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Finra Offers Funds Little Help on Pay-to-Play Rule

By Peter Ortiz June 15, 2011

Finra's efforts to encourage broker-dealers to help fund advisors comply with pay-to-play rules will do little to help advisors avoid running afoul of the regulation, industry sources say.

The Financial Industry Regulatory Authority issued an information notice addressing advisors' responsibilities and concerns with the pay-to-play rule. Under the rule, fund advisors have until Sept. 13 to establish systems or make arrangements with intermediaries to identify government entities that are invested in their funds.

But Finra's notice is being criticized by many in the fund industry as toothless in its attempt to push brokers to share the information necessary for advisors to comply with the rule.

Ed Pittman, counsel with **Dechert**, says the Finra notice has done very little to alleviate advisors' concerns. Currently, fund distributors are requesting the information from third-party distributors on behalf of the advisors and not getting very far.

"They are being stonewalled," Pittman says. "Distributors won't give them the information and [advisors] don't have the right to demand it."

The pay-to-play rule, adopted by the Securities and Exchange Commission last year, imposes — among other requirements — a two-year ban on compensation to investment advisors for providing advice to a government entity if the advisor and its covered associates (officers or employees) made contributions to an official of that entity. The rule impacts advisors to 403(b), 457 and 529 plans.

Finra's notice to its member firms states that fund advisors "may request information from intermediaries about fund holdings through omnibus accounts in order to determine whether the omnibus account includes holdings by a participant-directed government plan or program."

"We are stepping in to make firms aware of an SEC rule that imposes requirements on Advisers — not Broker-Dealers," writes a Finra spokeswoman in an e-mail response to questions. "The FINRA notice asks broker-dealers to assist Advisers when they seek to comply with the [pay-to-play] rule."

Without the cooperation of broker-dealers in sharing omnibus account details, fund advisors are largely blind to who their end investors are. That means an advisor, or one of its employees, could inadvertently violate the pay-to-play rule by making a campaign donation to the candidate of their choice.

"The problem with the rule is it requires advisors to have information they don't own, control or possess," says Tamara Salmon, senior associate counsel with ICI. "The fund has to reach out to the broker-dealer and other financial intermediaries to get that information."

While the Investment Company Institute praises Finra for "alerting its members to the need of advisors to obtain this information," it would prefer to see the regulator propose a rule, Salmon says.

Finra's notice falls short of that. "To the extent the information requested is readily available, FINRA encourages firms to make reasonable efforts to cooperate with investment advisers seeking information to comply with the requirements" of the rule, the notice reads.

Salmon echoes industry attorneys who say they wish Finra would have "pushed their members a little harder to cooperate" in providing information to advisors. Language in the notice such as "to the extent the information requested is readily available" and "to make reasonable efforts to cooperate" offers little incentive for broker-dealers to provide advisors with information, sources say.

Indeed, fund advisors report that to the extent broker-dealers are willing to provide information, they will not distinguish government clients in omnibus accounts, Salmon says. Instead, they have told advisors that they will provide them with all client names, she says. This is worrisome because it runs the risk of violating Regulation S-P, or the privacy of investors' personal and financial information, if there is no legal basis to provide information.

"We wish Finra had reminded broker-dealers of their duties and responsibilities under Regulation S-P," Salmon says.

Brian McCabe, partner at **Ropes & Gray**, says encouraging rather than requiring broker-dealers to provide information puts advisors in a difficult position. He agrees that advisors would have preferred Finra or the SEC to adopt a rule requiring intermediaries to provide the information.

The uncertainty has led many advisors "to adopt or consider the adoption of a complete ban on contributions by covered associates," McCabe says.

Niels Holch, executive director of the Coalition of Mutual Fund Investors, says the lack of transparency in omnibus accounts with pay-to-play has played out with market timing, breakpoint discounts and money market funds.

"I would not create a regulatory solution for each of these problems," Holch says. He is pushing for a regulation that would make all omnibus account information transparent.

Holch also contrasts the SEC's pay-to-play rule, which will require certain recordkeeping requirements on funds about their government clients, with Finra's call on broker-dealers to make reasonable efforts to help advisors.

"You are going to need to do more here than make recommendations to broker-dealers," he says.

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