Official Newsletter of Gordian Compliance Solutions, LLC.

# INVESTMENT ADVISER NEWS UPDATES

## SEC ISSUES PAY-TO-PLAY FAQs

In 2010, the SEC adopted Rule 206(4)-5 (commonly referred to as the "Pay-to-Play Rule") under the Investment Advisers Act of 1940. The Pay-to-Play Rule prohibits an SEC-registered investment adviser and certain of its officers and employees from paying a third party to solicit government entities for advisory business on behalf of the adviser if the third party is not a "regulated person."[1] On June 25, 2015, the SEC issued the Pay-to-Play FAQ, which announced that compliance with this provision of the rule would be required as of July 31, 2015.

**What is a Regulated Person?**

The term "regulated person" is defined in the Rule and includes three types of SEC-registered entities: investment advisers, broker-dealers, and municipal advisors. [2] However, to be a "regulated person," an individual or entity must also be subject to the Rule or a substantially similar rule that has been approved by the SEC. While both the Financial Industry Regulatory Authority (FINRA, which regulates broker-dealers) and the Municipal Securities Regulatory Board (MSRB, which regulates municipal advisors) have proposed new or amended pay-to-play rules that would cover broker-dealers and municipal advisors, respectively, neither has adopted such rules, and it is unclear—even if adopted—when such rules would go into effect or what other requirements would attach to broker-dealers and municipal advisors subject to them.

**Who May IA's Pay to Solicit Government Entity Clients?**

As a result of the SEC's announcement, as of July 31, 2015, the only third parties that an investment adviser may pay to solicit government entity clients on its behalf are other investment advisers that are subject to Rule 206(4)-5. [3]

To avoid concerns that the SEC staff would recommend enforcement action for violations of this provision of the Rule, the SEC staff updated its Pay-to-Play Rule FAQ to address the issue concurrently with the SEC's announcement of the

compliance date. The Pay-to-Play Rule FAQ clarifies that until both FINRA and MSRB adopt a pay-to-play rule (and each rule goes into effect), the SEC staff will not recommend enforcement action under the Rule for broker-dealers and municipal advisors, respectively.[4]

**Recent Enforcement Action**

In June 2015, the SEC instituted an enforcement action penalty against a Philadelphia-area private equity firm in the first case involving alleged violations of the Pay-to-Play rule. In that enforcement action, two political contributions from an employee of the private equity firm totaling less than $5,000 helped lead to an order requiring the firm to pay a $35,000 penalty and disgorge almost $260,000 in profits, plus interest.

In light of the SEC's recent movement in the pay-to-play space, investment advisers should consider their current solicitation practices to ensure that any interaction with government entity clients is done in compliance with the Pay-to-Play Rule.

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[1] *Staff Responses to Questions About the Pay to Play Rule,* https://www.sec.gov/divisions/investment/pay-to-play-faq.htm, June 25, 2015; *SEC Pay to Play July 31 Effective Date a 'Nonevent': IAA Chief*, Think Advisor, July 29, 2015

[2] *'Pay to Play' Developments - Updates from the SEC*, The National Law Review, July 28, 2015 at http://www.natlawreview.com/article/pay-to-play-developments-updates-sec.

[3] Id.

[4] Id.

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## SEC AWARDS WHISTLEBLOWER $3 MILLION DOLLARS

On July 17, 2015, the SEC announced a whistleblower award of more than $3 million to a company insider whose information helped the SEC crack a complex fraudulent scheme.[1] The multi-million dollar payout is the third highest award to date under the SEC's whistleblower program.

The SEC's press release noted that the whistleblower's specific and detailed information comprehensively laid out the fraudulent scheme which otherwise would have been very difficult for investigators to detect. [2] The whistleblower's initial tip also led to related actions that increased the whistleblower's award. By law, the SEC protects the confidentiality of whistleblowers and does not disclose information that might directly or indirectly reveal a whistleblower's identity.

Whistleblowers have the unique ability to provide the SEC with inside information about violations of a firm's compliance program and violations of the securities laws. This highlights the importance of instilling a firm wide culture of compliance. For more information or questions on how to instill a culture of compliance at your firm, please contact your Gordian Compliance Consultant.

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[1] *SEC Pays More than $3 Million to Whistleblower*, SEC Release 2015-150, July 17, 2015.

[2] id

# BROKER DEALER NEWS UPDATES

## SEC APPROVES PROPOSED FINRA RULES FOR EQUITY RESEARCH ACTIVITIES

On July 16, 2015, the Securities And Exchange Commission (SEC) approved two proposed rule changes from the Financial Industry Regulatory Authority (FINRA) regarding research analysts and research reports[1]. While the two rule changes carry some overlap, both largely concentrate on different areas of analyst research. FINRA Rule 2241 centers on equity research activities while FINRA Rule 2242 focuses on SRO regulation of debt research reports and debt research analysts[2].

This news bulletin highlights the changes found specifically within Rule 2241.

**Updated Definitions**

Several definitions are clarified with the adoption of Rule 2241:

- **Sales and Trading Personnel**: "Persons in any department or division, whether r not identified as such who perform any sales or trading service on behalf of a member."
- **Research Report**: Amended to exclude communications pertaining to open-end register investment companies that are not listed or traded on an exchange, as well as private placement memoranda and comparable offering related documents prepared in connection with investment banking services transactions.
- **Research Analyst Report**: Amended to clarify that the term does not include registered investment company that a research analyst or member of their family has discretion or control over—provided that the analyst or their family member has no financial interest in the investment company other than a performance or management fee[3].

**Prohibition on Joint Due Diligence**

The new Rule 2241 prohibits joint due diligence by research analysts and investment banking personnel prior to the selection of underwriters for an investment banking transactions—to the extent that the joint due diligence does not run contrary to the Jumpstart Our Business (JOBS) Act[4]. It is worth nothing that FINRA has carved out an important exception for the SEC, stating that it would not interpret the joint due diligence prohibition to apply where the activities involved a communication with the management of an Emerging Growth Company that is attended by both the research analyst and an investment banker[5].

**Identifying & Managing Conflicts of Interest**

Rule 2241 includes a section titled "Identifying and Managing Conflicts of Interest,"

incorporating many elements of the SRO Rules that require member firms to establish, maintain, and enforce written policies and procedures reasonably designed to identify and managing conflicts of interest related to research analyst interactions with themselves, "investment banking and sales and trading personnel, subject companies and customers[6]." Firm policies and procedures must be reasonably designed to promote "objective and reliable research reflecting truly held opinions of research analysts," and structured to "prevent the use of research or research analysts to manipulate or condition the market or favor the interests of the member firm, or of particular current or prospective customers[7]."

In addition, Rule 2241 also imposes significantly reduced quiet periods—periods where member firms cannot publish and distribute research—when compared to the SRO Rules[8]. The following outlines the new quiet period requirements in Rule 2241:

- (10) Days after completion of an IPO for underwriters and dealers[9]; and
- (3) days after the completion of a secondary offering for managers and co-managers of the offering[10].

It is worth noting that Rule 2241 still retains exceptions to the aforementioned quiet periods to allow for the distribution of significant news or events about a subject company, and the 3-day quiet period is lifted after secondary offering for issues that are actively traded as defined in Regulation M if the research is issued in reliance on the safe harbor in Rule 139 under the Securities Act of 1933[11].

### Disclosures

A new disclosure requirement is included in Rule 224, which is triggered "if a member or its affiliates maintain a significant financial interest in the debt or equity securities of the subject company," including if the member or its affiliates beneficially own 1% or more of any class of common equity of the subject company[12]. Member firms are required to disclose any other material conflicts of interest of the research analyst or the member firm known "by any associated person of the member with the ability to influence the content of a research report" or that such person has "reason to know" if the analyst possesses that knowledge[13].

### Distribution of Equity Research Reports to Different Groups

Rule 2241's Supplemental Material incorporates a concept from Rule 2242 regarding debt research. Specifically, that research products and services may be provided to different classes of customers where:

- the products are consistent with the meaning of the member's rating system for each respective product;
- the products are not differentiated based on the timing of receipt of a recommendation, rating, or other potentially market-moving information, or to allow certain customers to trade in advance of other customers;
- there is disclosure in the case that alternative research products and services may reach different conclusions or recommendations that could impact the price of the equity security[14].

### Personal Trading by Analysts

Rule 2241 also allows a research analyst to trade against a recommendation so

long as there is a "financial hardship" exception defined in a member's procedures governing conflicts of interest. It is worth noting that the Supplemental Material to Rule 2241 also allows a member firm to institute policies that prohibit the research analyst's accounts from holding securities, options, or derivatives of such securities of the companies in the research analyst's coverage universe[15]. Member's may permit trades inconsistent with the analyst's recommendations only if the transactions are part of a "reasonable plan to liquidate the holdings and that plan is approved by the firm's legal or compliance department[16]."

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[1] Securities and Exchange Commission, *Release No. 34-75471* (July 2015); Securities and Exchange Commission, *Release No. 34-75472* (July 2015)

[2] *SEC Approves Long-Anticipated FINRA Research Rules*, Morgan Lewis (July 22, 2015)

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *SEC Approves Long-Anticipated FINRA Research Rules*, Morgan Lewis (July 22, 2015)

[7] *Id.*

[8] *Id.*

[9] Securities and Exchange Commission, *Release No. 34-75471* (July 2015)

[10] *Id.*

[11] *Id.*

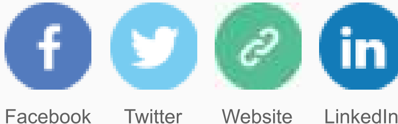
[12] *Id.*

[13] *SEC Approves Long-Anticipated FINRA Research Rules*, Morgan Lewis (July 22, 2015)

[14] *Id.*

[15] *Id.*

[16] *Id.*



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