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SEC's Pay-To-Play Universe Continues To Expand

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Over the past 18 months, the list of those covered by the U.S. Securities and Exchange Commission's pay-to-play restrictions has steadily expanded. And if a newly proposed rule is adopted, these pay-to-play restrictions will now cover a new category: the recently created class of broker-dealers called capital acquisition brokers. 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. The activities of CABs are more limited than those engaged in by a traditional broker-dealer — CABs 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, the SEC is now proposing to expand its pay-to-play rules to include CABs.

The SEC first promulgated its well-known "pay-to-play" rule in 2010. 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." Covered associates include "any general partner, managing member, or executive officer, or other individual with a similar status or function," "any employee who solicits a government entity for the investment advisor" and the direct or indirect supervisors of these employees, and political action committees controlled by these individuals. A lesser-known provision of the SEC rule 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 (1) already an investment adviser subject to pay-to-play restrictions, (2) a municipal adviser already subject to certain pay-to-play rules, or (3) 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 the Financial Industry Regulatory Authority, the primary regulator of broker-dealers (alongside the SEC), to adopt its own pay-to-play restrictions. FINRA's pay-

to-play rule finally became effective in August 2017. Those rules, among other things, prohibit covered FINRA members from engaging in "distribution or solicitation activities" for investment adviser clients within two years of the FINRA member or covered associates of the FINRA member making certain political contributions.

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." The comment period on the proposed rules closed on Sept. 14, 2017, and the SEC may be issuing the final rule soon. If the SEC 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.

Under the newly proposed rule, CABs, like other FINRA member firms, 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, unless an exemption applies. 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.

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 preapproval for certain political contributions and fundraising activities. The compliance or legal department would then need to review each covered contribution to determine whether the contribution would run afoul of these restrictions. This analysis will often turn on whether the recipient of the proposed contribution can influence the hiring of the investment adviser by the government entity or can appoint those who can influence the hiring of the investment adviser. Often, government officials who sit on the boards of government entity investors or appoint individuals to those boards are considered covered "officials."

If the new rule is adopted, CABs may also need to review the prior political contributions of incoming employees. Under the rule, a political contribution by a CAB executive, for example, could restrict the CAB from acting as a placement agent with a government entity even if the individual made the contribution in the months before becoming an executive at the CAB.

In addition to prompting CABs to adopt policies and procedures to comply with the new rules, as a practical matter, the rule may also encourage investment advisers to take certain steps. Advisers retaining CABs to solicit government entities might 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. A violation of the pay-to-play rules by the CAB may have negative business and reputational

consequences for the investment adviser that retained the CAB. If a CAB "covered associate" makes a restricted political contribution, the government entity might decide, for example, not to invest its assets with the adviser that retained the CAB.

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