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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-76767; 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

December 24, 2015

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act," "Exchange Act" or "SEA")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on December 16, 2015, 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 substantially 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

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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 (Nov. 2014) ("Regulatory Notice 14-50"). 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 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.

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 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 from providing advisory services for compensation to a government entity for two years after the adviser or its covered

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[5] 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).

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 which municipal advisors must register under the Exchange Act.[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 Advisers Act Release No. 3418 (June 8, 2012), 77 FR 35263 (June 13, 2012).

8 See Exchange Act Release No. 70462 (Sept. 20, 2013), 78 FR 67468 (Nov. 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 Advisers Act Release No. 4129 (June 25, 2015), 80 FR 37538 (July 1, 2015). In addition, staff of the Division of Investment Management 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

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 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

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pay-to-play rule, the Division of Investment Management would not recommend enforcement action to the Commission against an investment adviser or its covered associates under SEC Pay-to-Play 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).

10 "Solicitors" typically locate investment advisory clients on behalf of an investment adviser. See Advisers Act Release No. 2910 (Aug. 3, 2009), 74 FR 39840, 39853 n.137 (Aug. 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).

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]

FINRA sought comment on the proposed rule change in Regulatory Notice 14-50.[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 Regulatory Notice 14-50. In particular, as

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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 (Dec. 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 (Mar. 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.

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 Regulatory Notice 14-50, is set forth in further detail below.

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

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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.

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]

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

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

[20] See supra note 6.

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

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 (Aug. 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 Exchange Act Release No. 33868 (Apr. 7, 1994), 59 FR 17621 (Apr. 13, 1994) (Order Approving File No. SR-MSRB-94-2).

24 FINRA notes that a person that is registered under the Exchange Act 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

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 entities would include all state

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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).

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

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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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."

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

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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.

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

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 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

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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."

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."

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

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[38] See id.

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]

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

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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 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

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 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

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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 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).

"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).

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

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

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.

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 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 II.C below, FINRA has added proposed Rule 2030(d)(2) in response to comments on Regulatory Notice 14-50 to clarify, for purposes of the proposed rule, the

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 made, and when imposition of the prohibition would be unnecessary to achieve the rule's intended purpose. This provision would provide covered

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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).

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).

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 who 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.

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

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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.

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 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

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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.

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]

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

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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.

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 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

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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.

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 member 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. Member 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 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.

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

As discussed above, FINRA published Regulatory Notice 14-50 to request comment on the proposed rule change.[63] Regulatory Notice 14-50 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 Regulatory Notice 14-50 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.

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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.

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

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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 Exchange Act 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).

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 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 member firms and the extent to which their compliance procedures are automated, whether the covered member is (or

[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.

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 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,

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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.

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

72 See supra note 69.

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 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]

FINRA requested comment on the economic impacts of the proposed rule change as set forth in Regulatory Notice 14-50, 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

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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.

78 See supra note 76.

disclosure requirements set forth in Regulatory Notice 14-50, stating among other things, that the disclosure requirements are "overly burdensome and create difficult compliance challenges"[79] and that FINRA's cost estimates in Regulatory Notice 14-50 "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 FINRA-registered placement

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79 Monument Group.

80 SIFMA.

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 Regulatory Notice 14-50 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 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

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81 See, e.g., 3PM.

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

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.

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

In November 2014, FINRA published the proposed rule change for comment in Regulatory Notice 14-50. FINRA received 10 comment letters in response to Regulatory Notice 14-50. A copy of Regulatory Notice 14-50 is attached as Exhibit 2a to the proposed rule change that was filed with the Commission. A list of the comment letters received in response to

[83] See supra note 23.

Regulatory Notice 14-50 is attached as Exhibit 2b.[84] Copies of the comment letters received in response to Regulatory Notice 14-50 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 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

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

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).

associates to make political contributions.[87] As discussed in Regulatory Notice 14-50 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 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]

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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 Rule Adopting Release, 75 FR 41018, 41024 (discussing independent expenditures).

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

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 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 Regulatory Notice 14-50, 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

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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).

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 Regulatory Notice 14-50 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 Pay-to-Play Rule. Thus, at this time, FINRA declines to provide additional guidance as part of the proposed

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92 See supra note 28.

93 See supra note 29.

94 See supra note 30.

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 Regulatory Notice 14-50, 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 Regulatory Notice 14-50 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 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

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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").

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 Regulatory Notice 14-50 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 Regulatory Notice 14-50, 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

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

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 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

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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).

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 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

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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.

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 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

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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."

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 (Oct. 28, 1980), 45 FR 73898 (Nov. 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

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 Regulatory Notice 14-50, 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]

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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.

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 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 Regulatory Notice 14-50, 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]

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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.

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

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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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.

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

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

solicitation activities on behalf of an investment adviser. As stated in Regulatory Notice 14-50 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 Regulatory Notice 14-50, 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 Regulatory Notice 14-50 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

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

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

member or its covered associates funneling payments through a third party to trigger the two-year time out.[116]

F. Exceptions

In Regulatory Notice 14-50, 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 Regulatory Notice 14-50 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 Regulatory Notice 14-50 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

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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).

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 Regulatory Notice 14-50, 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

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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.

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 Regulatory 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 Regulatory Notice 14-50, 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.

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

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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.

(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
- 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 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 10:00 a.m. and 3:00 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 DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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

Brent J. Fields
Secretary

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

[FR Doc. 2015-32894 Filed: 12/29/2015 8:45 am; Publication Date: 12/30/2015]