FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS
AND INDEPENDENT FINANCIAL ADVISORS

**VIA ELECTRONIC MAIL**

January 20, 2016

Brent J. Fields
Secretary
U.S. Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: **SR-FINRA-2015-056: Notice of Filing to of a Proposed Rule Change to Adopt FINRA Rule 2030 and FINRA Rule 4580 to Establish "Pay-To-Play" and Related Rules**

Dear Mr. Fields:

On December 30, 2015, the Securities and Exchange Commission (SEC) published its request for public comment on the Financial Industry Regulatory Authority's (FINRA) proposal to establish pay-to-play rules for broker-dealers that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers (Proposed Rule).[1] The Proposed Rule mandates a "two-year time out" on engaging in distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser after the firm or one of its covered associates makes a contribution to an official of the government entity.

The Financial Services Institute[2] (FSI) appreciates the opportunity to comment on this important proposal. We support regulatory efforts to combat pay-to-play corruption activity. Nevertheless, we believe that both the SEC Pay-to-Play Rule and the Proposed Rule creates compliance uncertainties for our members. As such, we believe that practices that carry little risk of *quid pro quo* corruption nevertheless are deemed to require compliance with the Proposed Rule. We respectfully request further clarification and changes to the Proposed Rule to ensure that participant-directed government-sponsored retirement plans maintain access to the array of financial products that are so critical to ensuring public sector workers can save for a dignified retirement.

## Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the U.S., there are approximately 167,000 independent financial advisors, which account for approximately 64.5% percent of all producing registered representatives. These financial advisors are self-employed independent contractors, rather than employees of Independent Broker-Dealers (IBD).

[1] 80 Fed. Reg. 81650 (Dec. 30, 2015).

[2] The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

FSI member firms provide business support to financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners who typically have strong ties to their communities and know their clients personally. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations and retirement plans with financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their investment goals.

## Discussion

The Proposed Rule prohibits a broker-dealer from engaging in distribution or solicitation activities for compensation with a government entity on behalf of an investment adviser for two years after the broker-dealer or a covered associate has contributed to an official of the government entity. The Proposed Rule is designed to ensure that broker-dealers can continue to engage in distribution or solicitation activities with government entities on behalf of investment advisers. Absent a FINRA pay-to-play regime, the SEC Pay-to-Play Rule prohibits investment advisers from paying broker-dealers for such distribution or solicitation activities.[3]

FINRA initially requested comments on the Proposed Rule in Regulatory Notice 14-50.[4] As a result of public comments received in response to Regulatory Notice 14-50, FINRA has positively revised the Proposed Rule and its associated recordkeeping requirements. We appreciate FINRA's consideration of these comments and believe the changes will reduce the associated compliance burdens without jeopardizing the Proposed Rule's effectiveness.

While we appreciate these changes, we nevertheless continue to have concerns with the application of the rule to traditional brokerage activities between FSI members and participant-directed government-sponsored retirement plans, such as 403(b) and 457 plans. We believe the Proposed Rule applies to activities beyond those intended to be covered by the SEC Pay-to-Play Rule. As a result, we fear it may have detrimental impacts on the access of participants in such plans to financial products and services. In an effort to ensure firms have a clear understanding of their compliance obligations, we respectfully request certain amendments to the language of the Proposed Rule.

### I. Improvements from Prior Proposal

In response to comments regarding Regulatory Notice 14-50 FINRA has revised certain elements of its proposed pay-to-play regime. These changes include:

- Elimination of the disgorgement provision that would have required disgorgement of compensation in violation of the rule pursuant to a waterfall structure;

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[3] 17 C.F.R. 275.206(4)-5(a)(2)(i).

[4] FINRA Requests Comment on a Proposal to Establish a 'Pay-to-Play' Rule, FINRA Regulatory Notice 14-50, (Nov. 14, 2014), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p601679.pdf.

- Elimination of a provision requiring the maintenance of records concerning unsuccessful solicitations where the government entities do not become clients; and
- Elimination of proposed FINRA Rule 2271 which would have required broker-dealers to make specified disclosures to government entities that were duplicative of existing investor disclosures.

We applaud FINRA for making these helpful changes to the Proposed Rule. We believe these changes increase the similarities between the requirements of the Proposed Rule and the SEC Pay-to-Play Rule. As such, the amendments will ease some of the compliance burdens on broker-dealers while still inhibiting the potential for *quid pro quo* corruption.

## II. Sales of Covered Investment Pools

### A. Introduction

In our comment letter responding to Regulatory Notice 14-50, we expressed concern with the apparent application of the rule to traditional brokerage sales of mutual funds and variable annuities to participant-directed government-sponsored retirement plans.[5] FINRA has reiterated that the Proposed Rule is intended to apply to distribution activities concerning registered pooled investment vehicles if they are an investment option of a participant-directed government-sponsored retirement plan. Proposed Rule 2030(d) states that the distribution or solicitation activities by a broker-dealer on behalf of a covered investment pool are to be treated as though the broker-dealer was engaging in distribution or solicitation activities on behalf of the investment adviser to the covered investment pool.[6] The Proposed Rule further states that an investment adviser to a covered investment pool in which a government entity invests shall be treated as though the investment adviser were providing investment advisory services to the government entity.[7] We continue to be concerned with the impacts of such provisions. We believe they go beyond that which is required under Rule 206(4)-5(a)(2)(i) and Rule 206(4)-5(c) to the detriment of investors.[8]

### B. Mutual Fund Sales Should be Excluded

SEC Rule 206(4)-5(f)(9) requires FINRA to promulgate a pay-to-play rule that "prohibits members from engaging in distribution or solicitation activities if certain political contributions have been made."[9] However, the SEC Pay-to-Play Rule does not mandate a FINRA rule that applies to traditional sales activity of brokerage firms. As such, we believe that the Proposed Rule will subject our members to additional costs and compliance burdens not required under the SEC Pay-to-Play Rule.

FINRA states that Proposed Rule 2030(d) was intended to extend the protections of the rule to government entities that access the services of investment advisers through covered investment

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[5] See Letter from David T. Bellaire, Esq., Executive Vice President & General Counsel, FSI to Marcia E. Asquith, Corporate Secretary, FINRA (Dec. 15, 2014), *available at* http://www.finra.org/sites/default/files/notice_comment_file_ref/Financial%20Services%20Institute%20-%20Comments%20on%20Regulatory%20Notice%2014-37.pdf.
[6] Proposed FINRA Rule 2030(d)(1).
[7] Proposed FINRA Rule 2030(d)(2).
[8] 17 CFR 275.206(4)-5(a)(2)(i); 17 CFR 275.206(4)-5(c).
[9] 17 CFR 275.206(4)-5(f)(9).

pools. However, the Proposed Rule does not address such relationships. Rather it solely governs the relationship between an investment adviser and a broker-dealer. The Proposed Rule recasts this relationship in a novel way that stands in contrast to the traditional understanding of routine broker-dealer sales activities. The Proposed Rule serves to redefine the sale of securities, the hallmark of broker-dealer activity, as solicitation on behalf of an investment adviser. Such a categorical re-characterization of brokerage activities deserves ample debate and consideration. It should not be promulgated in the context of a narrow rule specifically addressing pay-to-play activities.

Moreover, the Proposed Rule conflicts with the realities of conventional mutual fund selling agreements. Typically, broker-dealers sell mutual funds to customers pursuant to a selling agreement with either the fund itself or its principal underwriter. A broker-dealer does not, as a matter of ordinary course, maintain relationships with the investment advisers to the funds for which it has executed selling agreements. Furthermore, such agreements do not call for the broker-dealer to distribute or solicit the investment advisory services of the investment adviser to the fund. Rather, these selling agreements call for the broker-dealer to sell a security, the mutual fund, for which the investment adviser is the portfolio manager. Such sales of securities do not implicate the political corruption that a pay-to-play rule is designed to prevent.

C. Variable Annuity Sales Should Be Excluded

We also do not believe that the Proposed Rule should apply to sales of variable annuity contracts which are supported by a separate account that invests in mutual funds. FINRA has stated that because the SEC did not exempt certain products from its rule, FINRA will not explicitly exempt products from the Proposed Rule. We respectfully request that FINRA reconsider this decision. Applying the Proposed Rule to variable annuities creates multiple questions for which FINRA has yet to provide clear guidance.

The relationship between a variable annuity contract holder and the investment adviser to a mutual fund supporting the variable annuity does not rise to a level such that it should implicate a pay-to-play obligation. Separate accounts contain multiple mutual funds that are chosen from a large menu of investment options. However, the nature of variable annuities and the way investment options are selected does not implicate the investment advisory solicitation activities contemplated by the SEC Pay-to-Play Rule. Applying the Proposed Rule to such products will significantly increase the compliance burden and as such may limit the options our members make available to 403(b) and 457 plans.

D. Grandfathering of Existing Accounts and Contracts

Should FINRA choose to not amend the Proposed Rule's treatment of covered investment pools, we request that FINRA clarify the application to existing government entity accounts or contracts. Broker-dealers may ultimately decide to cease providing brokerage services to government entities in order to avoid compliance with the contribution restriction requirements. However, such a decision would require a firm to terminate long-standing brokerage relationships and variable contracts, which can be a time consuming and difficult process. Additionally, as concerns variable contracts, such instruments cannot be unilaterally terminated by a broker-dealer. We are concerned that members wishing to exit the government entity business may inadvertently be required to comply with the Proposed Rule, despite their intent to stop servicing government entities. Therefore, to avoid such confusion and to limit the disruption to long-standing

brokerage relationships, in the event that FINRA does not amend the application of the Proposed Rule to covered investment pools we request that FINRA apply the Proposed Rule only to accounts and variable contracts opened after the effective date.

## III. Uncertain Application of Pay-to-Play Rules to the Independent Business Model

Our comments in response to the Proposed Rule reflect the difficulties our members have faced in attempting to comply with the SEC Pay-to-Play Rule. The difficulties primarily stem from a requirement for independent firms to implement a rule that is premised on the notion that solicitation of clients is performed pursuant to a centralized process controlled by the management of a Registered Investment Adviser (RIA). However, our members do not pursue client relationships in such a fashion. We believe that the SEC Pay-to-Play Rule has inadvertently captured non-corrupting activity. We fear that the Proposed Rule may do the same.

Independent financial advisors are not employees of a broker-dealer or RIA, but rather are independent contractors. While the broker-dealer or RIA provides transaction execution services and performs supervisory and oversight functions, the firms do not dictate the business decisions of individual financial advisors. Subject to compliance with applicable laws and regulations, independent financial advisors, as small business owners, are solely responsible for pursuing and servicing clients. In fact, many independent financial advisors do not market their services under the name of their broker-dealer or RIA, but rather use an alternate "doing business as" name.[10]

Moreover, independent financial advisors do not work in regional offices maintained by the broker-dealer or RIA, rather they are responsible for renting their own office space. As such, independent financial advisors may not even be aware of the other advisors in their immediate region that are also affiliated with their firm, let alone those advisors working and soliciting in other counties or states. As such, this business model poses little risk of corruptive coordination that a pay-to-play rule is designed to prevent.

Financial advisors affiliated with our members may provide advisory or brokerage services to government entities, typically defined benefit or defined contribution plans managing the retirement investments of state or municipal employees. As these advisors pursue business on their own, absent coordination with the home office, our member firms have faced difficulties in devising a compliance regime that does not overly restrict the ability of advisors and employees to contribute to political candidates. Unfortunately, the lack of clarity as to the application of the SEC Pay-to-Play Rule to our members' business model, and the scope of government officials that trigger the requirements, has led some firms to adopt aggressive compliance programs that prohibit political contributions. We fear that absent clarity concerning the application of the Proposed Rule to the brokerage services provided to 403(b) and 457 plans, our members will be faced with the choice of either adopting such an aggressive policy or prohibiting sales to government-sponsored retirement plans.

## IV. First Amendment Concerns

We believe that addressing these concerns regarding the application of the Proposed Rule is critical in light of the First Amendment issues implicated by pay-to-play rules. FINRA states that

[10] All client communications and disclosures, including Form ADV and customer account statements, make clear that services are provided by the registered entity.

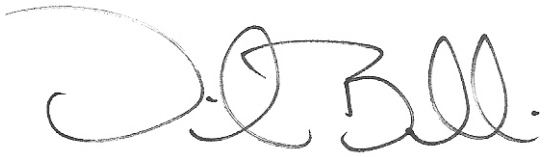
it believes the Proposed Rule strikes the appropriate balance required for a limit on campaign financing activity. FINRA argues that absent the Proposed Rule, broker-dealers would not be able to receive compensation for solicitations of government entities on behalf of investment advisers. However, we believe that the Proposed Rule is unclear in its application to brokerage activities provided by our members. As such, we believe that the Proposed Rule may inadvertently capture activity that does not present the risk of *quid pro quo* corruption. We believe it is imperative for FINRA to define the contours of the Proposed Rule as clearly and distinctly as possible to avoid an unnecessary limitation on one's First Amendment rights, especially in the area of political speech.

## **Conclusion**

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA and the SEC on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at [redacted].

Respectfully submitted,



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