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If you have any questions regarding the matters discussed in this memorandum, please call one of the following representatives in the Political Law Group (Washington, D.C. office) or your regular Skadden contact.

Kenneth A. Gross
Partner | 202.371.7007
kenneth.gross@skadden.com

Ki P. Hong
Partner | 202.371.7017
ki.hong@skadden.com

Matthew Bobys
Counsel | 202.371.7739
matthew.bobys@skadden.com

Melissa Miles
Counsel | 202.371.7836
melissa.miles@skadden.com

Patricia Zweibel
Counsel | 202.371.7089
patricia.zweibel@skadden.com

Rachel Applestein
Associate | 202.371.7511
rachel.applestein@skadden.com

Shayla Parker
Associate | 202.371.7534
shayla.parker@skadden.com

Charles Ricciardelli
Associate | 202.371.7573
charles.ricciardelli@skadden.com

Tyler Rosen
Associate | 202.371.7035
tyler.rosen@skadden.com

Tanya Sehgal
Associate | 202.371.7636
tanya.sehgal@skadden.com

Kelvin Reese
Head Political Reports Analyst
202.371.7498
kelvin.reese@skadden.com

FINRA Releases Proposed Pay-to-Play Rule for Third-Party and Affiliated Placement Agents

On November 14, 2014, the Financial Industry Regulatory Authority (FINRA) released the text of its proposed "pay-to-play" rule for placement agents and issued Regulatory Notice 14-50 (the Notice) explaining and requesting comments on the rule by December 15, 2014. Specifically, FINRA released and is seeking comment on three proposed new rules: Rule 2271 (Disclosure Requirement for Government Distribution and Solicitation Activities); Rule 2390 (Engaging in Distribution and Solicitation Activities With Government Entities); and Rule 4580 (Books and Records Requirements for Government Distribution and Solicitation Activities). Together, the three rules comprise the proposed pay-to-play rule (the Proposed Rule). Click here to view the link to the Notice (which provides a link to the text of the Proposed Rule).

The Proposed Rule would provide a pathway for investment advisers to continue to utilize affiliated and unaffiliated broker-dealers to solicit government entity investors when Securities and Exchange Commission (SEC) Rule 206(4)-5's placement agent provisions take effect. As a reminder, once effective, these provisions will prohibit an investment adviser from paying any person other than its own employee, including an affiliate or third party, to solicit government entities for investment advisory services unless such person is one of the following:

- a registered investment adviser (RIA) complying with SEC Rule 206(4)-5;
- a municipal advisor registered with the SEC that is subject to the Municipal Securities Rulemaking Board's (MSRB's) pay-to-play Rule G-37 (amendments to which the MSRB has recently voted to submit to the SEC in order to extend the rule to cover municipal advisers); or
- a registered broker-dealer complying with FINRA's pay-to-play rule (the proposed version of which is discussed herein).

Rule 206(4)-5's placement agent restrictions are scheduled to take effect nine months after the compliance date of the SEC's final rule requiring registration of municipal advisors, so these restrictions could be in effect as early as April 1, 2015. There has been a great deal of concern within the industry that FINRA might not finalize its pay-to-play rule before this time, thus prohibiting broker-dealers not registered as RIAs or municipal advisors from soliciting government business. The release of this Proposed Rule should allay those concerns. The Proposed Rule does not state when it will take effect, but, presumably it will have to be effective no later than the effective date of Rule 206(4)-5's placement agent restrictions.

It is important to note that the Proposed Rule has implications for RIAs as well as FINRA member firms. In particular, RIAs should consider how to implement appropriate due diligence measures to ensure that their placement agents — both those affiliated with the RIA and third-party entities — are in compliance with this Proposed Rule or other applicable pay-to-play rule for non-broker-dealers.

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What Type of Business Is Covered?

The Proposed Rule imposes restrictions on the activities of FINRA members engaged in distribution or solicitation activities for compensation with a state or local government entity on behalf of an investment adviser for investment advisory services, including through a separate managed account or an investment in a covered investment fund advised by that adviser (Covered Member). The Proposed Rule does not define "distribution or solicitation activities"; however, it does define "soliciting" as communicating, directly or indirectly, with a government entity for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser.

"Covered Members" excludes members engaging in activities that would require the member to register as a municipal advisor with the SEC. For example, a FINRA member soliciting state or local entities on behalf of an unaffiliated RIA for certain direct investment advisory services (*e.g.*, a separate managed account) may be required to register as a municipal advisor and be subject to the forthcoming amended MSRB Rule G-37 pay-to-play provisions. Accordingly, the Proposed Rule would not apply with respect to such activities that subject the member to municipal advisor registration and amended Rule G-37.

Parts of the Proposed Rule

The Proposed Rule includes three parts:

- a pay-to-play rule regarding political contributions (Rule 2390);
- disclosure requirements to government entities being solicited (Rule 2271); and
- record-keeping requirements related to government solicitation activities (Rule 4580).

Prohibitions on Making Political Contributions

Ban on Making Political Contributions – The Proposed Rule prohibits a Covered Member from engaging in distribution or solicitation activities described above for compensation for two years if the Covered Member, its Covered Associate (defined below) or any PAC either controls contributes to an official of that governmental entity. This includes not only political contributions to the official's election campaign but also to the official's inaugural and transition committees.

> Covered Officials: An official of a governmental entity is a candidate for (or incumbent of) a state or local elective office that can (1) directly or indirectly influence the governmental entity's selection of an investment adviser/investment pool; or (2) has the authority to appoint an official with such influence. This could cover state or local officials who are running for federal office.
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> Covered Associates: Any (1) associated person who engages in distribution or solicitation activities with a government entity; (2) associated person who directly or indirectly supervises such an individual; or (3) general partner, managing member or executive officer, or others with similar function or status.
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> Look-Back for New Covered Associates: For an individual who becomes a Covered Associate for the first time by engaging in distribution or solicitation activities, the contributions the individual made during the prior two years to an official of a government entity would trigger a ban for the Covered Member. Other new Covered

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Associates have a shorter, six-month look-back. Thus, when an associated person becomes a Covered Associate for the first time, one must "scrub" that employee to make sure the employee has not made a covered contribution during the relevant look-back period.

Exceptions:

- Individuals who contribute no more than $350 per election to a candidate for whom the individual is entitled to vote, or $150 per election to a candidate for whom he or she is not entitled to vote.
- If an individual contributes within the $350 per election limit but is not entitled to vote for the candidate, there is an automatic exception if (1) the Covered Member discovers the contribution within four months; and (2) a refund is obtained within 60 days of discovery. A Covered Member may use this automatic exception only twice (or if a Covered Member reports having more than 150 registered persons on its annual Schedule I to Form X-17A-5, no more than three times) during a calendar year and only once in a lifetime for any one Covered Associate.
- A Covered Member may seek from FINRA a discretionary exemption, where FINRA will consider a variety of factors, including but not limited to the sufficiency of the Covered Member's compliance procedures, whether the Covered Member had knowledge of the contribution before or at the time it was made, and the remedial steps, if any, the Covered Member took after discovering the contribution.

Ban on Soliciting Political Contributions – The Proposed Rule prohibits a Covered Member, its Covered Associates or a PAC either controls from soliciting or coordinating political contributions on behalf of (1) an official of a governmental entity with which the Covered Member is engaging in, or is seeking to engage in, distribution or solicitation activities on behalf of an investment adviser; or (2) a political party of the state or locality of a government entity with which the Covered Member is engaging in, or is seeking to engage in, distribution or solicitation activities on behalf of an investment adviser.

Indirect Violations – A Covered Member or Covered Associate is prohibited from doing indirectly what it is prohibited from doing directly (*e.g.*, using an affiliate, spouse or third party to make or solicit prohibited contributions).

Penalty / Disgorgement – In addition to other possible penalties, if a Covered Member engages in solicitation or distribution activities with a government entity on behalf of an investment adviser in violation of the Proposed Rule, the Covered Member is prohibited from accepting or retaining any compensation connected to such activity from the applicable investment adviser or government entity. For example, the Covered Member will be required to repay, in the following order, any compensation received as a result of such activity to (1) the investment pool in which the government entity was solicited to invest, if applicable, (2) the government entity, (3) any appropriate entity designated by the government entity if neither of the above is able to receive such payments or (4) the FINRA Investor Education Fund in the event none of the options above are available.

Disclosure to Government Entity of Distribution and Solicitation Activities

The Proposed Rule requires a Covered Member to disclose the following information in writing to the government entity at the time of the initial distribution or solicitation:

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- the fact that the Covered Member is engaging in distribution or solicitation activities on behalf of the investment adviser, and the name of such investment adviser;
- the nature of the relationship between the Covered Member and the investment adviser (*e.g.*, whether affiliated);
- a statement that the Covered Member will be compensated by the investment adviser, and the terms of such compensation arrangement;
- any incremental charges or fees that may be imposed on the government entity as a result of the Covered Member's distribution or solicitation activities;
- the existence and details of any pecuniary, employment, business or other relationship between the Covered Member or its Covered Associate and any person affiliated with the government entity that has influence in the decision-making process for choosing an investment adviser (relationships required to be disclosed are not limited to relationships with a person who is a covered official under the Proposed Rule); and
- the existence of the Covered Member's internal policies with respect to political contributions.

While engaging in covered activities, the Covered Member must update this disclosure within 10 days of any material change.

Record-Keeping Requirements

The Proposed Rule provides that a Covered Member must maintain the following books and records:

- the names, titles, and business and residential addresses of Covered Associates;
- the name and address of each investment adviser on whose behalf the Covered Member has engaged in distribution or solicitation activities with a government entity within the past five years, but not prior to the Proposed Rule's effective date;
- the name and address of all government entities with which the Covered Member has engaged in distribution or solicitation activities on behalf of an investment adviser within the past five years, but not prior to the Proposed Rule's effective date; and
- specific information regarding all contributions made by the Covered Member, Covered Associates and PACs either control to an official of a governmental entity, a state or local party committee, or a political action committee. The term "political action committee" is not defined and could, as currently worded, even include contributions made by a Covered Associate to the Covered Member's own PAC.