



Political Law Alert

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FINRA Submits Pay-to-Play Rule 2030 to SEC for Approval

On December 16, 2015, the Financial Industry Regulatory Authority (FINRA) submitted Rules 2030 and 4580 (the Draft Rules) to the Securities and Exchange Commission (SEC) for approval. The Draft Rules set forth pay-to-play restrictions and record-keeping requirements for broker-dealers that act as placement agents for investment advisers or their managed funds.

The Draft Rules are slated to take effect between six and 14 months after they are approved by the SEC. Within two months of SEC approval, FINRA will issue a release establishing the effective date for the Draft Rules. FINRA will set the effective date for the Draft Rules between six months and one year after the date of such release.

FINRA initially issued pay-to-play, disclosure and record-keeping rules for comment on November 14, 2014 (the Proposed Rules). In response to several comment letters, FINRA made a number of changes to the Proposed Rules. Below we summarize the Draft Rules as submitted to the SEC last week, beginning with a discussion of the significant changes made from the Proposed Rules issued in 2014.

Changes from the 2014 Proposed Rules

The core provisions of the Draft Rules are largely unchanged from the Proposed Rules issued for comment in 2014. However, in response to comment letters from various market participants, FINRA made three significant changes to other provisions:

- **Disclosure.** As issued for comment in 2014, Proposed Rule 2271 included a burdensome requirement that a Covered Member (as defined below) disclose various pieces of information regarding its solicitation activity to the government entity in writing at the time of an initial government distribution or solicitation. This disclosure requirement has been eliminated from the Draft Rules as submitted to the SEC.
- **Disgorgement.** As issued for comment in 2014, Proposed Rule 2390 contained a penalty provision requiring a Covered Member to repay compensation obtained from solicitations prohibited by the Rule according to a “waterfall” structure. This disgorgement requirement has been eliminated from the Draft Rules as submitted to the SEC.
- **Records of Unsuccessful Solicitations.** As issued for comment in 2014, Proposed Rule 4580 required, among other things, that a Covered Member keep records of the names and addresses of all government entities with which it engaged in solicitation or distribution activities on behalf of an investment adviser. As submitted to the SEC, Draft Rule 4580 limits this requirement to such solicitation and distribution activities engaged in “for compensation.” In the text of the release, FINRA states that this

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change is meant to clarify that the record-keeping requirement “would not apply to unsuccessful solicitations.” However, based on the plain language of Draft Rule 4580 as submitted, this record-keeping requirement could still cover an unsuccessful solicitation undertaken by a Covered Member on retainer or in connection with another compensation arrangement that is not contingent upon success.

What Type of Business Is Covered?

The Draft Rules impose 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 Draft Rules do not define “distribution or solicitation activities”; however, they 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.

In defining covered investment pools, the Draft Rules refer to:

- any investment company that is registered with the SEC (such as a mutual fund) and is an investment option of a plan or program of a government entity; or
- a company that is exempt from registration under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the Investment Company Act of 1940. Investment pools under this prong would include, among others, hedge funds and private equity funds.

Government entities contemplated under the Draft Rules include any government instrumentality, such as public pension funds, local pooled funds (*e.g.*, 529 college tuition savings programs), and 403(b) and 457 retirement plans. In response to a commenter’s request for confirmation, FINRA confirmed in the text of the release that the Draft Rules would apply to distribution activities involving 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.

“Covered Members” excludes members engaging in activities that would require the member to register as a municipal advisor with the SEC. For example, FINRA members soliciting state or local entities on behalf of an unaffiliated investment adviser 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 (which also were submitted to the SEC for approval last week and are discussed in a separate mailing). Under such circumstances, the member would not also be subject to the Draft Rules, but only with respect to the activities that

subject it to municipal advisor registration.

Prohibitions on Making Political Contributions (Draft Rule 2030)

Draft Rule 2030 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 they control makes a Covered Contribution to a Covered Official.

The following definitions apply:

- **Covered Contributions.** Anything of value to a Covered Official for the purpose of influencing an election, debt retirement for an election, or transition or inaugural expenses.
- **Covered Officials.** A candidate for, successful candidate for, or incumbent of a state or local elective office that (1) can directly or indirectly influence the government entity’s selection of an investment adviser/investment pool or (2) has the authority to appoint an official with such influence. This would cover certain state or local officials who are running for federal office.
- **Covered Associates.** This term includes any:
 - associated person who engages in distribution or solicitation activities with a government entity;
 - associated person who directly or indirectly supervises the government entity distribution or solicitation activities of such a solicitor; and
 - general partner, managing member or executive officer (the president, vice president in charge of a principal business unit, division or function, other officer or person who performs policy-making function), or other individual with a similar status or function.

Please note that under the Exchange Act, “associated person” of a broker-dealer includes, among others, any person directly or indirectly controlling, controlled by or under common control with such broker-dealer (*i.e.*, the broker-dealer’s affiliates).

Look-Back for New Covered Associates

For an employee who becomes a Covered Associate by engaging in distribution or solicitation activities with a government entity, the Covered Contributions he or she made during the prior two years would trigger a ban for the Covered Member. Other new Covered Associates have a shorter, six-month look-back. Thus, when an employee becomes a Covered Associate for the first time, one must “scrub” that employee to make sure he or she has not made a Covered Contribution during the relevant look-back period. The look-back, however, will not cover contributions made prior to the effective date of the Draft Rules.

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Exemptions

There is an exemption for an individual who contributes no more than \$350 per election to a candidate for whom he or she 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 exemption 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 exemption only three times (or if the Covered Member has reported on its annual Schedule I to Form X-17A-5 that it has 150 or fewer registered persons, no more than twice) during a calendar year and only once in a lifetime for any one individual.

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 it was made, and the remedial steps, if any, the Covered Member took after discovering the contribution.

Ban on Soliciting Political Contributions

Draft Rule 2030 prohibits a Covered Member, its Covered Associates or their PAC from soliciting or coordinating political contributions on behalf of (1) a Covered Official 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, or (2) a political party of the state or locality of such a government entity.

Indirect Violations

A Covered Member, Covered Associate or their PAC 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).

Record-Keeping Requirements

Draft Rule 4580 provides that a **Covered Member** must maintain the following books and records:

- 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 Draft Rule's effective date;
- The name and address of all government entities with which the Covered Member has engaged in distribution or solicitation activities for compensation on behalf of an investment adviser, or which are or were investors in any covered investment pool on behalf of which the Covered Member has engaged in distribution or solicitation activities with the government entity on behalf of the investment adviser to such pool, within the past 5 years, but not prior to the Draft Rule's effective date;
- Specific information regarding all contributions made by the Covered Member, Covered Associates and their PACs to an official of a government entity, a state or local party committee, or a political action committee.

Please contact us with any questions.

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