

## COMMENT LETTER

December 15, 2014

# ICI Comment Letter on FINRA's Notice 14-50 Relating to Proposed "Pay to Play" Rules (pdf)

December 15, 2014 Marcia E. Asquith Office of the Corporate Secretary Financial Industry Regulatory Authority 1735 K Street NW Washington, DC 20006-1506 Re: FINRA Notice 14-50 Relating to Proposed "Pay to Play" Rules Dear Ms. Asquith: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on FINRA's proposed adoption of three new rules to address concerns with members engaging in pay-to-play practices.<sup>2</sup> The proposed rules consist of a prohibition on pay-to-play practices (Rule 2390), a new disclosure requirement (Rule 2271), and a related recordkeeping rule (Rule 4580). Our interest in this proposal derives from the rules' impact on those FINRA members that solicit a government entity on behalf of a "covered investment pool," which term includes any registered investment company<sup>3</sup> "that is an investment option of a plan or program of a government entity." While the Institute supports FINRA's proposed prohibition on pay-to-play practices, we recommend that FINRA confirm that its proposed treatment of solicitations made on behalf of covered investment pools is consistent with that of the pay-to-play rule adopted by the U.S. Securities and Exchange Commission ("SEC"), Rule 206(4)-5. Additionally, we recommend that FINRA: eliminate Rule 2271, which imposes a disclosure

<sup>1</sup> The Investment Company Institute ("ICI") is the world's leading association of regulated funds, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts ("UITs") in the United States and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interests of funds, their shareholders, directors and advisers. ICI's U.S. fund members manage total assets of \$17.2 trillion and serve more than 90 million U.S. shareholders. <sup>2</sup> See FINRA Requests Comment on a Proposal to Establish a "Pay-to-Play" Rule, FINRA Notice 14-50 (November 2014) ("FINRA Notice"). <sup>3</sup> For purposes of this letter, "mutual fund" is used to mean a "registered investment company." Marcia E. Asquith December 15, 2014 Page 2 of 6 requirement on solicitors; not include in Rule 2390 a provision mandating disgorgement; and clarify an issue relating to the records that must be kept under Rule 4580 in connection with omnibus accounts. Each of these issues is discussed in more detail below. I. BACKGROUND The Institute has long supported regulatory efforts to address concerns with pay-to-play practices. To date, those efforts have consisted of Rules G-37 and G-38 adopted by the Municipal Securities Rulemaking Board ("MSRB") and Rule 206(4)-5 adopted by the SEC. We are pleased that FINRA is following suit and adopting rules in this area to govern the activities of its members that solicit business on behalf of an investment adviser. We are also pleased that FINRA's proposal is designed to generally complement

and be consistent with the SEC's pay-to-play rule. Of particular interest to ICI as pay-to-play rules are adopted by the various financial institution regulators is ensuring that all such rules align with each other to the maximum extent possible. Such alignment is important to avoid disparate regulatory standards for persons engaged in similar activities and to facilitate compliance by persons that are subject to all of the various rules. As noted in the FINRA Notice, its proposed pay-to-play rule, Rule 2390, "is modeled on the SEC's Pay-to-Play Rule."<sup>4</sup> SEC Rule 206(4)-5 prohibits an investment adviser from compensating third parties for soliciting government entities on behalf of the adviser unless the solicitor is a "regulated person." The rule defines "regulated person" to include, among others, a broker-dealer subject to a regulatory association's pay-to-play rule that both (1) prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made and (2) has been found by the SEC to impose requirements that are at least as stringent as Rule 206(4)-5. Rule 206(4)-5 further provides that such rule must be "consistent with the objectives of [Rule 206(4)-5]."<sup>5</sup> In the absence of FINRA adopting a pay-to-play rule, FINRA members, as regulated persons, would be prohibited from engaging or continuing to engage in solicitation activities on behalf of investment advisers unless they became registered under the Investment Advisers Act of 1940 as either investment advisers or municipal advisers. Accordingly, adoption of FINRA's rule is necessary to enable FINRA members to rely on the "regulated person" exception in the SEC's rule. II. FINRA SHOULD CONFIRM THE LIMITED IMPACT OF RULE 2390 ON SOLICITATIONS INVOLVING COVERED INVESTMENT POOLS Proposed FINRA Rule 2390 would prohibit a FINRA member from engaging in "distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser" within two years after the member or its covered associate has made a contribution to an official of that

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FINRA Notice at p. 3. <sup>5</sup> See SEC Rule 206(4)-5(f)(9)(ii)(B). Marcia E. Asquith December 15, 2014 Page 3 of 6 entity. Like SEC Rule 206-4(5), the distribution or solicitation activities that would be covered by FINRA's rule would include those relating to a "covered investment pool." We are pleased that FINRA's proposed definition of "covered investment pool" is identical to the SEC's definition and, consequently, with respect to mutual funds, would only include those mutual funds that are "an investment option of a plan or program of a government entity." Thus, with respect to mutual funds, the prohibitions of both the SEC's rule and FINRA's rule would only be triggered when a government entity is solicited on behalf of an investment adviser to include mutual funds advised by the adviser as an option in a retirement plan or college education savings plan (529 plan) offered by the government entity. Proposed Rule 2390, however, also references "distribution" activities in subdivisions (a) and (e). We do not believe that, with respect to the treatment of mutual funds under this rule, the inclusion of distribution is intended to prohibit conduct that is not prohibited by SEC Rule 206(4)-5 and we request confirmation of this. Specifically, we request confirmation that, with respect to mutual funds, FINRA's rule is only triggered when a FINRA member 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. This interpretation is fully consistent with the scope of the SEC's rule. As noted in the SEC's release adopting Rule 206(4)-5: [The] provision [in the rule relating to covered investment pools] will generally affect two common types of arrangements in which a government official is in a position to influence investment of funds in pooled investment vehicles. The first is the investment of public funds in a hedge fund or other type of pooled investment vehicle. The other is the selection of a pooled investment vehicle sponsored or advised by an investment adviser as a funding vehicle or investment option in a government-sponsored plan, such as a 529 plan."<sup>6</sup> [Emphasis added.] In our view, use of the term "distribution" in FINRA's rule is intended to capture the first of the arrangements discussed in the Adopting Release, which involves a distribution function, and not the

second arrangement, which involves a solicitation function. As noted above, we seek confirmation of our interpretation. III. FINRA SHOULD NOT IMPOSE DISCLOSURE REQUIREMENTS As proposed, FINRA Rule 2271 would require a FINRA member engaging in solicitation or distribution activities for compensation with a government entity on behalf of an investment adviser to

6 See Political Contributions by Certain Investment Advisers, SEC Release No. IA-3043 (July 1, 2010) ("Adopting Release") at p. 98. Our recommendation is also consistent with the clarification in the Adopting Release where the SEC noted that, in response to comments, it had modified the final rule to include a mutual fund in the definition of covered investment pool for purposes of all three of Rule 206(4)-5's pay-to-play prohibitions, "but only if it is an investment option of a plan or program of a government entity." See id. p. 106. [Emphasis in original.] See, also, related discussion at pp. 97-108. Marcia E. Asquith December 15, 2014 Page 4 of 6 disclose to that entity specific information about the relationship with the adviser. Among other things, this disclosure would be required to include the nature of the relationship between the adviser and the solicitor; the terms of the compensation arrangement with the investment adviser; any incremental charges or fees that may be imposed on the government entity as a result of the distribution or solicitation; details of any relationship between the FINRA member and any person affiliated with the government entity (not just covered officials) that has influence in the decision-making process in choosing an investment adviser; and a statement that the member has internal policies and procedures governing political contributions. This disclosure requirement would result in a significant deviation from the requirements of SEC Rule 206-4(5). Not only does the SEC rule not include a similar disclosure requirement, but the SEC considered and deliberately decided not to include such a disclosure requirement in its rule. In fact, in the Adopting Release, the SEC states that it had considered requiring greater disclosure to government entities by advisers of payments to solicitors as an alternative to Proposed 206(4)-5's ban on third-party placement agents but had rejected this approach because such disclosure is not "...useful when plan fiduciaries themselves are participants in the pay-to-play activities."7 The Adopting Release further notes that the MSRB had tried and failed to address the problem of placement agents and consultants engaging in pay-to-play activities on their principals' behalf by mandating greater disclosure of payments to placement agents. When this proved inadequate, the MSRB adopted Rule G-38, which prohibits any broker, dealer, or municipal securities dealer from compensating any person who is not an affiliated person of the broker, dealer, or municipal securities dealer for solicitation activities.8 We respectfully submit that this rationale similarly should inform FINRA's thinking in adopting rules to govern pay-to-play activities and we recommend that FINRA not impose disclosure requirements as part of its pay-to-play rules. In further support of this recommendation, we note that including a disclosure requirement in FINRA's rule would upset the regulatory alignment between the SEC's rule and FINRA's proposed rule. While we appreciate that FINRA's proposed disclosure requirements are generally comparable to those in the SEC rule government cash payments for client solicitations (i.e., SEC Rule 206(4)-3 under the Advisers Act), subsection (a)(2)(ii) of the SEC's rule effectively provides that employees of a person which controls, is controlled by, or under common control with an investment adviser are not required to provide the disclosure required by the rule at the time of solicitation. FINRA's proposed rule, however, fails to provide an exemption from its disclosure requirements for affiliated solicitors, resulting in a significant difference between the application of the two rules.

7 Adopting Release at page 79-80: "...some commenters [on Proposed Rule 206(4)-5] suggested alternatives to the proposed ban [on third-party placement agents] to address our concern that pay-to-play activities are often carried out through or with the assistance of third parties. Several commenters, for example, suggested that we instead require greater disclosure by advisers

of payments to solicitors. Such an approach could be helpful to give plan fiduciaries information necessary for them to satisfy their legal obligations and uncover abuses, but it would not be useful when plan fiduciaries themselves are participants in the pay to play activities." 8 Adopting Release at page 80. Marcia E. Asquith December 15, 2014 Page 5 of 6 In our view, these significant differences between FINRA's rule and that of the SEC would create an unlevel playing field for those solicitors that solicit in their capacity as FINRA members. Indeed, a solicitor that is a municipal advisor or investment adviser is subject to MSRB Rule G-37 or SEC Rule 206(4)-5, as applicable, neither of which has a similar disclosure requirement. We fail to see why FINRA members and their affiliated persons, alone among all solicitors, would be required to make pay-to-play related disclosures to government entities. We are concerned that this additional burden will put them at a disadvantage vis-à-vis their industry colleagues who may be soliciting the same business. For these reasons, we strongly recommend that FINRA not adopt a disclosure requirement.<sup>9</sup>

IV. FINRA SHOULD NOT INCLUDE A DISGORGEMENT REQUIREMENT IN RULE 2390 We also recommend that FINRA not include a disgorgement requirement in its pay-to-play rules because such a requirement is both unnecessary and is likely to create confusion. As proposed, in Rule 2390(b), in addition to other sanctions for violations of the rule's pay-to-play prohibitions, a FINRA member will be required to disgorge any compensation that it has accepted in violation of the rule. In our view, 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.<sup>10</sup> More importantly, by designating disgorgement as a required penalty, the proposal raises the question as to whether FINRA has to impose disgorgement as a penalty even after the FINRA member has already discovered and remedied the violation by voluntarily refunding the prohibited compensation it received. We understand that voluntarily refunding such compensation is common practice among firms that have discovered an impermissible contribution under a pay-to-play rule. By automatically imposing disgorgement as a penalty upon the occurrence of a pay-to-play violation, the proposal may effectively result in imposing double penalties on any FINRA member that has voluntarily refunded prohibited compensation. This result is likely to dissuade firms from voluntarily refunding such compensation to remedy a violation.<sup>11</sup>

<sup>9</sup> In the event FINRA disagrees with our recommendation and adopts a disclosure requirement, we strongly recommend that such requirement provide an exemption for affiliated solicitors in order to better ensure consistency with the SEC's disclosure requirements under the Investment Advisers Act. <sup>10</sup> See, e.g., In the Matter of T.L. Ventures, Inc. Release No. 3859, File No. 3-15940 (June 20, 2014); In the Matter of Goldman, Sachs & Co., Release No. 67934, File No. 3-15048 (September 27, 2012). <sup>11</sup> In the event FINRA retains the disgorgement provision in proposed Rule 2390, we recommend that FINRA clarify an issue relating to its wording. In particular, while subdivision (b)(2) of the rule would require a FINRA member to pay the disgorged remuneration to those persons listed in subdivision (b)(2)(A)-(d) "in the order listed," the rule does not indicate how a covered member is to determine the portion that must be paid to each of the persons listed. We suggest that FINRA could clarify the meaning of this provision. Marcia E. Asquith December 15, 2014 Page 6 of 6 V. FINRA'S RECORDKEEPING REQUIREMENTS SHOULD BE ALIGNED WITH THE SEC'S Finally, should FINRA adopt Rule 4580, we recommend that FINRA ensure that the rule's recordkeeping requirements are aligned with those of the SEC under its pay-to-play rule. This is particularly important in connection with the treatment of omnibus accounts under the rule. As proposed, Rule 4580 would require a FINRA member to maintain a record of "the name and business address of all government entities with which the covered member has

engaged in distribution or solicitation activities on behalf of the investment adviser.” If FINRA applies this requirement to a member 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 Rule 4580. To address this concern, we recommend that FINRA either (1) limit the recordkeeping requirements to the broker-dealer that solicited the government entity, that has a direct relationship with the government entity, and that maintains the account record on behalf of such client or (2) provide appropriate relief from the recordkeeping requirements for omnibus accounts along the lines of the relief that was provided to such accounts by the SEC under Rule 206(4)-5.12 ■ ■ ■ ■ ■ We appreciate FINRA’s consideration of our concerns and recommendation to address them. If you have any questions concerning these comments, please do not hesitate to contact the undersigned by phone (202-326-5825) or email (tamara@ici.org). Sincerely, /s/ Tamara K. Salmon Senior Associate Counsel  
12 See Investment Company Institute, Pub. Avail, September 13, 2011.

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