

FINRA CAPITAL ACQUISITION BROKERS NOW SUBJECT TO PAY-TO-PLAY RULES

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U.S. Investment Management Alert

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The pay-to-play rules have expanded to FINRA capital acquisition brokers ("CABs") and the investment advisers who use CABs to solicit governmental entities, which include public pension funds, for investment advisory services. [1] A CAB is a FINRA member firm that engages in limited types of broker-dealer activities, such as advising private equity funds and companies on corporate restructuring and capital raising and, under limited conditions, acting as a placement agent for unregistered securities to institutional investors. [2]

In 2010, the SEC adopted the first of several pay-to-play rules, SEC Rule 206(4)-5, which applies to investment advisers. [3] Pursuant to this rule, investment advisers are prohibited from receiving compensation from a governmental entity for two years after the investment adviser or its "covered associate" makes a contribution to an "official" of that governmental entity. This rule also prohibits investment advisers from hiring third parties to solicit a governmental entity for investment advisory services unless the third-party is a "regulated person." A "regulated person" includes, in part, an SEC-registered broker or dealer that is a member of a national securities association which has adopted rules that prohibits its members from engaging in distribution or solicitation activities when certain political contributions are made and the SEC has determined that such rules are consistent with the SEC pay-to-play rule.

In 2016, FINRA adopted pay-to-play rules, FINRA Rules 2030 and 4850, which are similar to the SEC pay-to-play rule and includes a recordkeeping component. Broker-dealers subject to the FINRA pay-to-play rules are deemed to be "regulated persons" under the SEC pay-to-play rule. Accordingly, an investment adviser may hire such broker-dealers to solicit a governmental entity for investment advisory services.

Pursuant to the FINRA pay-to-play rules, a covered member may not receive compensation for two years for distribution or solicitation activities to a governmental entity on behalf of an investment adviser if either the covered member or its "covered associates" has made a political contribution to an "official" of such governmental entity or to a political party of a state or locality of such governmental entity. Similar to the SEC pay-to-play rule, an "official" is any person who, at the time of the contribution, was an incumbent, candidate, or successful candidate for elective office of a governmental entity if the office is directly or indirectly responsible for, or can influence the outcome of, the governmental entity hiring the investment adviser or has the ability to appoint a person to such office. Also similar to the SEC pay-to-play rule, the FINRA pay-to-play rules have broad application as they prohibit a covered member or its covered associates from doing anything indirectly that, if done directly, would violate the FINRA pay-to-play rules.

In addition, a covered member who engages in distribution or solicitation activities with a governmental entity on behalf of an investment adviser is required to maintain certain records that include: the names and addresses of the investment advisers on whose behalf the covered member has engaged in distribution or solicitation activities

with a governmental entity; the names and addresses of such governmental entities; and the political contributions made by the covered member or its covered associates to an official of a governmental entity.

When the CAB rules were enacted, those rules did not explicitly subject CABs to the FINRA pay-to-play rules. This regulatory gap resulted in CABs not being included in the definition of a "regulated person" under the SEC pay-to-play rule. Therefore, CABs, unlike other broker-dealers, were prevented from engaging in distribution and solicitation activities with governmental entities on behalf of an investment adviser.

The new CAB rules eliminate this regulatory gap by explicitly subjecting CABs to the FINRA pay-to-play rules, and, accordingly, expanding the definition of a "regulated person" to include CABs. As a result of the new CAB rules, CABs will need to adopt pay-to-play policies. In addition, any investment adviser who engages a CAB for distribution or solicitation activities to a governmental entity should inquire as to the policies adopted by the CAB and obtain representations that the CAB has adopted such policies and is in compliance with the FINRA pay-to-play rules.

[1] The Securities and Exchange Commission ("SEC") approved CAB Rules 203 and 458 pursuant to SEC Release No. 34-81438, dated August 18, 2017. FINRA will announce the effective date of these rules in a publication of a Regulatory Notice published on the FINRA webpage by November 28, 2017, and the effective date will be 30 days thereafter.

[2] CABs are a new type of registration category for broker-dealers, which became effective earlier in 2017. A FINRA member firm that elects to be governed as a CAB is relieved of certain regulatory requirements applicable to traditional broker-dealers but is prohibited from certain activities such as engaging in proprietary trading or market-making, carrying or maintaining customer accounts, accepting customer trading orders, and handling customer funds or securities.

[3] SEC Rule 206(4)-5 applies to investment advisers registered or required to be registered with the SEC, "foreign private advisers" not registered in reliance on Section 203(b)(3) of the Investment Advisers Act, and "exempt reporting advisers."

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