

In the case of *McCutcheon v. FEC*, the Supreme Court ruled that aggregate limits on contributions to candidates are unconstitutional.[27] In the opinion, the Court specifically noted that Congress had failed in its duty to consider any of the available "alternatives" that would also serve the government's interest "while avoiding 'unnecessary abridgment' of First Amendment rights."[28]

There are many possible, and effective, alternatives to the draconian contribution restrictions proposed by the Draft Amendments. There is no evidence that the Board considered these other, less restrictive alternatives.

One possible approach would provide for tougher penalties for those who use pay-to-play arrangements to obtain contracts. Stronger investigative tools to audit suspected pay-to-play activities could focus resources on the bad actors in the system. Whistleblower protections could be written to protect those who report wrongdoing and whistleblowers could also be given rewards based on the size of the ill-gotten contracts or the penalties imposed for violations.

FINRA also appears not to have considered alternatives that would provide exemptions from the rule if contracts are put up for bid in a transparent way that forecloses pay-to-play manipulation. Similarly, certain contracting procedures might be imposed, or certain officials may be required to recuse themselves from decisions regarding certain contractors. A contribution limit

[26] Josh Gerstein, *Judge Mulls SEC Limits on Political Donations*, POLITICO (Sept. 12, 2014), http://www.politico.com/blogs/under-the-radar/2014/09/judge-mulls-sec-limits-on-political-donations-195402.html.
[27] 134 S. Ct. at 1462.
[28] 134 S. Ct. at 1458 (quoting *Buckley*, 424 U.S. at 25)/

rule, if retained, should be limited to those circumstances where it is indeed needed, and only after alternative means of preventing pay-to-play practices have been considered.

FINRA Should Clearly Exempt Contributions in Support of Independent Expenditures from the Proposed Rules

In adopting Rule 206(4)-5, the SEC explained that "the rule does not in any way impinge on a wide range of expressive conduct in connection with elections. For example, the rule imposes no restrictions on activities such as making independent expenditures to express support for candidates, volunteering, making speeches, and other conduct."[29] This reasoning tracks that of *Citizens United*, where the Court ruled that "independent expenditures do not lead to, or create the appearance of, quid pro quo corruption. In fact, there is only scant evidence that independent expenditures even ingratiate. Ingratiation and access, in any event, are not corruption."[30]

Clearly, particularly given the Authority's stated intention to closely hew to the path blazed by the SEC when it promulgated Rule 206(4)-5, the Proposed Rules likely do permit contributions in support of independent expenditures. Nevertheless, FINRA ought to make that point explicit.

* * *

CCP respectfully requests that FINA reconsider these elements of the Draft Amendments, and thanks the Authority for the opportunity to comment. Should you have any questions or desire CCP's assistance in modifying the Draft Amendments further, please contact me at 703-894-6800 or adickerson@campaignfreedom.org.

Very truly yours,

Allen Dickerson
Legal Director

[29] Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41018, 41024 (July 14, 2010).
[30] 558 U.S. at 360 (internal citation omitted).

December 15, 2014

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

Re: Regulatory Notice 14-50: Political Contributions

Dear Ms. Asquith:

We appreciate the opportunity to comment on the proposal in FINRA's Regulatory Notice 14-50 ("Notice") to adopt three new related pay-to-play rules: 2271 (Disclosure Requirement for Government Distributions and Solicitation Activities); Rule 2390 (Engaging in Distribution and Solicitation Activities with Government Entities); and Rule 4580 (Books and Records Requirements for Government Distributions and Solicitation Activities) (each a "Proposed Rule" and collectively the "Proposed Rules"). While we appreciate that the SEC has required FINRA to adopt a pay-to-play rule in order for broker-dealers, like ours, to continue to solicit investments from certain government entities, we wish to voice our concerns that the rule could have unnecessary negative consequences for Monument Group Inc. ("Monument Group") and other similar FINRA-regulated independent third-party placement agents for private funds.

1. Background on Monument Group/Independent Placement Agents for Private Funds

Monument Group is an independent broker-dealer registered with the Commission and a member of FINRA. Its primary business is helping investment advisers that manage private investment funds to raise capital from institutional investors. The firm is independently owned and currently employs a total of 21 employees with 12 FINRA licensed registered representatives who, collectively, have over 200 years of experience in the investment business with an average of approximately 17 years. The business and educational credentials of the firm's principals and employees are those of investment professionals - CFAs, MBAs, investment analysts and consultants. The firm helps investment advisers that manage private investment funds, such as private equity, venture capital, real estate and energy funds, raise capital from institutional investors. Monument Group provides placement agency services *only* for issuers of private funds – *i.e.*, generally, for funds that are exempt from registration under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act").

The help that Monument Group, as an independent placement agent, provides to private fund advisers includes: (i) providing advice on building a compelling investment case to prospective investors; (ii) preparing presentation and offering materials as well as detailed due diligence information; (iii) identifying and targeting potential investors (including public pension plans) based on Monument Group's knowledge of their investment allocations, preferences and anticipated investment activity levels; (iv) introducing private investment funds managed by investment adviser clients to investors; (v) arranging roadshows of investor meetings; (vi)

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coordinating follow-up meetings between investment advisers and investors; (vii) coordinating investors' due diligence requests; (viii) intermediating in terms negotiations; and (ix) providing post-closing updates to clients and to investors.

Independent placement agents, such as Monument Group, not only help the private fund advisers find the market for their funds, but also provide significant benefits to *investors* in these private funds, including: (i) "quality screening" of funds prior to their introduction to investors -- investors have come to rely on Monument Group's expertise and successful track record in identifying good investment opportunities; (ii) the compilation and provision of extensive due diligence packages – *e.g.*, references, historical track record verification and analysis, models for testing market variables (leverage, P/E or EBITDA multiples, etc.) and independent macroeconomic data useful to provide context to the market opportunity – to often understaffed and overwhelmed in-house investment staffs; and (iii) providing a conduit for feedback –experienced and knowledgeable placement agents such as Monument Group assist both large and small investors in getting their voices heard by investment advisers on topics ranging from fees to governance terms.

While some of the better known placement agents are departments of major Wall Street firms, the vast majority of independent placement agents are small businesses. In addition, many independently owned placement agents, including Monument Group, are minority- or women-owned businesses. They operate with a focused staff and with no revenues from other lines of business such as trading, mergers and acquisitions, or other banking/brokerage services. Accordingly, incremental regulatory requirements that have little impact on larger firms, can create significant resource and cost issues for independent agents such as Monument Group.

2. FINRA's Proposed Rules

a. Background

As FINRA notes in its Notice, the principle motivation for its adoption of pay-to-play rules is a requirement in Investment Advisers Act of 1940 ("IAA") Rule 206(4)-5 that prohibits investment advisers from providing "payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless such person is . . . [a] regulated person." "Regulated persons" include brokers or dealers, as defined in Sections 3(a)(4) and (5) of the Securities Exchange Act of 1934 that are registered with the Commission and are members of a national securities association, "provided that (A) the rules of the association prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and (B) The Commission, by order, finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers" than those Rule 206(4)-5 imposes on investment advisers.[1]

[1] Regulated persons also include other registered investment advisers that have not and whose covered persons have not, in the preceding two years, made or coordinated contributions to the government entity being solicited and municipal advisors, provided that the MSRB's rules require municipal advisers to comply with pay-to-play rules that are at least substantially equivalent to Rule 206(4)-5. The MSRB is in the process of amending Rule G-37 to apply to municipal advisers. *See* Request for Comment on Draft Amendments to MSRB Rule G-37 to Extend Provisions to Municipal Advisors, MSRB Regulatory Notice 2014-15 (Aug. 18, 2014).

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Rule 206(4)-5 prohibits advisers from receiving compensation from a government entity for two years after they or their covered persons have made a contribution to "an official of the government entity." FINRA currently does not have the necessary rules in place and, if it fails to have rules approved before April 1, 2015, member firms (that are not required to register as a municipal adviser) will no longer be permitted to be compensated to solicit government entities on behalf of investment advisers.

In its Notice, FINRA proposes the adoption of three rules. Proposed Rule 2390 prohibits broker-dealers and certain of their associated persons ("covered associates"), in the two years before soliciting a government entity, from making contributions to officials of the government entity. The Proposed Rule also prohibits the broker-dealers and covered associates from soliciting or coordinating contributions that the member or covered associate could not themselves make. Proposed Rule 2390 -- with the exception of section (b) -- compliments the requirements in Rule 206(4)-5. Proposed Rule 2271 requires all broker-dealers engaged by investment advisers to solicit government entities to make certain mandatory disclosures to the government entity. Proposed Rule 4580 requires broker-dealers that solicit government entities to keep certain records of their solicitation activities and political contributions.

Monument Group supports FINRA's effort to adopt pay-to-play rules. Indeed, FINRA's adoption of a pay-to-play rule is critical to Monument Group being able to continue its current business model. For the most part, the Proposed Rules accomplish the goal of adopting rules that are substantially equivalent to 206(4)-5. As noted, Proposed Rule 2390 should satisfy the SEC's requirement that FINRA pass a rule substantially equivalent or more stringent than 206(4)-5. Proposed Rule 4580, similarly, imposes recordkeeping requirements that are reasonable for a firm to demonstrate and monitor compliance and for FINRA to adequately review compliance with the Proposed Rules.

FINRA's inclusion of Proposed Rules 2271, however, goes beyond what is necessary to satisfy the requirements in Rule 206(4)-5. In addition, the Proposed Rule would place significant and unique burdens on Monument Group and other independent third-party private fund placement agents[2] that threaten their ability to continue to provide valuable services to both advisers and investors.[3]

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[2] Although Monument Group seeks investors in private funds, not investment advisory clients for registered advisers, its activity is covered by Proposed Rule 2390(e) since the funds are "covered investment pools" as defined in Proposed Rule 2390(h)(3).

[3] The SEC, in adopting Rule 206(4)-5, recognized the legitimate and valuable role placement agents play in the process of marketing private funds to public pension plans. In particular, the SEC created this registered solicitor exception based on numerous concerns raised by commenters, including that a full ban on the use of third-party solicitors for government business would be particularly harmful to smaller advisers and government plans with limited resources that often rely on legitimate research, marketing and similar services of solicitors/placement agents in gathering information about and assessing investment opportunities. *See* Political Contributions by Certain Investment Advisers ("Adopting Release") 17 FR 41018, 41036 – 41042 (July 14, 2010).

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b. Proposed Rule 2271: Disclosure Requirements

As currently drafted, the disclosure requirements in proposed rule 2271 would require a "covered member[4] engaging in distribution or solicitation activities for compensation with a government entity on behalf of one or more investment advisers" to make certain written disclosures "at the time of the initial distribution or solicitation" "to such government entity." Adoption of this requirement is unnecessary and adds substantially to the similar disclosure and other compliance burdens already borne by firms like Monument Group in connection with existing pay-to-play laws and regulations.

i. Proposed Rule 2271 Is Not Necessary to Satisfy the Requirements in Rule 206(4)-5

As noted above, Monument Group supports the adoption of Proposed Rules 2390 and 4580. Proposed Rule 2390 contains the limitations on political contributions that are at the heart of the pay-to-play rules and tracks the SEC's Rule 206(4)-5. Monument Group also does not doubt the importance of making and keeping records -- as proposed in Rule 4580 -- to demonstrate and monitor compliance with Proposed Rule 2390. The adoption of Proposed Rule 2271, by contrast, is unnecessary to comply with the SEC's mandate that FINRA establish a rule substantially equivalent to Rule 206(4)-5.

The need to provide the proposed disclosures to government entities is not entirely apparent. As discussed below,[5] many government entities already mandate that funds, advisers and placement agents make certain disclosures and periodic reports. It is not clear why FINRA believes the benefits of the disclosures mandated by the Proposed Rule outweigh their costs, particularly where the government entities receiving the Proposed Rule 2271 disclosures have independently determined, and mandated, the information they consider to be relevant be provided. Indeed Proposed Rule 2271 seems aimed at solving an entirely different problem -- conflicts of interest -- than the pay-to-play rule, which is focused specifically on the issue of political contributions.

As drafted,[6] and as addressed further below, the disclosure requirements are, furthermore, overly burdensome and create difficult compliance challenges for firms like Monument Group. In light of the importance of timely adoption of a pay-to-play rule in the relatively short time left before the SEC's compliance date, Monument Group urges FINRA not to include Proposed Rule 2271 in its proposed rules.

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[4] "Covered members" are all FINRA members that are not required to register as municipal advisors. *See* Proposed Rule 2390(h)(4).

[5] *See, infra,* at 2.c.

[6] *See, infra,* at 2.b.ii.

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ii. Proposed Rule 2271 Is Substantially More Burdensome Than Similar Disclosure Requirements Applicable to Broker-Dealers Soliciting Investors on behalf of Registered Investment Advisers

Proposed Rule 2271 will impose a substantial burden on Monument Group and other similar firms. The disclosures mandated by Proposed Rule 2271 generally parallel the requirements in IAA Rule 206(4)-3 that solicitors that are paid to solicit advisory services on behalf of registered investment advisors make a series of disclosures regarding their solicitation arrangement with the advisor. Although Rule 206(4)-3 does not apply in the context of the solicitation of private fund investors,[7] that rule provides a benchmark for the type and scope of investor disclosure by those soliciting on behalf of investment advisers that the SEC considers relevant and reasonable.[8] Notably, there are three material differences between the Proposed Rule and Rule 206(4)-3 that substantially increase the burden these proposed disclosures will impose on third party placement agents.

First, the Proposed Rule requires that the member disclose "the existence and details of 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," a requirement that is not included in Rule 206(4)-3. Whereas to comply with Rule 206(4)-3 a solicitor may need a different disclosure document for each advisor for whom it solicits, Proposed Rule 2271 will require covered members to prepare a different disclosure document for *each government entity* it solicits. Moreover, the scope of the inquiry to prepare the required disclosure is impossibly broad.

From outside of the government entity, it is virtually impossible to determine the universe of persons affiliated with the entity that have influence in the decision-making process. Each entity is structured differently, and each may look to a variety of people in making decisions. This may include certain obvious persons -- a chief investment officer, certain other executives, board members, or members of an investment committee -- but could also include attorneys (in-house or outside), investment advisers, analysts, or even an intern who contributes research on certain investment opportunities. Covered members will have no reliable way to know, for each government entity with which they interact, that they have identified all the relevant affiliated persons.

Even if the covered member successfully identified the universe of affiliated persons, they must then determine whether there is any pecuniary, employment, business or *other relationships* between the firms and its covered associates on the one hand, and "any person affiliated with the government entity that has influence in the decision-making process" on the other. Pecuniary, employment and business are not defined in the Proposed Rule. "Other relationships," moreover, is a broad and vague term. It could encompass hundreds of possible connections including, for

[7] Rule 206(4)-3 does not apply to broker-dealers, like Monument Group, who solicit investments only in private funds. *See*, Mayer Brown LLP, No Action Letter (July 15, 2008).

[8] Monument Group acknowledges that the two rules would apply in different contexts – e.g., government entities (such as public pension plans) versus private investors -- and that certain disclosures that may be important in the context of an investment of public funds may not be relevant to a private investor. However, the differences identified herein demonstrate that the FINRA Proposed Rule – as compared to the SEC's Cash Solicitation rule – imposes burdens that lack proportion to the Proposed Rule's stated intent.

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example, membership in the same local, regional or national philanthropic or trade organizations, a school attended in common by a covered associate and an affiliated person of the government entity or by their spouses, domestic partners or children, or even attendance at the same conferences. Would a covered member have to disclose that the same law firm represented them and the government entity in unrelated matters? Tracking and researching all of these relationships for dozens of government entities from whom a covered member solicits business will impose substantial administrative costs on the firm.

Second, while Rule 206(4)-3 requires the disclosure to be made before the client enters into "any written or oral investment advisory contract," Proposed Rule 2271 requires the disclosure to be made "at the time of the *initial* distribution or solicitation." "Solicit" is defined in the Proposed Rules as "to communicate directly or indirectly for the purposes of obtaining or retaining a client for or referring a client to an investment adviser."[9] Given the broad scope of "solicit" virtually any activity -- making a call to a prospective investor, arranging a meeting, sending a letter -- could trigger the disclosure obligations in Rule 2271. This requirement, which is absent from Rule 206(4)-3, means that before a covered member initiates any contact with a public entity, and before it has any idea whether the government entity has any interest in or present ability to make an investment, the firm will be required to undertake the substantial investigation and analysis described above.

Finally, the Proposed Rule requires that the member update the disclosure "during any period in which [the member] is engaged in distribution or solicitation activities for compensation" with "any material changes to the information previously provided" within ten days of the change.[10] In Monument Group's business model, this requirement may apply to all investors with whom it has a relationship at all times. Monument Group's success stems from the long term relationships it develops with, on the one hand, the investment advisers forming and managing the funds, and on the other, with the investors in those funds. At any given time, Monument Group may be marketing one or more funds to existing investors. And even when Monument Group is not actively soliciting investors for a new investment, it will be in regular contact with them to provide updates on prior investments. The substantial task described above to identify relationships, is compounded by the need to constantly monitor each of those relationships for any changes that may occur and immediately send an update to the government entity.

iii. Disclosure of Compensation Puts Firms at a Competitive Disadvantage.

Proposed Rule 2271(a)(4) requires covered members to disclose the "terms of [the] compensation agreement [with the adviser], including a description of the compensation paid or to be paid to the covered member." Proposed Rule 2271(a)(5) requires disclosure of "[a]ny incremental charges or fees that may be imposed on the government entity as result of the distribution or solicitation activities engaged in by the covered member." Making these disclosures to government entities puts firms, like Monument Group, at a substantial competitive disadvantage with respect to other investors it may solicit and other advisers it may represent. Records provided to government entities are often discoverable by any member of the public through a state's equivalent of a

[9] Proposed Rule 2390(h)(10).

[10] Proposed Rule 2271(b).

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Freedom of Information Act ("FOIA") request. Any member of the public, including Monument Group's competitors and other investors, may have the legal right to receive copies of the disclosure statements, regardless of whether the government entity itself ever invested in the securities at issue. This may severely disadvantage Monument Group in competing for business with advisers and investors, limiting its ability to either raise or lower its rates if circumstances demand an adjustment. Moreover, these disclosures are likely to harm the government entities. Full transparency on costs and prices may stifle price competition between fund advisers and placement agents, in favor of a common fee accepted and publicized across the market. Finally, the fund advisers have their own substantial disclosure requirements under the IAA, including disclosures regarding fees and conflicts of interest. Requiring this additional disclosure is both burdensome and unnecessary.

c. Cost of Compliance

The Notice describes the Proposed Rules as a "comprehensive regime to regulate the activities of member firms that engage in the distribution or solicitation activities with government entities on behalf of investment advisers." In fact, while the Proposed Rules may be comprehensive in their approach, they do not account for the entire regulatory burden and cost firms like Monument Group face when they engage in distribution or solicitation activities with government entities.

Beyond the SEC's rule, FINRA's proposal, and the MSRB's rules applicable to municipal advisors, "pay-to-play" regulations now in place in many states require placement agents to register as lobbyists at state, county *and* municipal levels in order to receive any payment from funds for legitimate placement agent activities. Some state or local laws ban receipt of contingency fees by placement agents (even by those registered as lobbyists). Still others ban the participation of third party placement agent activities entirely. Even where compensation is permitted, placement agents are required by most of the local lobbyist laws to submit to onerous registration, reporting and annual compliance requirements (again, at many different state and local levels).[11] Many of these lobbyist regulations and placement agent policies also require fund issuers to register at these various state and local levels as "lobbyist employers" and to submit onerous disclosures to the investing plans *simply as a result of engaging a third party placement agent.*[12]

The cost of implementing the Proposed Rules, while substantial (and, as noted above, potentially difficult to manage in some respects), would have a less significant impact on the viability of firms like Monument Group if they truly were comprehensive – i.e., in preempting the thousands of different state and local requirements that the industry already faces. ***The Proposed Rules are not being built on an empty field, but rather are being layered on top of an existing collection of unwieldy state and local laws and regulations.*** Firms already spend substantial sums to track and comply with these various requirements. A single regime mandating uniform national eligibility

[11] *See* Adopting Release at n. 262 (collecting examples of state action to regulate solicitation of government entities). Indeed, as noted above, government entities' own disclosure and reporting requirements call into question the need for FINRA's mandated disclosures.

[12] Many public pension plans have recently adopted "placement agent policies" requiring investment managers who use independent placement agents to file and update periodic reports disclosing compensation paid, *etc.*, on a regular basis.

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requirements, disqualifications, disclosures and reporting would be more effective, easier to administer and less expensive than the current patchwork of state, county and local requirements. Adding unnecessarily burdensome requirements within the FINRA Proposed Rules to an already burdensome structure may ultimately jeopardize the ability of placement agents like Monument Group to remain in business.

As these sorts of compliance costs rise, firms will inevitably be forced to consider whether they can continue their relationships with significant numbers of government entities, and they may conclude they have to limit their exposure in this area. Such decisions could limit the investment opportunities presented to government entities, and would adversely affect the financial viability of independent placement agents and the funds and advisers to whom they provide services, ultimately impeding capital formation and investment.

3. Conclusions and Recommendations

Monument Group supports FINRA's proposal to adopt a pay-to-play rule and encourages FINRA to seek quick approval so as to not jeopardize the ability of independent third-party placement agents, like Monument Group, to continue solicitation activity after April 1, 2015.

To that end, Monument Group suggests that FINRA streamline its proposal, bringing it more into line with the SEC's pay-to-play rule. Monument Group recommends that FINRA eliminate Proposed Rule 2271 as it is not necessary to meet FINRA's primary objective of enacting a rule substantially equivalent to the IAA rule. If Proposed Rule 2271 is to be included, the provision in Proposed Rule 2271(a)(6) should be eliminated, allowing firms to create a single disclosure document for each adviser for which they solicit, rather than dozens of specially customized disclosures for each government entity. If FINRA continues to require some customized disclosure in the final rule, the timing of that disclosure should be moved to much later in the investment process, such as at the signing of a subscription agreement or the closing of a transaction. Forcing firms to undertake substantial due diligence and create customized disclosures at a very early stage is likely to chill firm's interest in approaching government entities with investment opportunities.

Similarly, FINRA should eliminate the update requirement in Proposed Rule 2271(b). In particular, the requirement that updates be provided within 10 days of a change presents a substantial administrative burden. Indeed the advisers for whom the covered members are soliciting do not generally update their client disclosures as often or as quickly as is mandated by Rule 2271(b). If FINRA believes updates are necessary, it should adopt a requirement that they be made annually.

Finally, Monument Group encourages FINRA to consider the already existing state, municipal and local lobbyist registration, disclosure and reporting requirements and pay-to-play regimes in connection with calculating cost and competitive impact of the Proposed Rules. The Proposed Rules disproportionately affect FINRA-registered placement agents (as compared with other broker-dealers) and have the largest economic and anti-competitive effect on small independent

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firms, like Monument Group, who – as the SEC has itself recognized – add legitimate value to the private fund marketplace.[13]

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Thank you in advance for considering these comments. I am available for and would welcome further discussion.

Yours sincerely,

Molly M. Diggins
General Counsel

cc: Robert L. D. Colby Chief Legal Officer, FINRA

[13] Monument Group does not doubt the importance that states place on being able to regulate and oversee those who market investments to entities investing public fund. We would, however, encourage FINRA to partner with the state and local governments to develop a truly comprehensive set of pay-to-play regulations that might mitigate the unintended and burdensome consequences, particularly on independent placement agents, of having to track and comply with several dozen different regulatory schemes.

3PM
THIRD PARTY MARKETERS ASSOCIATION

OUTSOURCED GLOBAL MARKETING OF ALTERNATIVE + TRADITIONAL INVESTMENTS

December 22, 2014

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

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

Dear Ms. Asquith:

The Third Party Marketers Association ("3PM") supports FINRA's initiative to implement a "Pay-to-Play" and related rules that would regulate the activities of member firms that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers that provide or are seeking to provide investment advisory services to such government entities; specifically through the following three new proposed rules:

- Rule 2271: Disclosure Requirement for Government Distribution and Solicitation Activities
- Rule 2390: Engaging in Distribution and Solicitation Activities with Government Entities
- Rule 4580: Books and Records Requirements for Government Distribution and Solicitation Activities

3PM acknowledges that the SEC adopted the Advisers Act Rule 206(4)-5 in July 2010 addressing pay-to-play practices by investment advisers (the SEC Pay-to-Play Rule), and the framework of this Rule was purposeful and impactful to the specific constituency of the marketplace to which it was directed: investment advisers. 3PM also acknowledges that other market practitioners, namely FINRA members firms and their registered representatives, should be addressed by specific rules, and this comment letter will address the proposed rules as well as FINRA's specific questions.

1. ***The proposed pay-to-play rule is modeled on the SEC Pay-to-Play Rule. Is this approach appropriate or are there alternative models that FINRA should consider that would be as or more effective in deterring pay-to-play practices and also meet the requirement in the SEC Pay-to-Play Rule that FINRA's rules impose substantially equivalent or more stringent restrictions on member firms than the SEC Pay-to Play Rule imposes on investment advisers?***

3PM believes that FINRA's goal should be to harmonize its rules regarding pay-to-play with those of the SEC and the MSRB and implement equivalent restrictions on member firms to those imposed on investment advisers by the SEC. Given the overlapping regulatory oversight that exists in today's investment industry, 3PM believes that in order for firms to participate in a fair and competitive marketplace participants should not be disadvantaged relative to their competitors because their business model falls under one regulatory scheme rather than another. We believe that FINRA members will in fact be disadvantaged should FINRA move forward with its proposal to impart more stringent restrictions on member firms. FINRA members are already subjected to more regulatory rules and requirements than either investment or municipal advisers. As proposed, this rule would only serve to further shift the playing field in favor of these advisers at the expense of FINRA Members.

2. ***The proposed pay-to-play rule applies to covered members that 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. Could member firms engage in activities with government entities that are not covered by this rule that should be covered? If so, what are those activities and how should FINRA design a pay-to-play rule to cover such activities?***

   3PM believes that there are in fact a number of activities that may trigger compliance outside the proposed scope of the rule; however that meaningful regulation cannot be accomplished without placing substantial burden for compliance on the government entity. Recognizing that governmental entities are outside the jurisdiction of FINRA, 3PM urges FINRA to exercise caution so that it does not create a 'check' without 'balance.'

3. ***FINRA is proposing to interpret and apply the terms in its proposed pay-to-play rule consistent with how the SEC has interpreted the terms in the SEC Pay-to-Play Rule. Is this approach appropriate? Are there terms that require additional clarification or that should be interpreted or applied differently? Are there differences between broker-dealers and investment advisers that would warrant a different interpretation or application of terms in the proposed rule?***

   In order to further protect investors, 3PM believes that the definition of an investment adviser in Rule 2390 should be expanded to include not only SEC registered investment advisers, but also State registered investment advisers. Investment advisers who are not registered with the SEC due to their size or by choice should not have an advantage over firms that are not subject to federal regulatory oversight. 3PM believes that state regulators should be drawn into the regulatory dialogue on this issue to ensure that future state lawmaking will not further complicate or contradict the direction FINRA is taking with its BD constituents.

4. ***How prevalent are pay-to-play practices by member firms? What are the effects of such pay-to-play practices on the ability to obtain business from government entities?***

The results of past unscrupulous activities are still being deeply felt by firms who distribute product or solicit investments from government entities. These activities have tarnished the credibility of an entire industry which for the most part is comprised of highly ethical and properly regulated firms. While some government entities have realized that these pay-to-play activities could not have occurred without some "loopholes" in the processes utilizes by these government entities many still believe the problem to be one-sided. As a result there are a number of states which have made our jobs nearly impossible by either banning our activities, prohibiting payment on any investments we were involved in, by requiring us to register as lobbyists or by enacting such overreaching and onerous disclosure and reporting requirements.

While 3PM recognizes that pay-to-play 'bad actors' still exist, despite increased awareness and regulation we believe that this problem is two-sided. As such, 3PM encourages FINRA to coordinate its efforts as much as possible with other regulators including NASAA (state BD and IA regulators), to close the gaps that seem to be the primary source of violations in the pay-to-play arena. We also believe that FINRA should increase awareness among its examiners, in its regional and district offices and others among its ranks wherever possible as a meaningful alternative to more stringent rulemaking initiatives.

5. ***How prevalent are pay-to-play practices in connection with member firms engaging in distribution or solicitation activities with government entities on behalf of investment advisers that provide or are seeking to provide investment advisory services to the government entity? Would the proposed rules be effective at deterring such practices?***

3PM believes that unscrupulous pay-to-play activities are not as common as they once were however; we believe that any industry that offers the opportunity to make large sums of money will always attract bad actors. As such, we believe that the answer is not in more stringent rulemaking, but rather in closing the gap between regulated and unregulated entities. We believe that a harmonized rule making effort will make it easier for firms to comply with the rules and at the same time make it easier for the regulatory authorities to identify who is operating within the confines of the law and who is not. This is also why we believe that the definition of an investment adviser in Rule 2390 should be expanded to include all investment advisers not just federally registered ones.

6. ***Are the proposed recordkeeping requirements appropriately tailored to obtain information that would be relevant for purposes of monitoring for compliance with the proposed rule?***

3PM does not believe that the recordkeeping requirements are appropriately tailored to obtain information that would be relevant for purposes of monitoring compliance with the proposed rule. While monitoring the direct political contributions is an important way to curb pay-to-play activities, requiring firms to also track and monitor indirect contributions could become extremely time consuming and costly for firms. As such we believe that the indirect compensation recordkeeping requirement should be eliminated.

7. ***Are the proposed disclosure requirements appropriately tailored to provide government entities with the information necessary for the government entity to determine if there are potential conflicts of interest that could influence the selection process by the government entity?***

   3PM believes that a written disclosure is an extremely important and necessary part of the investment industry and helps to alert investors to information that they may have not been previously aware of. In this case we are not adverse to providing investors with most of the information outlined in Rule 2271 and appreciate that we would be permitted to do so electronically. We believe that investors have the right to know information that could impact their investment decision.

   3PM further believes that the requirement to update any disclosure within 10 days is not a reasonable length of time and is inconsistent with other FINRA requirements which allow firms 30 days to update important firm information on filings such as Form BD, BR, U4s and U5s. We believe this time frame should be extended to be consistent with other regulatory filing requirements.

   We also ask FINRA for some clarification regarding some of the disclosure items required under Rule 2271. It appears that these requirements incorporate most of the components of the Solicitor Disclosure Rule (Rule 206(4)-3 under the Investment Advisers Act of 1940) disclosure. In an interpretive letter dated July 28, 2008, the SEC Office of Chief Counsel, Division of Investment Management replied to Mayer Brown's inquiry to clarify that Rule 206(4)-3 does not apply to cash payments by registered advisers to persons who solicit investors to invest in investment pools managed by the adviser. Given that most of FINRA's members who solicit for investment advisers are soliciting for pools of funds, ie Hedge Funds, Private Equity and Real Estate Funds, as well as other types of commingled LPs, we believe that there is a disconnect between the SEC's interpretation and FINRA's proposed rule. We respectfully request that you address how FINRA's proposed rule would reconcile with the SEC's interpretive letter.

8. ***What would be the likely effects on competition, efficiency and capital formation of the proposed pay-to-play rule?***

   3PM believes that the proposed pay-to-play rule in its current form would disadvantage FINRA members by imposing a more stringent rule set on its constituents without adding any new investor protections. By adding more onerous requirements, the rule would also disadvantage members who would compete with firms not subject to the same requirements.

   The rule would also add a new and significant burden on small firms in terms of disclosure and recordkeeping requirements. Not only would small firms be impacted by cost, but also by their limited personnel resources who would now have to take on additional responsibilities to comply with this rule.

9. ***How many member firms are expected to be impacted by the proposed pay-to-play rule? What is the estimated number of covered associates per member firm?***

The information below is based in information obtained in early 2013. While the data may not be as current as we would like we believe numbers reflect a viable estimate of the firms that would be impacted by the proposed pay-to-play rule.

FINRA, defines a small firm is any firm with 150 or fewer licensees, or registered representatives. FINRA is comprised of approximately 4400 firms of which 85% are categorized as small firms. A significant percentage of small broker-dealers that have only 2 or fewer business lines, have less than $1mm in annual revenue, and/or engage in business lines such as private placements, mergers and acquisitions, and other such business lines which would fall under the category of LCFB.

These types of small broker-dealers are readily identifiable using BrokerCheck, FINRA's public resource for broker-dealer background reviews, or through its central data depository (CRD) with the following acronyms:

- Other
- PLA – Private Placement
- PLA and Other

Of the 4400 FINRA broker-dealers registered, the statistics reveal the following:

- 191 broker-dealers report that private placement activity is their only business line;
- 174 broker-dealers do not fall into any of the customary FINRA business lines and disclose "Other" as their only line of business. Most of these describe their business as mergers and acquisitions;
- 541 broker-dealers disclose that they engage solely in private placement agent and "other" activity, again describing the other activity as mergers, acquisitions and placement agent or third party marketing services.

Cumulatively, these 906 firms represent a class of broker-dealer that does not open securities or investment accounts, does not carry or introduce assets or securities, and which does not have customers in the retail sense. The business activities of these firms are governed by contract, and are not 'transactional.'

It is important to note that the majority of these firms are also very small firms, and many have revenue of less than $1mm/year. Of the 457 firms reporting only one line of business (private placements or "other") all but 13 are small firms (fewer than 50 employees). Of those reporting two business lines (Private placements and "other"), 98% have fewer than 50 employees.

Attributes	# Firms	# with Fewer than 50 RRs	As %
PLA	191	188	98%
Other	174	164	94%
PLA and Other	541	528	98%
Total or Average	**906**	**880**	**97%**

10. ***What are the sources and estimates of benefits associated with the proposed pay-to-play rule, proposed disclosure requirements and proposed recordkeeping requirements?***

While we understand the importance and timing of FINRA's rulemaking in support of the continued activities of placement agents currently engaged in covered activities, however we believe that the desired result can only occur if FINRA makes a commitment to carefully coordinate its rules with those already in place, and in the context of the size and variety of firms in its jurisdiction. We support the pay-to-play rulemaking to the extent that FINRA is committed to ongoing dialogues with state and federal regulators with both the IA and BD jurisdiction to ensure consolidation and coordination of rules and associated examination initiatives.

We do not believe there to be a measurable benefit in any disclosure requirements that would exceed those already required under SEC rules. Disclosure of the existence of written policies and procedures, for instance, is unlikely to serve any real benefit to the recipient of the disclosure.

We believe the proposed record keeping requirements go beyond what would be necessary to facilitate ease of review by FINRA examiners and should be expressly limited to meaningful activities. For instance, record keeping related to attempted solicitations and/or to non-clients should be eliminated as should indirect contributions that may be extremely difficult to monitor and track.

11. ***What are the sources and estimates of compliance costs associated with the proposed pay-to-play rule, proposed disclosure requirements and proposed recordkeeping requirements? Would the proposed rules impose different costs based on the size or the business model of the member firm?***

As discussed briefly above, to the extent that FINRA rules for BDs exceed those established rules for SEC or state investment advisers, municipal advisers or others operating in this space, the costs of compliance are proportionately unfair. Particularly burdensome are disclosure requirements, especially in the context of the proposed 10-day window for updates, and the record keeping requirements related to solicitations and/or to non-clients.

12. ***How many member firms would engage outside legal services to assist in drafting policies and procedures to comply with the proposed rules? What are the estimated costs?***

    3PM estimates that the majority of its members will spend between $1,500 and $2,500 or approximately 5 to 10 hours of a professional consultant's time to draft and implement effective pay-to-play procedures. In addition, 3 PM estimates that a BD in compliance with rulemaking will exert approximately 10-20 additional hours of compliance oversight in connection with the proposed rules each year. While 3PM believes this investment will not be overly burdensome, it encourages FINRA to be sensitive to the costs and burdens. Particularly, 3 PM requests that FINRA dedicate its resources to incorporating instructive guidance wherever possible in its implementing release (if any) and to create and publish forms, checklists and model procedures and disclosure language to assist BDs in achieving compliance.

13. ***How many member firms that would be impacted by the proposed pay-to-play rule are subject to (or are affiliated with entities subject to) the SEC Pay-to-Play Rule or MSRB pay-to-play rules? Would the compliance costs associated with the proposed rule be lower for these member firms? What are the estimates of compliance costs?***

    3PM believes that there would be some substantial overlap in the requirements in certain circumstances relating to the different regulatory bodies governing the specific market practitioners, therefore it makes sense for these regulatory bodies, namely the SEC, FINRA, NASAA and the MSRB, to open and maintain specific channels of communication between themselves to make the process more efficient.

    The regulatory bodies could increase efficiency further by providing a standardized format by which market practitioners could share relevant information and document this information accordingly. 3PM would be interested in giving its initial and ongoing input in a joint regulatory committee, to the extent such a body is formed.

14. ***The proposed pay-to-play rule does not cover member firms that are SEC-registered municipal advisors subject to MSRB pay-to-play rules. FINRA recognizes that both its and the MSRB's proposed rules are still undergoing the public comment process and subject to modifications. Would the applicability of the two sets of rules on member firms create any competitive imbalances? What are they? How substantial are they?***

    When the regulators themselves cannot coordinate the release and implementation of what should be substantially similar rule-making, BDs, and especially small BDs are significantly disadvantaged. Juggling pending internal compliance initiatives, including timing the drafting and implementation of new policies, gauging whether or not disclosures are advisable in the context of one jurisdiction or the other, and even making hiring decisions are substantial and costly considerations in the context of pending rulemaking. Structuring a business plan, licensing, registration, training and other business considerations border on impossible. Unless and until the regulators come together to create a meaningful landscape for all market participants, bad actors will continue to engage in regulatory arbitrage to the detriment of those firms trying to do it right.

15. ***Would the proposed pay-to-play rule create any competitive imbalances among member firms because some dually registered investment advisers would be subject to the SEC Pay-to-Play Rule while others would be subject to the proposed rule?***

    The answer to the question is yes, to the extent that substantially similar rules are not applied evenly across all firms engaging in the business of placing business with government entities. To be effective, the rules must take into account all relevant factors and all relevant jurisdictions. 3PM recognizes that the regulatory scheme will not be changed with this one area of rulemaking. Nonetheless, we see no reason why FINRA's rules regarding pay-to-play should be any different for BDs than the existing rules for SEC registrants.

16. ***Are there any other expected economic impacts associated with the proposed rules? What are they, what entities would be impacted, and what are the estimates of those impacts?***

    3PM believes that the potential for substantial economic impact exists, based on the substantial size of some of the government entities involved. Headline events surrounding the bad actors reveal the potential for abuse. Importantly, these same events highlight the involvement of unregulated individuals and/or the government entities themselves, in the violations of laws, rules regulations and trust. It is imperative that FINRA's rulemaking does not disadvantage its compliant members. 3PM believes FINRA should do what is minimally necessary to address the present regulatory gap rather than go overboard by implementing more stringent regulation that will offer no added benefits or protections.

If you have any questions or comments regarding any of the information contained in this letter or would like to discuss any of these comments in further detail, please feel free to contact me directly by phone at (212) 209-3822 or by email at donna.dimaria@tesseracapital.com.

Thank you in advance for your consideration.

Regards,

Donna DiMaria

Donna DiMaria
Chairman of the Board of Directors
3PM Association

Appendix

3PM is an association of independent, outsourced sales and marketing firms that support the investment management industry worldwide.

3PM Members are properly registered and licensed organizations consisting of experienced sales and marketing professionals who come together to establish and encourage best practices, share knowledge and resources, enhance professional standards, build industry awareness and generally support the growth and development of professional outsourced investment management marketing.

Members of 3PM benefit from:

- Regulatory Advocacy
- Best Practices and Compliance
- Industry Recognition and Awareness
- Manager Introductions
- Educational Programs
- Online Presence
- Conferences and Networking
- Service Provider Discounts

3PM began in 1998 with seven member-firms. Today, the Association has more than 35 member organizations, as well as significant number of prominent firms that support 3PMs and participate in the Association as 3PPs, Industry Associates, Member Benefit Providers, Media Partners and Association Partners.

A typical 3PM member-firm consists of two to five highly experienced investment management marketing executives with, on-average, more than 10 years' experience selling financial products in the institutional and/or retail distribution channels. The Association's members run the gamut in products they represent. Members work with traditional separate account managers covering strategies such as domestic and international equity, as well as fixed income. In the alternative arena, members represent fund products such as mutual funds, hedge funds, private equity, fund of funds and real estate. Some firms' business is comprised of both types of product offerings. The majority of 3PM's members are currently registered with FINRA or affiliated with a broker-dealer that is a member of FINRA.

For more information on 3PM or its members, please visit www.3pm.org

Invested in America

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

Submitted by electronic mail:
pubcom@finra.org

Date December 22, 2014

Subject FINRA Regulatory Notice 14-50

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("**SIFMA**" or "**we**")[1] is grateful for the opportunity to comment on Proposed Rules 2271,[2] 2390,[3] and 4580[4] (together, the "**Proposed Rules**"), issued for comment in Regulatory Notice 14-50 by the Financial Industry Regulatory Authority ("**FINRA**").[5] SIFMA has long supported efforts to combat "pay-to-play" practices[6] and appreciates the extent to which the Proposed Rules are harmonized with Rule 206(4)-5 of the Securities and Exchange Commission (the "**SEC**") under the Investment Advisers Act of 1940, as amended (the "**SEC Pay-to-Play Rule**").[7] Our comments below are focused on those aspects of the Proposed Rules that diverge from the SEC Play-to-Play Rule.

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation, and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, please visit www.sifma.org.
[2] Proposed FINRA Rule 2271 ("**Proposed Rule 2271**").
[3] Proposed FINRA Rule 2390 ("**Proposed Rule 2390**").
[4] Proposed FINRA Rule 4580 ("**Proposed Rule 4580**").
[5] FINRA Requests Comment on a Proposal to Establish a 'Pay-to-Play' Rule, FINRA Regulatory Notice 14-50, (Nov. 14, 2014), available at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p601679.pdf ("**Regulatory Notice 14-50**").
[6] *See*, *e.g*., Comment Letter of SIFMA to Elizabeth Murphy, Sec'y, SEC (Oct. 5, 2009), *available at* http://sec.gov/comments/s7-18-09/s71809-166.pdf (the "**2009 Letter**").
[7] Political Contributions by Certain Investment Advisers, Final Rule, Investment Advisers Act Release No. IA-3043, 75 Fed. Reg. 41018, 41019 (Jul. 14, 2010) ("**SEC Pay-to-Play Final Release**"). The SEC Pay-to-Play Rule is set forth in Rule 206(4)-5, Political Contributions by Certain Investment Advisers, 17 C.F.R. § 275.206(4)-5 (2014), under the Investment Advisers Act of 1940, as amended, 15 U.S.C. § 80b-1 *et seq*. (2012) (the "**Advisers Act**").

The SEC Pay-to-Play Rule includes a provision that prohibits an investment adviser and its covered associates from "provid[ing] or agree[ing] to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such investment adviser unless such person is a *regulated person*..." (emphasis added).[8] On account of the SEC Pay-to-Play Rule's expanded definition of "investment advisory services," this prohibition applies to parties soliciting a government entity both (i) to enter into an advisory relationship and (ii) to purchase an ownership interest in a pooled investment vehicle, and accordingly would prevent a FINRA member from engaging in either type of solicitation activity unless it qualified as a "regulated person."[9] A FINRA "covered member"[10] qualifies as a "regulated person" for purposes of the SEC Pay-to-Play Rule to the extent that FINRA adopts its own pay-to-play rule that the SEC deems to impose restrictions on covered members that are substantially equivalent to or more stringent than, and otherwise consistent with the objectives of, the SEC Pay-to-Play Rule (the "**Regulated Person Requirement**").[11]

The Regulated Person Requirement is scheduled to take effect on April 1, 2015.[12] If FINRA covered members are not subject to an SEC-approved pay-to-play rule by that time, they will be effectively banned from engaging in solicitation activity covered by the SEC Pay-to-Play Rule.[13] We agree with FINRA that a disruption of these solicitation activities would be harmful not only to the covered members themselves but also to the investment advisers and government entities that rely on them,[14] resulting in higher costs for investment advisers, reduced investment opportunities for government entities, and an overall decrease in the "allocative efficiency" of capital markets.[15] Given the limited time remaining before the April 1 effective date, we believe that it would be imprudent to include provisions in this rulemaking that are neither required by, nor necessary to effectuate, the Regulated Person Requirement.

We therefore recommend that FINRA (i) eliminate Proposed Rule 2271 or, at a minimum, remove it from this rulemaking for consideration on a separate track, (ii) harmonize key terms appearing in both the Proposed Rules

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[8] 17 C.F.R. § 275.206(4)-5(a)(2)(i).

[9] Although the Advisers Act does not extend to brokerage activities, the SEC Pay-to-Play Rule provides that "an investment adviser to a covered investment pool in which a government entity invests or is solicited to invest [is] treated as though that investment adviser were providing or seeking to provide investment advisory services directly to the government entity." 17 C.F.R. § 275.206(4)-5(c). The SEC Pay-to-Play Rule defines "covered investment pool" as (i) any registered investment company "that is an investment option of a plan or program of a government entity" or (ii) any entity that would be a registered investment company but for its reliance on an exclusion under Sections 3(c)(1), 3(c)(7), or 3(c)(11) of the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-1 *et seq*. (2012). 17 C.F.R. § 275.206(4)-5(f)(3). The Proposed Rules use the same definition of "covered investment pools" as the SEC Pay-to-Play Rule and otherwise mirror the SEC Pay-to-Play Rule's approach. *See* Proposed Rule 2390(e); Proposed Rule 2390(h)(3); Proposed Rule 2271(c) (stating that "the terms used in [Proposed] Rule 2271 shall have the same meaning as defined in [Proposed] Rule 2390")); Proposed Rule 4580(c) (stating that "the terms used in [Proposed] Rule 4580 shall have the same meaning as defined in [Proposed] Rule 2390").

[10] "Covered member" is defined for purposes of the Proposed Rules as "any [FINRA] member except when the member is engaging in activities which would cause the member to be a municipal advisor." Proposed Rule 2390(h)(4). Solicitations of government entities with respect to investment advisory relationships by a FINRA member on behalf of an unaffiliated investment adviser are regulated by the municipal advisor rules set forth under Section 15B(e)(4) of the Securities Exchange Act of 1934, as amended (the **"Exchange Act"**). 15 U.S.C. § 78o-4(e)(4); 17 C.F.R. § 240.15Ba1-8. FINRA members that must register as municipal advisors as a result of engaging in such third-party solicitation activity are not subject to the Proposed Rules. *See* Regulatory Notice 14-50, at 4. Covered members therefore fall into three general categories of government entity solicitors: (i) broker-dealers soliciting investment in a covered investment pool on behalf of an affiliated investment adviser, (ii) broker-dealers soliciting investment in a covered investment pool on behalf of an unaffiliated investment adviser, and (iii) broker-dealers soliciting investment advisory relationships on behalf of an affiliated investment adviser. Categories (i) and (ii) involve brokerage activity, *i.e*., the solicitation of a security, and are accordingly governed by the Exchange Act and the rules thereunder (including FINRA rules). In contrast, category (iii) involves advisory activity, *i.e*., the solicitation of a fiduciary investment advisory relationship, which is governed by the Advisers Act and the rules thereunder.

[11] Under the Regulated Person Requirement, a FINRA member qualifies as a "regulated person" if "(A) [FINRA rules] prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made; and (B) the [SEC], by order, finds that such rules impose substantially equivalent or more stringent restrictions on broker-dealers 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]." 17 C.F.R. § 275.206(4)-5(f)(9)(ii).

[12] By rule, the Regulated Person Requirement takes effect nine months after the compliance date of a final rule establishing registration requirements for municipal advisors. *See* Advisers Act Release No. 3418, 77 Fed. Reg. 35263 (June 13, 2012). The SEC adopted the final municipal advisor rule on September 20, 2013, with a compliance date of July 1, 2014. Exchange Act Release No. 70462, 78 Fed. Reg. 67468 (Nov. 12, 2013). April 1, 2015 falls nine months after July 1, 2014. *See* Regulatory Notice 14-50, at 3.

[13] *See* Regulatory Notice 14-50, at 12 ("FINRA must propose its own pay-to-play rule to enable member firms to continue to engage in distribution and solicitation activities for compensation with government entities on behalf of investment advisers.").

[14] *Id*.

[15] *Id*. *See also* 2009 Letter, at 9.

and the SEC Pay-to-Play Rule, (iii) harmonize the recordkeeping requirements of Proposed Rule 4580 and the SEC Pay-to-Play Rule, and (iv) remove the mandatory disgorgement provision from Proposed Rule 2390.

I. FINRA SHOULD NOT IMPOSE THE PROPOSED DISCLOSURE REQUIREMENTS

As a threshold matter, the rationale for including Proposed Rule 2271 in the present rulemaking is unclear, since, as noted above, Proposed Rule 2271's disclosure requirements are unrelated to FINRA's primary objective of putting into place a FINRA pay-to-play regime by the April 1, 2015 deadline. No other federal pay-to-play rule, including the SEC Pay-to-Play Rule, imposes similar disclosure obligations on covered parties, and FINRA has not explained why a different approach is necessary here.[16] Indeed, in adopting the Regulated Person provision, the SEC determined that a disclosure regime would be ineffective in addressing pay-to-play concerns. In particular, in response to commenters who had suggested adoption of a disclosure regime in lieu of the proposed blanket ban on payments to solicitors, the SEC noted that disclosure is not "…useful when plan fiduciaries themselves are participants in the pay-to-play activities" and that "the [Municipal Securities Regulatory Board ("**MSRB**") ha[s] already sought *unsuccessfully* to address the problem of placement agents and consultants engaging in pay to play activities on their principals' behalf through mandating greater disclosure" (emphasis added).[17] Furthermore, it is not apparent that Proposed Rule 2271 is necessary for purposes of investor protection. Broker-dealers are already subject to numerous investor protection-related disclosure and conduct requirements that apply to the solicitation activity covered by Proposed Rule 2271,[18] and Regulatory Notice 14-50 does not fully examine why additional disclosures are needed beyond what is already required for a broker-dealer selling a security to, or soliciting an investment advisory relationship with, a government entity.

Proposed Rule 2271 also presents insurmountable legal and operational challenges. First, the proposed disclosure requirements—and especially the "relationship" disclosure requirement of Proposed Rule 2271(a)(6)—are unworkable in light of their scope, timing, and requirement for rolling disclosure updates. Second, Proposed Rule 2271 is neither tailored to deal with the variations in the multiple business lines that will be subject to the proposed disclosure requirements nor sufficiently considers overlapping and related regulated regimes.

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[16] FINRA observes in a footnote to Regulatory Notice 14-50 that "the SEC imposes similar disclosure requirements [to Proposed Rule 2271] in connection with cash payments by investment advisers to solicitors with respect to solicitation activities," citing Advisers Act Rule 206(4)-3, 17 C.F.R. § 275.206(4)-3 (2014) (the "**Cash Solicitation Rule**"). Regulatory Notice 14-50, at n. 56. As discussed below, however, the proposed disclosure requirements are significantly broader than the disclosures required under the Cash Solicitation Rule and, in particular, include a "relationship" disclosure obligation that is not part of that rule. More importantly, we note that—in contrast to Proposed Rule 2271—the Cash Solicitation Rule only applies to the fiduciary context of the solicitation of investment advisory relationships and has no application to brokerage transactions. We therefore encourage FINRA to refrain from applying the Cash Solicitation Rule's rationale and objectives indiscriminately to disclosure obligations for parties engaged in typical broker-dealer activities, such as the sale of interests in covered investment pools, at least until such time as FINRA and other interested parties have duly considered the consequences of this conflation of the separate regulatory regimes normally applicable to investment advisers and broker-dealers. To the extent that FINRA seeks to impose disclosure obligations on covered members that solicit or refer investment advisory relationships, SIFMA has no objection to maintaining consistency with the Cash Solicitation Rule for such activity.

[17] SEC Pay-to-Play Final Release, at 41039. *See also* Comment Letter of the Investment Company Institute to Marcia E. Asquith, Office of the Corp. Sec'y, FINRA (Dec. 15, 2014), at 4 ("**ICI Letter**").

[18] *See*, *e.g.*, Securities Act of 1933, 15 U.S.C. § 77q(b) (2012) (making it unlawful for any person to use jurisdictional means to "publish, give publicity to, or circulate any notice, circular, advertisement, newspaper article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof"); SEC Rule 10b-5, Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2014) (making it unlawful for any person to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading"); SEC Rule 10b-10, Confirmation of Transactions, 17 C.F.R. § 240.10b-10 (2014) (requiring disclosure of "specified information in writing to customers at or before completion of a transaction," including the name of any entity on whose behalf the broker-dealer is acting and details as to any remuneration received or to be received by the broker-dealer); SEC Rule 206(4)-3, Cash Payments for Client Solicitations, 17 C.F.R. 275.206(4)-3 (requiring a separate written disclosure document to be furnished by solicitors with respect to solicitation of advisory relationships on behalf of an investment adviser); FINRA Rule 2010 (requiring FINRA members to "observe high standards of commercial honor and just and equitable principles of trade"); FINRA Rule 2020 (prohibiting FINRA members from "effect[ing] any transaction in, or induc[ing] the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance"); FINRA Rule 2210 (setting forth standards governing the content, approval, recordkeeping, and filing of retail and institutional communications for the duration of the retention period required by SEC Rule 17a-4).

SIFMA accordingly believes that Proposed Rule 2271 should be eliminated in its entirety. If FINRA is inclined to proceed with promulgating Proposed Rule 2271, however, SIFMA would ask, at a minimum, that the considerable burdens and ambiguities associated with Proposed Rule 2271 be ameliorated by decoupling the rule from the other Proposed Rules for later consideration and substantial modification via a separate rulemaking process.

A. The scope, timing, and updating requirements of Proposed Rule 2271 preclude effective implementation of the rule.

Proposed Rule 2271 would impose extraordinary burdens on covered members, which would be exacerbated by the timing and updating requirements of the rule. The required disclosures must be made "in writing" and "at the time of the initial distribution or solicitation on behalf of each investment adviser."[19] Covered members must also "update in writing…any material changes to the information previously provided to the government entity…within 10 business days of the date of such change" during "any period in which [such covered member] is engaging in the distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser."[20] When combined with the broad scope and ambiguous text of Proposed Rule 2271, these requirements as to the manner and timing of disclosures along with the requirement for rolling disclosure updates would make compliance with Proposed Rule 2271 unworkable.

Compliance with Proposed Rule 2271 requires the preparation of lengthy, tailored, and written disclosures. Perhaps the most burdensome of the proposed disclosure requirements is Proposed Rule 2271(a)(6), which would mandate that a covered member disclose at the time of first solicitation "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."[21] The breadth of this provision is only increased by the lack of a limiting principle. The degree of separation necessary to establish such "relationships" is unclear, as the rule text leaves undefined the terms "pecuniary," "employment," or "business" and includes a virtually unlimited savings clause to cover all "other relationships." Our experience with various state law disclosure regimes highlights the administrative complexities involved with policing the boundaries of human relationships.[22] FINRA has given no indication as to how broadly or narrowly covered members are meant to interpret Proposed Rule 2271(a)(6). Does a "pecuniary" or "business" relationship exist where a covered associate's brother patronizes a restaurant owned by a government affiliate's wife? Does an "employment" relationship exist where a government official began his career as an employee of the covered member? Does an "other relationship" exist where the children of a covered associate and government affiliate attend the same university? To comply with such a rule would necessitate substantial due diligence research as to the "pecuniary, employment, business or other" relationships (however defined) of each covered associate employed by a covered member.

After mapping this network of relationships, a covered member would then have to cross-check the list against a list of associates of government entities possessing the requisite degree of "influence in the decision-making process in choosing an investment adviser." Determining this list of "influencers" is not necessarily a fact subject to immediate or obvious confirmation in all cases and would itself require an ongoing due diligence process. For example, while the chief investment officer of a state employee pension fund may generally be

[19] Proposed Rule 2271(a)
[20] Proposed Rule 2271(b).
[21] Proposed Rule 2271(a)(6).
[22] A handful of jurisdictions (*e.g*., Virginia Retirement System, North Carolina Retirement System) have begun to require more narrow and tailored "relationship"-related disclosure obligations than those required under Proposed 2271(a)(6). Because these disclosures obligate covered members to assess, monitor, and make legal representations concerning the professional and personal relationships between individuals affiliated with the covered members and individuals affiliated with government entities, however, compliance with even these more narrow and tailored regimes involves substantial administrative and compliance burdens. Moreover, these burdens would be substantially magnified under Proposed Rule 2271, which, unlike the state and local regimes, would require such "relationship"-related disclosures to be made at the time of the initial solicitation, a requirement that we consider to be unworkable.

presumed to be an "affiliated person" with the necessary degree of "influence," other pension fund employees may present a more ambiguous case. Yet Regulatory Notice 14-50 provides no indication of whether, and to what extent, covered members are under an obligation to perform such diligence or even submit pre-solicitation inquiries to government entities. Compounding this difficulty, each time that the covered member employs a new covered associate or the "influencers" within a government entity change, this process must be repeated and committed to a new written document along with the other disclosures required by the rule.

All of the above preparatory due diligence activity must be completed *ex ante*, that is, prior to the first meeting with any covered affiliate of a government entity, since a covered member's disclosure document must be maintained current for use at the time of "initial distribution or solicitation." "Initial solicitations" may take many forms, including, for example, chance encounters at public events. In our experience, potential customers would almost certainly be reluctant to sign an acknowledgment of receipt of such disclosures so early in the investment process, as opposed to at the time of closing or the execution of the advisory agreement, as is common in most state or entity-level disclosure regimes.[23]

A simple numerical example may help to illustrate these burdens. Suppose that a covered member employs 10 covered associates, whose mandate is to place fund interests with 50 state employee pension funds. Suppose further that the covered member had through due diligence determined that each such pension fund employed 10 persons with the requisite degree of influence over the investment adviser selection process. The relationship mapping phase in this stylized example would, at a minimum, require the covered member to ascertain the nature of 5,000 separate bilateral relationships between covered associates and affiliates of government entities. Each of these bilateral relationships would be analyzed according to the vague and ill-defined categories discussed above and could conceivably involve highly complex networks of hundreds or thousands of individuals, depending on the definitions of "pecuniary," "employment," "business," and "other" relationships. If the covered member were mandated to place interests of 10 different funds managed by 10 separate investment advisers, thus requiring disclosure of 10 different compensation arrangements, the number of possible permutations of the disclosure document would soon become astronomical. No two disclosure documents would be alike; thus, covered members would not be in a position to prepare a uniform set of disclosures for general use. Each of these permutations would need to be carried in some form, presumably electronic, in the back pockets of each of the covered associates in any context in which such covered associates might potentially engage in a solicitation of a government entity.

Next, pursuant to the updating requirements of Proposed Rule 2271(b), the covered member would be obligated to establish compliance policies to account for the addition of new covered associates or the real-time creation of new "relationships," cross-referenced against an updated list of government entity "influencers." Where, for example, the covered member discovers that one of its covered associates has established a "relationship" with a government entity influencer, the covered member would then be under an obligation to provide a revised and updated disclosure document to any affected government entity within 10 business days, on a rolling basis, for the duration of the "distribution or solicitation" period. This requirement could have a particularly long tail if the distribution or solicitation period were interpreted to be coextensive with the full period of the engagement. Not only would such a requirement be so burdensome as to be unworkable for the covered member, government entities across the country would be inundated with duplicative and essentially meaningless disclosure documents from every covered member with whom they do business.

Other provisions of Proposed Rule 2271 are similarly unworkable. For example, Proposed Rule 2271(a)(4) would require covered members engaged in covered brokerage activity to disclose the terms of any "compensation arrangement" with an investment adviser on whose behalf the member solicits government

[23] *Id.*

entities, as well as "a description of the compensation paid or to be paid" to the member.[24] A covered member soliciting government entities to invest covered investment pools, however, regularly makes solicitations that involve multiple covered investment pools, with the covered member subject to a different compensation arrangement with respect to each covered investment pool. Requiring tailored disclosure of each of these compensation arrangements at the time of initial solicitation adds considerably to the complexity of implementing Proposed Rule 2271 and also exposes covered members to potentially severe competitive effects.[25] Moreover, the term "compensation" is not defined for purposes of Proposed Rule 2271(a)(4), and it is therefore unclear what qualifies as compensation for purposes of the rule. For example, would "compensation" include the reimbursement of a covered member's solicitation-related expenses by an investment adviser? Would it include the payment of fees for general back-office and administrative support in connection with marketing a particular fund? Nor is it clear what level of detail is required in connection with the obligation to disclose the "terms" of a compensation arrangement. Would it be sufficient to provide a general description that a covered member is paid on a basis of total assets raised, or would Rule 2271 require a fee schedule that specifies the fee ratio to be paid for each tier of assets raised and that indicates how much has been raised to date?

SIFMA would argue that, in light of the extensive SEC, FINRA, state, and entity-level disclosure regimes to which broker-dealers are already subject, the further disclosures mandated by Proposed Rule 2271 are unnecessary, duplicative, and potentially confusing to the recipient government entities. The compliance costs of the regime established by Proposed Rule 2271 would create a strong incentive for broker-dealers to exit the market for government entity placements, thus denying government entities access to a competitive market for placement agent services and limiting the opportunities of these entities to invest public resources profitably and efficiently. The implementation challenges outlined in this section become exponentially greater when the variety of covered business lines and overlapping or related regulatory regimes at the federal, state, or local levels are taken into account, as detailed in the following section.

B. The proposed disclosure requirements do not fully account for the variety of business lines affected and the numerous overlapping and related regulatory regimes.

Proposed Rule 2271 also should be eliminated in light of the fact that (i) the rule takes a one-size-fits-all approach to disclosure when covered members will engage in a wide range of activities that will be subject to the Proposed Rules and (ii) covered members will need to implement these requirements against the backdrop of a regulatory landscape that imposes inconsistent and contradictory requirements. As a consequence, SIFMA is concerned that Proposed Rule 2271 would impose indiscriminately broad requirements, and that such requirements would not be tailored to different business contexts nor harmonized with other applicable legal requirements.

First, Proposed Rule 2271 would demand identical disclosures from all business lines subject to the rule, without regard to the wide range of circumstances in which members solicit government entities on behalf of investment advisers. For example, Proposed Rule 2271 would require uniform disclosures from broker-dealers acting on behalf of affiliates and those acting on behalf of third parties, from covered members that assist advisers to obtain business through a formal procurement process and those that engage in "cold-calling" of government entities, and from placement agents soliciting new business and those that are seeking to obtain the extension of existing contracts. SIFMA believes that the context of a solicitation should inform the need for particular

[24] Proposed Rule 2271(a)(4). Although the Cash Solicitation Rule includes a similar compensation disclosure obligation for parties soliciting investment advisory relationships on behalf of third parties, no comparable disclosure requirement presently exists for any of the categories of government entity solicitor principally covered by the Proposed Rules. *See supra* note 16.

[25] In addition, as noted above, broker-dealers—including those soliciting government entities to invest in covered investment pools—are already subject to numerous disclosure obligations, including obligations to disclose their compensation to investors. These obligations, however, do not apply at the point of solicitation. *See supra* note 18.

disclosures. We note that certain state disclosure regimes have accordingly been tailored to account for the circumstances in which particular solicitations are made.[26] Similarly, at the federal level, broker-dealers who solicit *investment advisory relationships* on behalf of affiliated and third-party investment advisers are currently covered by the Cash Solicitation Rule, which is designed to address the potential conflicts of interest that may arise in compensated solicitations of fiduciary relationships.[27] Moreover, the SEC tailored the Cash Solicitation Rule's disclosures to distinguish between affiliated and third-party solicitations.[28] The lack of any such tailoring in Proposed Rule 2271 increases the compliance burdens for covered members while simultaneously reducing the informational value of the proposed disclosures for government entities.

Second, Proposed Rule 2271 does not fully account for the dense regulatory landscape in which the proposed disclosure requirements will operate. In addition to the federal securities laws and state and local disclosure regimes discussed above,[29] there are other regulatory regimes that either regulate the solicitation activity covered by the Proposed Rules or related conduct. These regimes should be examined and addressed in assessing the costs, benefits, and likely effectiveness of Proposed Rule 2271. Put simply, the proposed disclosure requirements have not been harmonized or otherwise limited to account for these disclosure regimes, which both overlap with and diverge from Proposed Rule 2271.[30] As a result, in many instances, covered members will be required to make a number of different disclosures relating to the same activity, each of which is required at a different time and using different regulatory definitions. For example, a number of covered members may solicit both governmental plans and retirement plans subject to the Employee Retirement Income Security Act of 1974 ("**ERISA**")[31] to include a specific registered investment company as a plan option. Those members are required to make detailed compensation and conflict disclosures pursuant to the Department of Labor's regulation under ERISA Section 408(b)(2) when doing business with ERISA retirement plans, and—although governmental plans are not subject to ERISA—many governmental plans affirmatively request such disclosures.[32] Thus, in practice, Proposed Rule 2271 may result in the provision of multiple sets of disclosures to a governmental plan in connection with a single transaction.

[26] For example, although the California state public pension law requires disclosure of payments to persons who qualify as "placement agents" with respect to state and local retirement systems, it excludes from that obligation any individual who is (i) an employee, officer, director, equityholder, partner, member, or trustee of an external manager and (ii) who spends one-third or more of his or her time, during a calendar year, managing the securities or assets owned, controlled, invested, or held by the external manager (known as the "portfolio manager" exception). *See* Cal. Gov. Code §§ 7513.85 (requiring a retirement board to adopt a policy requiring the disclosure of payments to placement agents), 7513.8 (providing a definition of "placement agent"). The law imposes additional disclosure obligations on "placement agents" by requiring them to register as state lobbyists and to make disclosures under the state lobbying law prior to soliciting a state retirement system, and also requiring them to comply with applicable local lobbying laws. *See* Cal. Gov. Code §§ 7513.86, 7513.87. With respect to these lobbying-related disclosure requirements, the law includes an exception for certain solicitations made in the context of a competitive bidding process, and other exclusions may apply depending on the circumstances. *See* Cal. Gov. Code § 82047.3(b) (providing an exception to state lobbying registration tied to participation in a competitive bidding process), 7513.87(b) (providing a similar exception to the local lobbying requirement); *see also* California Fair Political Practices Commission Advice Letter No. I-11-015 (Apr. 7, 2011) (discussing a further exception to lobbyist registration and reporting for an individual who accompanies a registered placement agent to provide further information in meetings with public pension fund representatives on no more than an occasional basis).
[27] *See generally*, Mayer Brown LLP, SEC No-Action Letter (July 28, 2008) (noting further that "investors in investment pools (as such) do not typically enter into investment advisory contracts with the investment advisers of the pools").
[28] Requirements Governing Payments of Cash Referral Fees by Investment Advisers, Final Rule, Investment Advisers Act Release No. IA-688, 44 Fed. Reg. 42126, 42128 (Jul. 18, 1979) ("In light of the comments, the Commission has concluded that the objective circumstances surrounding all employees of the adviser and certain close affiliates are such as to ensure that prospective clients would be aware of the solicitor's bias. As long as a client is aware that the recommended adviser is the solicitor's employer or a close affiliate of the solicitor's employer, there appears to be little need to require the imposition of additional disclosure and recordkeeping requirements regardless of the specific duties of the solicitor."). Although we understand the temptation to extend the Cash Solicitation Rule beyond the solicitation of advisory relationships and have it apply to all of the solicitation activity covered by the Proposed Rules, the Cash Solicitation Rule has never been applied to brokerage activity and more consideration is required to determine whether such a regime is appropriate in the brokerage context. *See supra* notes 10 and 16.
[29] *See supra* notes 18 and 22.
[30] Although Regulatory Notice 14-50 briefly touches on the application of the Proposed Rules to an entity registered as a broker-dealer, municipal advisor, and investment adviser, noting that such an entity "should follow the rules that apply to the services it is performing," Regulatory Notice 14-50 at n. 21, this limited statement only focuses on one area of potential regulatory overlap and does not address how Proposed Rule 2271 may interact with or affect other, non-pay-to-play-related regulatory obligations to which covered members are subject.
[31] 29 U.S.C. § 1001 *et seq*. (2012).
[32] 29 C.F.R. § 2550.408b-2.

SIFMA is concerned that this will result in high compliance costs for covered members and confusion on the part of government entities, which will be left to reconcile the divergent and seemingly contradictory statements that covered members are required to provide under different regimes. In our view, the lack of harmonization or consideration of the existing legal landscape further calls into question the need for new disclosure requirements.

C. If not eliminated in its entirety, Proposed Rule 2271 should at a minimum be considered via a separate rulemaking process, so as to allow a fuller consideration of the rule and to avoid disrupting the adoption of Proposed Rule 2390.

As FINRA has explained, the purpose of the current rulemaking is to adopt a "pay-to-play rule to enable member firms to continue to engage in distribution and solicitation activities" with government entities once the Regulated Person Requirement becomes effective.[33] Proposed Rule 2271 is unrelated to this goal and would moreover impose novel and complex disclosure requirements without precedent in other federal pay-to-play rules, including the SEC Pay-to-Play Rule. Given the unprecedented nature of the proposal, FINRA has not had the benefit of an administrative record on whose basis it can assess the legal and operational issues discussed in this letter, nor have FINRA members had an adequate opportunity to consider the potential burdens of the rule.[34]

We are furthermore concerned that consideration and implementation of Proposed Rule 2271, which is not required for purposes of the Regulated Person Requirement, could potentially interfere with the adoption of Proposed Rule 2390, which clearly *is* required at this time. As stated above, the SEC Pay-to-Play Rule provides that a broker-dealer may qualify as a "regulated person," but only to the extent that the broker-dealer is a "member of a national securities association" that has adopted rules that "prohibit members from engaging in distribution or solicitation activities if certain political contributions have been made."[35] In addition, the SEC must, by order, find that the association's rules "impose substantially equivalent or more stringent restrictions" on broker-dealers than the SEC Pay-to-Play Rule imposes on investment advisers.[36] Proposed Rule 2271 is not necessary to satisfy either requirement, and if the rule is eventually included in a proposed rulemaking by the SEC in accordance with its obligations under the Administrative Procedure Act,[37] we expect that the rule will be subject to considerable public comment, threatening a delay of Proposed Rule 2390.

Consequently, we respectfully request that, if FINRA decides to proceed with promulgating Proposed Rule 2271, it do so via a separate rulemaking process not subject to the Regulated Person Requirement's April 1, 2015 deadline.

II. FINRA SHOULD CONFIRM THAT KEY TERMS IN THE PROPOSED RULES HAVE THE SAME MEANING AS THOSE IN THE SEC PAY-TO-PLAY RULE

The Proposed Rules use several undefined or ambiguous terms that are identical to terms used in the SEC Pay-to-Play Rule. We therefore request confirmation that the terms "distribution," "covered associate," "executive officer," and "indirect contribution" as used in the Proposed Rules bear the same meaning as those terms have for purposes of the SEC Pay-to-Play Rule.[38]

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[33] Regulatory Notice 14-50, at 12.
[34] In addition, as noted above, the limited administrative record from the SEC Pay-to-Play Rule rulemaking indicates that disclosure requirements would not be "useful" in furthering pay-to-play goals. *See* SEC Pay-to-Play Final Release, at 41039.
[35] 17 C.F.R. § 275.206(4)-5(f)(9)(ii).
[36] *Id.* at §275.206(4)-5(f)(9)(ii)(B).
[37] 5 U.S.C. § 500 *et seq*. (2012).
[38] *See* ICI Letter, at 3.

"Distribution"

The term "distribution" is used in multiple provisions of Proposed Rule 2271 and is critical to the Proposed Rules generally—indeed, the term appears in the titles of each of the Proposed Rules and repeatedly throughout their substantive provisions. For example, Proposed Rule 2271 mandates that "a covered member engaging in *distribution* or solicitation activities for compensation with a government entity on behalf of one or more investment advisers shall, at the time of the initial *distribution* or solicitation on behalf of each investment adviser, disclose to such government entity in writing (which may be electronic) [certain] information with respect to each investment adviser" (emphasis added).[39] Several of the required disclosures also make reference to a "covered member…engaging in *distribution* or solicitation activities" (emphasis added).[40] The requirement to update such disclosures on a rolling basis similarly applies "during the period in which [the covered member] is engaging in *distribution* or solicitation activities…" (emphasis added).[41] Nevertheless, FINRA has provided neither an explicit definition nor guidance as to the interpretation of the term "distribution." By contrast, the definition of "solicit" in Proposed Rule 2390 makes specific reference to "investment advisory services."[42] Our understanding is that the phrase "distribution and solicitation," as used in the SEC Pay-to-Play Rule, is interpreted to mean "the solicitation of investment advisory services."[43] In the interests of harmonization, we would request that FINRA clarify that for purposes of the Proposed Rules, the phrase "distribution and solicitation" pertains exclusively to the solicitation of investment advisory services and that the scope of the Proposed Rules is coterminous with the SEC Pay-to-Play Rule.

"Covered Associate"/"Executive Officer"

The term "covered associate" is used throughout the Proposed Rules and, importantly, in Proposed Rule 2271(a)(6), which sets forth the "relationship" disclosure requirement discussed above. As noted by FINRA in Regulatory Notice 14-50,[44] Proposed Rule 2390(h)(2) is consistent with the SEC Pay-to-Play Rule in defining "covered associate" to mean, *inter alia*, "any general partner, managing member[,] or *executive officer* of a covered member..." (emphasis added).[45] The term "executive officer," however, is not defined in Proposed Rule 2390. We would request that FINRA include the definition of "executive officer" from the SEC Pay-to-Play Rule in Proposed Rule 2390(h)'s list of defined terms.

"Indirect Contribution"

SIFMA also requests that FINRA confirm that the term "indirect contribution" as used in the Proposed Rules has the same meaning as the equivalent term in SEC Rule 204-2(a)(18)(i)(C).[46]

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[39] Proposed Rule 2271(a).
[40] *See* Proposed Rule 2271(a)(1), (2), (4), (5).
[41] Proposed Rule 2271(b).
[42] Proposed Rule 2390(h)(10) ("Solicit means (A) with respect to *investment advisory services*, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser….") (emphasis added).
[43] 17 C.F.R. § 275.206(4)-5(f)(9)(ii).
[44] *See* Regulatory Notice 14-50, at n. 34.
[45] Proposed Rule 2390(h)(2).
[46] SEC Rule 204-2(a)(18)(i)(C), Books and Records to be Maintained by Investment Advisers, 17 C.F.R. § 275.204-2(a)(18)(i)(C) (2014) (requiring books and records containing a list of "all direct or *indirect contributions* made by the investment adviser 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 political action committee" (emphasis added)).

III. THE RECORDKEEPING REQUIREMENTS OF PROPOSED RULE 4580 SHOULD BE REVISED TO ELIMINATE RECORDKEEPING OBLIGATIONS WITH RESPECT TO UNSUCCESSFUL SOLICITATIONS

Proposed Rule 4580 requires that covered members engaged in distribution or solicitation activities create and maintain books and records pertinent to Proposed Rules 2271 and 2390, including records of "all government entities with which the covered member has engaged in distribution or solicitation activities."[47] SIFMA does not believe that recordkeeping requirements should extend to unsuccessful solicitations where the covered member receives no compensation because maintaining such records would impose significant costs on covered members with little corresponding benefit. Indeed, a similar provision in the proposed SEC Pay-to-Play Rule was specifically rejected on those grounds.[48]

Under the SEC Pay-to-Play Rule, the SEC requires investment advisers to maintain records of all "government entities to which the investment adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services."[49] Thus, the SEC Pay-to-Play Rule requires recordkeeping only with respect to *successful* solicitations. The SEC initially considered a broader recordkeeping requirement that would have required investment advisers to "maintain lists of government entities solicited that do not become clients,"[50] but ultimately removed the proposed requirement from the final rule. In so amending the proposal, the SEC acknowledged the concerns of some commenters that "solicitation does not trigger [the] two-year time out [provision of the SEC Pay-to-Play Rule], rather it is providing advice for compensation that does so."[51] In addition, we note that there are numerous existing FINRA recordkeeping rules pursuant to which communications with government entities must already be maintained.[52]

Similarly, Proposed Rule 4580(a) is not necessary to supervise member firms' compliance with Proposed Rule 2390. Proposed Rule 2390(a) would prohibit member firms from "engag[ing] in distribution or solicitation activities for compensation with a government entity" within two years of a covered contribution.[53] Solicitations for which a member firm does not receive compensation do not implicate the rule, and therefore recordkeeping obligations with respect to unsuccessful solicitations are unnecessary. Accordingly, SIFMA respectfully requests that Proposed Rule 4580(a) be modified to read as follows:

> The name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities *for compensation* on behalf of an investment adviser within the past five years, but not prior to [insert the effective date of the Rule].

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[47] Proposed Rule 4580(a).
[48] SEC Pay-to-Play Final Release, at 41050.
[49] SEC Rule 204-2(a)(18), 17 C.F.R. § 275.204-2(a)(18).
[50] SEC Pay-to-Play Final Release, at 41050.
[51] *Id*.
[52] *See*, *e.g.*, SEC Rule 17a-4(b)(4), Records to be Preserved by Certain Exchange Members, Brokers, and Dealers, 17 C.F.R. § 240.17a-4(b)(4) (2014) (requiring preservation of copies of all external communications relating to a broker-dealer's securities or investment banking business); FINRA Rule 2210(b)(4) (requiring FINRA members to maintain all retail communications and institutional communications for the duration of the retention period required by SEC Rule 17a-4); FINRA Rule 3110 (requiring the establishment of supervisory procedures for the review of incoming and outgoing written (including electronic) correspondence relating to a member's investment banking or securities business); FINRA Rule 4511 (requiring that members "make and preserve books and records as required under the FINRA rules [and] the [Exchange Act and rules thereunder]").
[53] Proposed Rule 2390(a).

IV. THE DISGORGEMENT REMEDY OF PROPOSED RULE 2390(a) SHOULD NOT BE MANDATORY

Where a covered member violates Proposed Rule 2390(a)'s prohibition on certain compensated distribution or solicitation activities within two years of a covered contribution,[54] Proposed Rule 2390(b)(2) imposes a disgorgement remedy that prohibits "such covered members…from receiving any compensation or other remuneration pertaining to, or arising from [such] distribution or solicitation activities from (A) the investment adviser or covered investment pool advised by the investment adviser on whose behalf the covered member was soliciting…; or (B) the government entity solicited by the covered member on behalf of the affected investment adviser…."[55] The provision also mandates payment of any such compensation or remuneration in accordance with a strict "waterfall" of parties in order of payment priority.[56]

While disgorgement is the almost universal remedy for violations of various pay-to-play rules, SIFMA is concerned that making application of the remedy mandatory could have the deleterious effect of dissuading covered members from voluntary disgorgement of fees where such members discover pay-to-play violations themselves.[57] Moreover, specifying the precise waterfall of payment priorities may in some cases lead to perverse outcomes and windfalls, as the disgorged compensation would not be paid to the party that generally is responsible for paying placement agent fees, namely, the investment adviser itself. We encourage FINRA to leave application of the remedy and the question of payment priority open to be decided on a case-by-case basis, thus reducing opportunities for gaming or unjust enrichment of third parties.

Proposed Rule 2390(b)(2) prohibits the receipt of "any compensation or other remuneration *pertaining to, or arising from*" the distribution or solicitation activities of the covered member (emphasis added).[58] It is unclear from the text of Proposed Rule 2390(b)(2) precisely what "compensation or other remuneration" is subject to the disgorgement penalty. Historically, under other pay-to-play rules, only fees collected in connection with the violative conduct, however defined, have been subject to disgorgement, not other fees or remuneration that may have a tangential connection to the conduct in question.[59] We therefore request similar treatment under Proposed Rule 2390(b)(2): only fees collected directly in connection with the solicitation of a government entity in violation of Proposed Rule 2390(a) should be subject to disgorgement. This would exclude any other compensation or remuneration that may be received by a covered member that is arguably "pertaining to, or arising from" its solicitation activities.

V. FINRA SHOULD REVISIT ITS COST-BENEFIT ANALYSIS OF THE PROPOSED RULES

While SIFMA believes that addressing pay-to-play practices that undermine the merit-based selection of investment advisers by government entities is an important and laudable effort, FINRA appears to have dramatically understated the compliance costs that the Proposed Rules would impose on covered members.

In describing the expected costs of implementing the Proposed Rules, FINRA identifies a number of factors that are expected to affect compliance costs, including "the number of covered associates, business models of

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[54] Proposed Rule 2390(a). For the reasons discussed above, and in the interest of harmonization with the SEC Pay-to-Play Rule, we would request that FINRA clarify that "distribution and solicitation activities" refers only to the solicitation of investment advisory services.
[55] Proposed Rule 2390((b)(1).
[56] Proposed Rule 2390(b)(2) (specifying the order of payment as "(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 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.").
[57] *See also*, ICI Letter, at 5.
[58] *Id*.
[59] *See*, *e.g.*, T.L. Ventures, Inc., Advisers Act Release No. 3859 (June 20, 2014); Goldman, Sachs & Co., Exchange Act Release No. 67934 (Sept. 27, 2012). *See also* ICI Letter, at 5.

member firms and the extent to which their compliance procedures are automated, whether the covered member is (or is affiliated with) a registered investment adviser subject to the SEC Pay-to-Play Rule, and whether the covered member is a registered municipal securities dealer and thus subject to [Municipal Securities Rulemaking Board] pay-to-play rules."[60] FINRA also states that "a small covered member with fewer covered associates may expend fewer resources to comply with the [Proposed Rules] than a large covered member."[61] On the assumption that the Proposed Rules are consistent with the SEC Pay-to-Pay Rule, FINRA's estimate of the compliance costs of the Proposed Rules is based on the SEC's own compliance cost estimates. In that rule, the SEC estimated such costs for "smaller firms" (fewer than 5 covered associates), "medium firms" (between 5 and 15 covered associates), and "larger firms" (more than 15 covered associates).[62] The SEC estimated that initial compliance costs for smaller firms, medium firms, and larger firms would be $2,352, $29,407, and $58,813, respectively. The SEC also estimated that annual, ongoing compliance expenses for such firms would be $2,940, $117,625, and $235,250, respectively.

SIFMA believes that these estimates do not accurately reflect the true compliance costs associated with the Proposed Rules, and particularly the costs associated with the disclosure requirements of Proposed Rule 2271, which does not have a corresponding provision under the SEC Pay-to-Play Rule. As discussed above, the Proposed Rules are in fact far more stringent and extensive than is required in order to comply with the Regulated Person Requirement. Proposed Rule 2271 exposes covered members to an enormous and ongoing compliance burden with respect to the relationship mapping of their covered associates. This burden correlates strongly with the size of the covered member, such that a larger firm with many covered associates and thousands of "relationships" will be subject to exceedingly burdensome mapping and disclosure obligations. Even for smaller firms, which may lack in-house marketing units, the costs associated with staffing an internal team to monitor and maintain updated disclosures will in many cases be prohibitive. These substantial costs are further justification for eliminating Proposed Rule 2271 or, at a minimum, for removing it from this rulemaking for separate consideration. We therefore urge FINRA to revisit its cost-benefit analysis of the Proposed Rules, with a particular focus on the costs of Proposed Rule 2271.

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SIFMA appreciates this opportunity to comment on the Proposed Rules. Should you have any questions regarding our analysis or recommendations, please do not hesitate to contact me at (212) 313-1317 or mgibson@sifma.org, or contact our counsel Barbara Stettner (Tel.: (202) 683-3850; E-mail: barbara.stettner@allenovery.com) and Charles Borden (Tel.: (202) 683-3852; E-mail: charles.borden@allenovery.com) of Allen & Overy LLP.

Respectfully submitted,

Marin E. Gibson
Managing Director & Associate General Counsel

[60] Regulatory Notice 14-50, at 13.
[61] *Id*.
[62] *Id*. at 14.

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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

Marcia E. Asquith
January 2, 2015
Page 2

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

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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

[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. <u>Proposed Rule 2390(e) is Unworkable and Inconsistent with Precedent Under the Advisers Act</u>

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, <u>not</u> 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 <u>not</u> 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."
>
> . . . .
>
> 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.

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[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

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[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]

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[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.

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[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 not 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

[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,

SUTHERLAND ASBILL & BRENNAN LLP

BY: Cliff Kirsch IJH
Cliff Kirsch

BY: Michael Koffler MBK
Michael Koffler

FOR THE COMMITTEE OF ANNUITY INSURERS

INVESTMENT ADVISER ASSOCIATION

December 22, 2014

Via Electronic Mail

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

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

Dear Ms. Asquith:

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

Background

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Technical Comments Concerning Proposed Rule 4580 (Recordkeeping)

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

* * *

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

Respectfully submitted,

/s/ Sanjay Lamba

Sanjay Lamba
Assistant General Counsel

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

APPENDIX

REVISED PROPOSED RULE TEXT

* * * * *

2200. COMMUNICATIONS AND DISCLOSURES

* * * * *

2271. Disclosure Requirement for Government Distribution and Solicitation Activities

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

(1) The fact that the covered member is engaging in distribution or solicitation activities on behalf of the investment adviser;

(2) The name of the investment adviser on whose behalf the covered member is engaging in distribution or solicitation activities;

(3) The nature of the relationship, including any affiliation, between the covered member and the investment adviser;

(4) A statement that the covered member will be compensated by the investment adviser for its distribution or solicitation activities and the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the covered member;

(5) Any incremental charges or fees that may be imposed on the government entity as a result of the distribution or solicitation activities engaged in by the covered member;

(6) The existence and details of any pecuniary, employment, business or other relationships between the covered member or any covered associate and any person affiliated with the government entity that has influence in the decisionmaking process in choosing an investment adviser; and

(7) The existence of the covered member's internal policies and procedures with respect to political contributions by covered associates and other associated persons.

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

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

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

* * * * *

M & R
MONAHAN & ROTH, LLC

December 22, 2014

Lisa Roth
630 First Avenue
San Diego, CA 92101
619-283-3500

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

Dear Ms. Asquith,

Thank you for the opportunity to comment on Regulatory Notice 14-50, FINRA's request for comments on a proposal to establish a "Pay-to-Play" rule. I am a registered associated principal of a FINRA member firm, a past member of the FINRA Small Firm Advisory Board, the PCAOB Standing Advisory Group, and I have served on the board of the Third Party Marketers Association, among other industry roles and affiliations. I have been involved in industry initiatives related to Pay-to-Play including the design and implementation of policies and procedures as a registered person, formerly acting as a placement agent, and as a compliance consultant to BDs, investment advisers and other market participants.

I recognize that FINRA must take some action by April 2015 to avoid prohibitions on broker-dealers engaging in placement agent activities. As such, I generally support the implementation of rules to satisfy the outstanding regulatory deficiency, and to prevent further uncertainty on the part of the covered BDs.

Nonetheless, it is important to note that FINRA's Pay-to-Play rulemaking comes after the SEC has issued its rules for investment advisers, behind the MSRB's establishment of a new registration category for Municipal Advisers, trailing certain states that have passed laws requiring BDs engaging in placement agent activity to register as lobbyists among other related law-making, and following steps taken by government entities themselves to implement policies, forms and other procedures for placement agents. In fact, for more than 5 years, broker-dealers engaging in placement agent activity have been forced to closely monitor pending rulemaking over multiple jurisdictions, adopting, accommodating and coordinating their internal operations as best as possible to stay within the changing laws. Compliance with the myriad of regulations has required firms to undertake new registrations, draft and implement new policies and procedures, and engage in some tough decision-making. For instance, some broker-dealers (including my firm at the time) found the CA law requiring registration as a lobbyist so objectionable that they opted out of the business line altogether. So to the extent that FINRA's new rulemaking does anything more than accommodate existing rules and meet the pending deadline, I believe it to be unnecessarily burdensome and disadvantageous to broker-dealers without any measurable benefit to investors.

Instead of imposing more stringent new rules, I urge FINRA to leverage its position of hindsight to its and its constituents' best advantage, and to promote and ensure meaningful investor protections in the process. I believe FINRA can do this by writing its rules in substantial likeness to the existing SEC Pay-to-Play rules. To do this, FINRA should eliminate the components of its proposal that are more stringent than existing rules, including those that would require additional disclosures, shorter time frames for updates, and/or additional record keeping. Judging by the comments that have already been received, save those submitted by NASAA and perhaps with some clarification on scope, the proposition of Pay-to-Play rules that conform to existing rules in other jurisdictions does not seem to be disagreeable to the BD community.

Then, with the regulatory gap thus closed, FINRA can lead a dialogue among the stakeholders, including the SEC, the MSRB, NASAA and representative government entities with the goal of issuing joint regulatory guidance that will address any related concerns and satisfy any outstanding needs for disclosures, forms, records or the like. Considering that the majority of headline events related to Pay-to-Play involved the dodgy practices of unscrupulous and, to a meaningful extent, unregistered persons a coordinated regulatory initiative seems to be an approach that will benefit all. In particular, with all the stakeholders at the table, this approach could best ensure the orderly adoption of rules and guidance that would leave less opportunity for regulatory arbitrage.

In addition to my comments above, I support the comments submitted by the Third Party Marketer's Association (3PM).

Thank you again for the opportunity to submit my comments.

Best regards,

//Lisa Roth//
Lisa Roth
President

INVESTMENT
COMPANY
INSTITUTE

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December 15, 2014

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

Re: FINRA Notice 14-50 Relating to
Proposed "Pay to Play" Rules

Dear Ms. Asquith:

The letter we submitted on Friday, December 12 was submitted in error. The attached corrected letter should supersede and replace the previous letter.

Sincerely,

/s/

Tamara K. Salmon

INVESTMENT COMPANY INSTITUTE

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December 15, 2014

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

Re: FINRA Notice 14-50 Relating to Proposed "Pay to Play" Rules

Dear Ms. Asquith:

The Investment Company Institute[1] appreciates the opportunity to comment on FINRA's proposed adoption of three new rules to address concerns with members engaging in pay-to-play practices.[2] The proposed rules consist of a prohibition on pay-to-play practices (Rule 2390), a new disclosure requirement (Rule 2271), and a related recordkeeping rule (Rule 4580). Our interest in this proposal derives from the rules' impact on those FINRA members that solicit a government entity on behalf of a "covered investment pool," which term includes any registered investment company[3] "that is an investment option of a plan or program of a government entity." While the Institute supports FINRA's proposed prohibition on pay-to-play practices, we recommend that FINRA confirm that its proposed treatment of solicitations made on behalf of covered investment pools is consistent with that of the pay-to-play rule adopted by the U.S. Securities and Exchange Commission ("SEC"), Rule 206(4)-5. Additionally, we recommend that FINRA: eliminate Rule 2271, which imposes a disclosure

[1] The Investment Company Institute ("ICI") is the world's leading association of regulated funds, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts ("UITs") in the United States and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interests of funds, their shareholders, directors and advisers. ICI's U.S. fund members manage total assets of $17.2 trillion and serve more than 90 million U.S. shareholders.

[2] *See FINRA Requests Comment on a Proposal to Establish a "Pay-to-Play" Rule,* FINRA Notice 14-50 (November 2014) ("FINRA Notice").

[3] For purposes of this letter, "mutual fund" is used to mean a "registered investment company."

requirement on solicitors; not include in Rule 2390 a provision mandating disgorgement; and clarify an issue relating to the records that must be kept under Rule 4580 in connection with omnibus accounts. Each of these issues is discussed in more detail below.

I. BACKGROUND

The Institute has long supported regulatory efforts to address concerns with pay-to-play practices. To date, those efforts have consisted of Rules G-37 and G-38 adopted by the Municipal Securities Rulemaking Board ("MSRB") and Rule 206(4)-5 adopted by the SEC. We are pleased that FINRA is following suit and adopting rules in this area to govern the activities of its members that solicit business on behalf of an investment adviser. We are also pleased that FINRA's proposal is designed to generally complement and be consistent with the SEC's pay-to-play rule. Of particular interest to ICI as pay-to-play rules are adopted by the various financial institution regulators is ensuring that all such rules align with each other to the maximum extent possible. Such alignment is important to avoid disparate regulatory standards for persons engaged in similar activities and to facilitate compliance by persons that are subject to all of the various rules.

As noted in the FINRA Notice, its proposed pay-to-play rule, Rule 2390, "is modeled on the SEC's Pay-to-Play Rule."[4] SEC Rule 206(4)-5 prohibits an investment adviser from compensating third parties for soliciting government entities on behalf of the adviser unless the solicitor is a "regulated person." The rule defines "regulated person" to include, among others, a broker-dealer subject to a regulatory association's pay-to-play rule that both (1) prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made and (2) has been found by the SEC to impose requirements that are at least as stringent as Rule 206(4)-5. Rule 206(4)-5 further provides that such rule must be "consistent with the objectives of [Rule 206(4)-5]."[5] In the absence of FINRA adopting a pay-to-play rule, FINRA members, as regulated persons, would be prohibited from engaging or continuing to engage in solicitation activities on behalf of investment advisers unless they became registered under the Investment Advisers Act of 1940 as either investment advisers or municipal advisers. Accordingly, adoption of FINRA's rule is necessary to enable FINRA members to rely on the "regulated person" exception in the SEC's rule.

II. FINRA SHOULD CONFIRM THE LIMITED IMPACT OF RULE 2390 ON SOLICITATIONS INVOLVING COVERED INVESTMENT POOLS

Proposed FINRA Rule 2390 would prohibit a FINRA member from engaging in "distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser" within two years after the member or its covered associate has made a contribution to an official of that

[4] FINRA Notice at p. 3.

[5] *See* SEC Rule 206(4)-5(f)(9)(ii)(B).

entity. Like SEC Rule 206-4(5), the distribution or solicitation activities that would be covered by FINRA's rule would include those relating to a "covered investment pool." We are pleased that FINRA's proposed definition of "covered investment pool" is identical to the SEC's definition and, consequently, with respect to mutual funds, would *only* include those mutual funds that are "an investment option of a plan or program of a government entity." Thus, with respect to mutual funds, the prohibitions of both the SEC's rule and FINRA's rule would only be triggered when a government entity is solicited on behalf of an investment adviser to include mutual funds advised by the adviser as an option in a retirement plan or college education savings plan (529 plan) offered by the government entity.

Proposed Rule 2390, however, also references "distribution" activities in subdivisions (a) and (e). We do not believe that, with respect to the treatment of mutual funds under this rule, the inclusion of distribution is intended to prohibit conduct that is not prohibited by SEC Rule 206(4)-5 and we request confirmation of this. Specifically, we request confirmation that, with respect to mutual funds, FINRA's rule is only triggered when a FINRA member solicits a government entity to include a mutual fund in a government entity's plan or program and not when the member is selling mutual fund shares to a government entity. This interpretation is fully consistent with the scope of the SEC's rule. As noted in the SEC's release adopting Rule 206(4)-5:

> [The] provision [in the rule relating to covered investment pools] will generally affect two common types of arrangements in which a government official is in a position to influence investment of funds in pooled investment vehicles. The first is the *investment* of public funds in a hedge fund or other type of pooled investment vehicle. The other is the *selection* of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a 529 plan.'"[6] [Emphasis added.]

In our view, use of the term "distribution" in FINRA's rule is intended to capture the first of the arrangements discussed in the Adopting Release, which involves a distribution function, and not the second arrangement, which involves a solicitation function. As noted above, we seek confirmation of our interpretation.

III. FINRA SHOULD NOT IMPOSE DISCLOSURE REQUIREMENTS

As proposed, FINRA Rule 2271 would require a FINRA member engaging in solicitation or distribution activities for compensation with a government entity on behalf of an investment adviser to

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[6] *See Political Contributions by Certain Investment Advisers,* SEC Release No. IA-3043 (July 1, 2010) ("Adopting Release") at p. 98. Our recommendation is also consistent with the clarification in the Adopting Release where the SEC noted that, in response to comments, it had modified the final rule to include a mutual fund in the definition of covered investment pool for purposes of all three of Rule 206(4)-5's pay-to-play prohibitions, "but *only* if it is an investment option of a plan or program of a government entity." *See id.* p. 106. [Emphasis in original.] *See, also,* related discussion at pp. 97-108.

disclose to that entity specific information about the relationship with the adviser. Among other things, this disclosure would be required to include the nature of the relationship between the adviser and the solicitor; the terms of the compensation arrangement with the investment adviser; any incremental charges or fees that may be imposed on the government entity as a result of the distribution or solicitation; details of any relationship between the FINRA member and any person affiliated with the government entity (not just covered officials) that has influence in the decision-making process in choosing an investment adviser; and a statement that the member has internal policies and procedures governing political contributions. This disclosure requirement would result in a significant deviation from the requirements of SEC Rule 206-4(5). Not only does the SEC rule *not* include a similar disclosure requirement, but the SEC considered *and deliberately decided not to include such a disclosure requirement in its rule.* In fact, in the Adopting Release, the SEC states that it had considered requiring greater disclosure to government entities by advisers of payments to solicitors as an alternative to Proposed 206(4)-5's ban on third-party placement agents but had rejected this approach because such disclosure is not "...useful when plan fiduciaries themselves are participants in the pay-to-play activities."[7] The Adopting Release further notes that the MSRB had tried and failed to address the problem of placement agents and consultants engaging in pay-to-play activities on their principals' behalf by mandating greater disclosure of payments to placement agents. When this proved inadequate, the MSRB adopted Rule G-38, which prohibits any broker, dealer, or municipal securities dealer from compensating any person who is not an affiliated person of the broker, dealer, or municipal securities dealer for solicitation activities.[8] We respectfully submit that this rationale similarly should inform FINRA's thinking in adopting rules to govern pay-to-play activities and we recommend that FINRA not impose disclosure requirements as part of its pay-to-play rules.

In further support of this recommendation, we note that including a disclosure requirement in FINRA's rule would upset the regulatory alignment between the SEC's rule and FINRA's proposed rule. While we appreciate that FINRA's proposed disclosure requirements are generally comparable to those in the SEC rule government cash payments for client solicitations (*i.e.,* SEC Rule 206(4)-3 under the Advisers Act), subsection (a)(2)(ii) of the SEC's rule effectively provides that employees of a person which controls, is controlled by, or under common control with an investment adviser are not required to provide the disclosure required by the rule at the time of solicitation. FINRA's proposed rule, however, fails to provide an exemption from its disclosure requirements for affiliated solicitors, resulting in a significant difference between the application of the two rules.

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[7] Adopting Release at page 79-80: "...some commenters [on Proposed Rule 206(4)-5] suggested alternatives to the proposed ban [on third-party placement agents] to address our concern that pay-to-play activities are often carried out through or with the assistance of third parties. Several commenters, for example, suggested that we instead require greater disclosure by advisers of payments to solicitors. Such an approach could be helpful to give plan fiduciaries information necessary for them to satisfy their legal obligations and uncover abuses, but it would not be useful when plan fiduciaries themselves are participants in the pay to play activities."

[8] Adopting Release at page 80.

In our view, these significant differences between FINRA's rule and that of the SEC would create an unlevel playing field for those solicitors that solicit in their capacity as FINRA members. Indeed, a solicitor that is a municipal advisor or investment adviser is subject to MSRB Rule G-37 or SEC Rule 206(4)-5, as applicable, neither of which has a similar disclosure requirement. We fail to see why FINRA members and their affiliated persons, alone among all solicitors, would be required to make pay-to-play related disclosures to government entities. We are concerned that this additional burden will put them at a disadvantage vis-à-vis their industry colleagues who may be soliciting the same business. For these reasons, we strongly recommend that FINRA not adopt a disclosure requirement.[9]

IV. FINRA SHOULD NOT INCLUDE A DISGORGEMENT REQUIREMENT IN RULE 2390

We also recommend that FINRA not include a disgorgement requirement in its pay-to-play rules because such a requirement is both unnecessary and is likely to create confusion. As proposed, in Rule 2390(b), in addition to other sanctions for violations of the rule's pay-to-play prohibitions, a FINRA member will be required to disgorge any compensation that it has accepted in violation of the rule. In our view, including disgorgement as a penalty is not necessary given that the SEC and FINRA both have full authority to require disgorgement of fees, and indeed, disgorgement has been the penalty universally applied (along with additional penalties) in enforcement actions under existing pay-to-play rules, such as MSRB Rule G-37 and SEC Rule 206(4)-5.[10] More importantly, by designating disgorgement as a required penalty, the proposal raises the question as to whether FINRA has to impose disgorgement as a penalty even after the FINRA member has already discovered and remedied the violation by voluntarily refunding the prohibited compensation it received. We understand that voluntarily refunding such compensation is common practice among firms that have discovered an impermissible contribution under a pay-to-play rule. By automatically imposing disgorgement as a penalty upon the occurrence of a pay-to-play violation, the proposal may effectively result in imposing double penalties on any FINRA member that has voluntarily refunded prohibited compensation. This result is likely to dissuade firms from voluntarily refunding such compensation to remedy a violation.[11]

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[9] In the event FINRA disagrees with our recommendation and adopts a disclosure requirement, we strongly recommend that such requirement provide an exemption for affiliated solicitors in order to better ensure consistency with the SEC's disclosure requirements under the Investment Advisers Act.

[10] *See, e.g.*, *In the Matter of T.L. Ventures, Inc.* Release No. 3859, File No. 3-15940 (June 20, 2014); *In the Matter of Goldman, Sachs & Co.*, Release No. 67934, File No. 3-15048 (September 27, 2012).

[11] In the event FINRA retains the disgorgement provision in proposed Rule 2390, we recommend that FINRA clarify an issue relating to its wording. In particular, while subdivision (b)(2) of the rule would require a FINRA member to pay the disgorged remuneration to those persons listed in subdivision (b)(2)(A)-(d) "in the order listed," the rule does not indicate how a covered member is to determine the portion that must be paid to each of the persons listed. We suggest that FINRA could clarify the meaning of this provision.

V. FINRA's Recordkeeping Requirements Should be Aligned with the SEC's

Finally, should FINRA adopt Rule 4580, we recommend that FINRA ensure that the rule's recordkeeping requirements are aligned with those of the SEC under its pay-to-play rule. This is particularly important in connection with the treatment of omnibus accounts under the rule. As proposed, Rule 4580 would require a FINRA member to maintain a record of "the name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities on behalf of the investment adviser." If FINRA applies this requirement to a member holding an omnibus account on behalf of another broker-dealer that solicited a government entity, and the omnibus dealer is unaware of the broker-dealer's solicitation activities, the omnibus dealer will likely be unable to maintain records required by Rule 4580. To address this concern, we recommend that FINRA either (1) limit the recordkeeping requirements to the broker-dealer that solicited the government entity, that has a direct relationship with the government entity, and that maintains the account record on behalf of such client or (2) provide appropriate relief from the recordkeeping requirements for omnibus accounts along the lines of the relief that was provided to such accounts by the SEC under Rule 206(4)-5.[12]

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We appreciate FINRA's consideration of our concerns and recommendation to address them. If you have any questions concerning these comments, please do not hesitate to contact the undersigned by phone (202-326-5825) or email (tamara@ici.org).

Sincerely,

/s/
Tamara K. Salmon
Senior Associate Counsel

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[12] *See* Investment Company Institute, Pub. Avail, September 13, 2011.

EXHIBIT 5

Below is the text of the proposed rule change. Proposed new language is underlined.

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2000. DUTIES AND CONFLICTS

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2030. Engaging in Distribution and Solicitation Activities with Government Entities

(a) Limitation on Distribution and Solicitation Activities

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 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).

(b) Prohibition on Soliciting and Coordinating Contributions

No covered member or covered associate may solicit or coordinate any person or political action committee 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.

(c) Exceptions

(1) De minimis Exception

Paragraph (a) shall not apply to contributions made by a covered associate that is a natural person, to officials for whom the covered associate was entitled to vote at the time of the contributions and which in the aggregate do not exceed $350 to any one official, per election, or to officials for whom the covered associate was not entitled to vote at the time of the contributions and which in the aggregate do not exceed $150 to any one official, per election.

(2) Exception for Certain New Covered Associates

The prohibitions of paragraph (a) shall not apply to a covered member as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the covered member unless such person, after becoming a covered associate, engages in, or seeks to engage in, distribution or solicitation activities with a government entity on behalf of the covered member.

(3) Exception for Certain Returned Contributions

(A) A covered member that is prohibited from engaging in distribution or solicitation activities with a government entity pursuant to paragraph (a) as a result of a contribution made by a covered associate is excepted from such prohibition, subject to subparagraphs (B) and (C) below, upon satisfaction of the following requirements:

(i) The covered member must have discovered the contribution that resulted in the prohibition within four months of the date of such contribution;

(ii) Such contribution must not have exceeded $350; and

(iii) The contributor must obtain a return of the contribution within 60 calendar days of the date of discovery of such contribution by the covered member.

(B) In any calendar year, a covered member that has reported on its annual Schedule I to Form X-17A-5 that it has more than 150 registered persons is entitled to no more than three exceptions pursuant to subparagraph (A), and a covered member that has reported on its annual Schedule I to Form X-17A-5 that it has 150 or fewer registered persons is entitled to no more than two exceptions pursuant to subparagraph (A).

(C) A covered member may not rely on the exception provided in subparagraph (A) more than once with respect to contributions by the same covered associate of the covered member regardless of time period.

(d) Prohibitions as Applied to Covered Investment Pools

For purposes of this Rule:

(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.

(e) Further Prohibitions

It shall be a violation of this 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.

(f) Exemptions

FINRA, upon application, may conditionally or unconditionally exempt a covered member from the prohibition described in paragraph (a). In determining whether to grant an exemption, FINRA shall consider, among other factors:

(1) Whether the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this Rule;

(2) Whether the covered member:

(A) Before the contribution resulting in the prohibition was made, adopted and implemented policies and procedures reasonably designed to prevent violations of this Rule;

(B) Prior to or at the time the contribution that resulted in such prohibition was made, had no actual knowledge of the contribution; and

(C) After learning of the contribution:

(i) Has taken all available steps to cause the contributor involved in making the contribution that resulted in such prohibition to obtain a return of the contribution; and

(ii) Has taken such other remedial or preventive measures as may be appropriate under the circumstances;

(3) Whether, at the time of the contribution, the contributor was a covered associate or otherwise an associated person of the covered member, or was seeking to become an associated person, or covered associate of the covered member;

(4) The timing and amount of the contribution that resulted in the prohibition;

(5) The nature of the election (e.g., federal, state or local); and

(6) The contributor's apparent intent or motive in making the contribution that resulted in the prohibition, as evidenced by the facts and circumstances surrounding such contribution.

(g) Definitions

For purposes of this Rule:

(1) "Contribution" means 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.

(2) "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 of a covered member who supervises, directly or indirectly, the government entity distribution or solicitation activities of a person in subparagraph (B) above; and

(D) Any political action committee controlled by a covered member or a covered associate.

(3) "Covered investment pool" means:

(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.

(4) "Covered member" means any member except when that member is engaging in activities that would cause the member to be a municipal advisor as defined in Exchange Act Section 15B(e)(4), SEA Rule 15Ba1-1(d)(1) through (4) and other rules and regulations thereunder;

(5) "Executive officer of a covered member" means:

(A) The president;

(B) Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);

(C) Any other officer of the covered member who performs a policy-making function; or

(D) Any other person who performs similar policy-making functions for the covered member.

(6) “Government entity” means any state or political subdivision of a state, including:

(A) Any agency, authority or instrumentality of the state or political subdivision;

(B) A pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including but not limited to a “defined benefit plan” as defined in Section 414(j) of the Internal Revenue Code, or a state general fund;

(C) A plan or program of a government entity; and

(D) Officers, agents or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

(7) “Investment adviser” means any investment adviser registered (or required to be registered) with the Commission, or unregistered in reliance on the exemption available under Section 203(b)(3) of the Investment Advisers Act, or that is an exempt reporting adviser, as defined in Rule 204-4(a) of that Act.

(8) “Official” means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office:

(A) Is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or

(B) Has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.

(9) “Payment” means any gift, subscription, loan, advance or deposit of money or anything of value.

(10) “Plan or program of a government entity” means any participant-directed investment program or plan sponsored or established by a state or political subdivision or any agency, authority or instrumentality thereof, including but not limited to a “qualified tuition plan” authorized by Section 529 of the Internal Revenue Code, a retirement plan authorized by Section 403(b) or 457 of the Internal Revenue Code, or any similar program or plan.

(11) “Solicit” means:

(A) With respect to investment advisory services, to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser; and

(B) With respect to a contribution or payment, to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.

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4000. FINANCIAL AND OPERATIONAL RULES

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4500. BOOKS, RECORDS AND REPORTS

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4580. Books and Records Requirements for Government Distribution and Solicitation Activities

(a) A covered member that engages in distribution or solicitation activities with a government entity on behalf of any investment adviser that provides or is seeking to provide investment advisory services to such government entity shall maintain books and records that pertain to Rule 2030, including a list or other record of:

(1) The names, titles and business and residence addresses of all covered associates of the covered member;

(2) The name and business address of each investment adviser on behalf of which the covered member has engaged in distribution or solicitation activities with a government entity within the past five years, but not prior to [insert the effective date of the Rule];

(3) The name and business address of all government entities with which the covered member has engaged in distribution or solicitation activities for compensation on behalf of an investment adviser, or which are or were investors in any covered investment pool on behalf of which the covered member has

engaged in distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool, within the past five years, but not prior to [insert the effective date of the Rule]; and

(4) 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 political action committee.

(b) Records relating to the contributions and payments referred to in paragraph (a)(4) must be listed in chronological order and indicate:

(1) The name and title of each contributor;

(2) The name and title (including any city/county/state or other political subdivision) of each recipient of a contribution or payment;

(3) The amount and date of each contribution or payment; and

(4) Whether any such contribution was the subject of the exception for certain returned contributions pursuant to Rule 2030.

(c) The terms used in this Rule 4580 shall have the same meaning as defined in Rule 2030.

(d) Any book or other record made, kept, maintained and preserved in compliance with SEA Rules 17a-3 and 17a-4, or with rules adopted by the Municipal Securities Rulemaking Board, which are substantially the same as the book or other record required to be made, kept, maintained and preserved under this Rule, shall be deemed to be made, kept, maintained and preserved in compliance with this Rule.

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