

SEC Pay-to-Play Rule Set to Expand to Capital Acquisition Brokers

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Election and Political Law

The universe of those covered by the SEC's pay-to-play restrictions is expanding. If a newly proposed SEC rule is adopted as expected, pay-to-play restrictions will now extend to cover the recently created class of broker-dealers called Capital Acquisition Brokers ("CABs"). CABs are brokers whose activities are generally limited to advising companies and private equity funds on certain types of securities offerings, mergers and acquisitions, and capital raising. This is a more limited form of activity than may be engaged in by a traditional broker-dealer—in particular, a CAB may not carry or maintain customer accounts, handle customers' funds or securities, accept customers' trading orders or engage in proprietary trading or market-making. The CAB rules are designed to facilitate activities by intermediaries in smaller transactions that would not typically warrant the participation of a fully licensed broker-dealer.

Because CABs may act as placement agents in the sale of certain securities, in some situations they could be covered by new pay-to-play restrictions if the proposed rule is adopted. In this advisory, we discuss the background on the proposed rule and its implications for CABs themselves and for investment advisers who retain CABs to solicit business from government entities.

As background, in 2010, the Securities & Exchange Commission promulgated its well-known "pay-to-play" rule. The rule, among other things, prohibits investment advisers from providing paid investment advisory services to public pension funds and other government entities within two years following the date of covered political contributions made by the investment adviser or those affiliated with the adviser, so-called "covered associates." A lesser-known provision, however, also sets forth a mechanism to expand the rule's reach beyond investment advisers and their covered associates.

That provision prohibits investment advisers from hiring third-parties "to solicit a government entity for investment advisory services" unless the third-party is (i) already an investment adviser subject to pay-to-play restrictions or (ii) an SEC-registered broker or dealer that is a "member of a national securities association" that has adopted pay-to-play rules the SEC finds to be "substantially equivalent or more stringent" than those the SEC imposes on investment advisers. This provision pushed national securities associations, such as the Financial Industry Regulatory Authority ("FINRA"), the primary regulator of broker-dealers (alongside the SEC) to adopt their own pay-to-play restrictions. FINRA's pay-to-play rule finally became effective last month.

But FINRA's new rules do not extend to CABs. To address this discrepancy, FINRA has now proposed to expand its pay-to-play rules to cover CABs and the SEC has submitted the proposed rule change for public comment. In the meantime, the SEC's Division of Investment Management has announced that it will not recommend enforcement against investment advisers that retain CABs to solicit a government entity "until the effective date of any rules subjecting CABs to the FINRA pay to play rules."

Under the newly proposed rule, CABs would be barred from providing paid "distribution or solicitation activities ... with a government entity on behalf of an investment adviser" for two years after the date a political contribution to an official of the government entity is made by the CAB. CABs will also be restricted from soliciting or coordinating certain political contributions and will need to comply with record-keeping requirements. Importantly, the political contribution and fundraising restrictions apply not only to contributions made or solicited by the CAB itself but also to political contributions made or solicited by the CAB's "covered associates," which includes its general partners, managing members, executive officers, similar individuals, those who engage in distribution or solicitation activities with a government entity, those who supervise these individuals, and political action committees controlled by the CAB or these individuals.

Following receipt of comments, the SEC will decide whether to approve the rule change. If it approves the rule change, it will announce an effective date, which "will be no later than 30 days following publication" of the notice announcing SEC approval of the rule in the Federal Register.

As a consequence of these rules, CABs that act as placement agents with government entities on behalf of investment advisers should adopt their own pay-to-play policies. These policies typically require, among other things, that executives and other employees obtain compliance or legal department pre-approval for certain political contributions and fundraising activities.

As a practical matter, the rule may also prompt *investment advisers* to take certain steps. Advisers retaining CABs to solicit government entities might, for example, consider confirming that the CABs have adopted and are following pay-to-play compliance policies and that the CAB and its covered associates have not made any political contributions that would restrict the CAB's ability to provide the requested services. While the investment adviser may not face liability for the actions of the CAB, if a CAB "covered associate" makes a restricted political contribution, the government entity may decide not to invest its assets with the adviser that retained the CAB.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Election and Political Law practice:

<u>Robert Kelner</u>	+1 202 662 5503	rkelner@cov.com
<u>Bob Lenhard</u>	+1 202 662 5940	rlnhard@cov.com
<u>Bruce Bennett</u>	+1 212 841 1060	bbennett@cov.com
<u>Zack Parks</u>	+1 202 662 5208	zparks@cov.com
<u>Derek Lawlor</u>	+1 202 662 5091	dlawlor@cov.com

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