

SEC Approves FINRA Pay-to-Play Rules

Placement agents to private funds who seek investments by state and local pension plans must comply with restrictions on political contributions and related activities.

On August 25, 2016, the Securities Exchange Commission (SEC) approved Pay-to-Play Rules 2030 and 4580 (the Rules) submitted by the Financial Industry Regulatory Authority (FINRA).¹ The impact of the approved Rules will be felt primarily by placement agents for investments by government instrumentalities, such as public pension funds, in private funds.

In July 2010, the SEC adopted Rule 206(4)-5 under the Investment Advisers Act of 1940 (the SEC Pay-to-Play Rule).² The SEC Pay-to-Play Rule prohibits an investment adviser from providing advisory services to a government entity for two years after the adviser or its covered associates makes a contribution to an official of the government entity, unless an exception or exemption applies. The rule also prohibits an investment adviser and its covered associates from providing payment, directly or indirectly, to any third party to solicit a government entity for investment advisory services on behalf of such investment adviser unless such third party is an SEC-registered investment adviser, a FINRA member subject to FINRA pay-to-play rules, or a registered municipal adviser subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board (MSRB).³ The rule further states that the FINRA and MSRB pay-to-play rules must impose “substantially equivalent or more stringent restrictions on broker-dealers than the [the SEC Pay-to-Play Rule] imposes on investment advisers and ... [must be] consistent with the objectives of [the SEC Pay-to-Play Rule].”⁴

In response, FINRA released and requested comment on an initial set of proposed rules on November 14, 2014.⁵ These rules largely paralleled the SEC rule, but were more stringent in two respects. First, they imposed additional disclosure requirements that would require FINRA members to make specified disclosures to government entities in writing at the time of the initial distribution or solicitation. Second, they included a disgorgement requirement that would prevent a FINRA member from retaining compensation or other remuneration in connection with activities that are contrary to the requirements of the FINRA proposed rules. The comments FINRA received were largely critical of these two facets of the proposed rules, and FINRA eliminated these requirements in the final rules.⁶ With these two restrictions removed, the final Rules closely parallel the SEC Play-to-Play Rule.

FINRA’s Rule 2030(a) prohibits a FINRA member from 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 to an official of the government entity is made by the member or an associated person of the member.⁷ The two-year ban is also triggered by contributions made by an associated person before such person was hired by the member,⁸ except where the associated person (i) made the contribution more than six

months prior to being hired and (ii) is not engaging or seeking to engage in distribution or solicitation activities with the government entity on behalf of the FINRA member.⁹

Notably, in most other contexts, an investment adviser to a private fund is not deemed to provide investment advice directly to a government entity by the mere fact of the government entity's investment in the private fund as a limited partner or limited liability company member.¹⁰ However, Rule 2030(d) provides that for purposes of the Rule, the investment adviser to a private fund in which a government entity has invested will be deemed to provide investment advisory services directly to the government entity. Accordingly, the FINRA member firm's activities on behalf of the investment adviser in soliciting government entities are captured under Rule 2030(a).¹¹

The Rules also prohibit a FINRA member or an associated person from soliciting or coordinating with another person or a political action committee to make a contribution to (i) an official of a government entity or (ii) a political party of a state or locality of a government entity with which the member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser.¹²

Following the SEC Pay-to-Play Rule, there is a *de minimis* exception for contributions made by an associate person to a government entity official for whom such associated person is entitled to vote at the time of the contribution, provided that the contributions do not exceed US\$350 in the aggregate to any one official per election.¹³ Additionally, a "foot-fault" exemption is provided for certain limited situations in which the FINRA member discovers contributions that would trigger the compensation ban after the contribution has been made.¹⁴

Finally, Rule 4580 requires FINRA 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.¹⁵

FINRA has stated that it intends to make the Rules effective within six months following FINRA's publication of a Regulatory Notice announcing the SEC's approval of the Rules.¹⁶ As of the date of this publication, FINRA has not yet published this Regulatory Notice, but has stated that the Regulatory Notice will be published no later than 60 days following SEC approval.¹⁷

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Endnotes

- ¹ See Securities Exchange Act Release No. 34-78683 (Aug. 25, 2016), *available at* http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2016-056-approval-order.pdf (SEC Release).
- ² 17 C.F.R. 275.206(4)-5.
- ³ 17 C.F.R. 275.206(4)-5(a)(2)(i).
- ⁴ 17 C.F.R. 275.206(4)-5(f)(9)(ii).
- ⁵ See FINRA Regulatory Notice 14-50 (November 14, 2014), *available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/14-50.pdf.
- ⁶ FINRA Proposed Rule Change, *available at* http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2015-056.pdf (FINRA Proposed Rule Filing).
- ⁷ Rule 2030(a). *See also* SEC Release *at* 7.
- ⁸ Rule 2030(a). *See also* SEC Release *at* 17-18.
- ⁹ Rule 2030(c)(2). *See also* SEC Release *at* 17-18.
- ¹⁰ *See* Goldstein v. SEC, 451 F.3d 873 (D.C.Cir. 2006).
- ¹¹ Rule 2030(d). *See also* SEC Release *at* 20.
- ¹² Rule 2030(b). *See also* SEC Release *at* 15.
- ¹³ Rule 2030(c)(1). *See also* SEC Release *at* 16.
- ¹⁴ Rule 2030(f). *See also* SEC Release *at* 21.
- ¹⁵ Rule 4580. *See also* SEC Release *at* 22.
- ¹⁶ FINRA Proposed Rule Filing *at* 4.
- ¹⁷ *Id.*