Securities Regulation Daily Wrap Up, TOP STORY—D.C. Cir.: Appeals court upholds FINRA pay-to-play rule, (Jun. 18, 2019)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

The D.C. Circuit upheld the SEC's approval of a FINRA rule barring placement agents from getting paid for soliciting government business after making political contributions.

The appeals court in the capital upheld the SEC's Rule 2030, also known as the pay-to-play rule, over a challenge by two state political organizations. The 2-1 decision was made on the merits and echoed the court's 2015 affirmance of the dismissal of a challenge by the same organizations to an analogous rule affecting investment advisers (*New York Republican State Committee v. SEC*, June 18, 2019, Ginsburg, D.).

Pay-to-play rule. The SEC in 2010 adopted a rule under the Advisers Act making it unlawful for an investment adviser to provide services for compensation to a government entity within two years after making a contribution to an official of that entity. The SEC was aware, however, that investment advisers sometimes acted through a placement agent rather than contributing directly to a candidate or incumbent. The SEC addressed this concern by allowing advisers to retain a placement agent that is a FINRA member, provided FINRA would adopt a rule analogous to the Advisers Act rule.

Rule 2030 is that FINRA rule. It imposes a two-year waiting period after a placement agent makes a contribution to a government official who can influence the government entity's choice of investment adviser. Only after waiting out those two years can the placement agent, or his or her firm, accept payment for soliciting that government entity on behalf of a client. When the SEC approved the rule in 2016, the New York Republican State Committee (NYGOP) and the Republican parties of Tennessee and Georgia filed a joint petition for review in the Eleventh Circuit. The Eleventh Circuit held that the Georgia party lacked standing and transferred the case to the D.C. Circuit.

The petitioners argued that the SEC did not have authority to enact Rule 2030; that a lack of evidence the rule was needed made the agency's action arbitrary and capricious; and that the rule violates the First Amendment. The SEC challenged the petitioners' standing and defended the rule against their arguments. After holding the petitioners did have standing based on an affidavit by a placement agent, the appellate panel denied their petition on the merits.

The petitioners had Article III standing. The court observed that it is typically skeptical about a petitioner's standing when it is not regulated by the challenged rule. However, the New York committee met its burden by advancing specific facts supporting its claim of an injury: the affidavit of a placement agent who stated that if Rule 2030 were no longer prohibiting him from doing so, he would solicit contributions for the NYGOP from his personal contacts. This reduced ability to raise funds during the rule constituted a concrete and particularized injury for purposes of NYGOP's Article III standing. Furthermore, NYGOP met its burden of demonstrating that it faced a substantial risk of this harm actually materializing.

The dissenting judge, however, would dispense with the petition for lack of standing. According to the dissent, the petitioners established no injury in fact, because they failed to show that any contributor stopped contributing because of the SEC's action. NYGOP's affiant was unable to attest with any certainty that his personal contacts would contribute to the petitioners in the absence of the rule, meaning the petitioners did not carry their burden of establishing a substantial risk of injury. Finally, even if the petitioners established an injury in fact, they did not establish that this injury was caused by the SEC's act.

The SEC had authority to approve the rule. Section 15A of the Exchange Act provides that the SEC "shall approve" a rule proposed by FINRA if it is consistent with the requirements of the Act. The court agreed with the SEC's view that it had authority to approve the rule because pay-to-play makes political contributions, rather than competence and price, the deciding factor by which government officials choose investment advisers. This, in turn, means public pension funds are more likely to be managed by less qualified investment advisers and to pay higher fees and puts investment advisers and placement agents who decline to pay at a competitive disadvantage.

The petitioners argued that this view of the SEC's authority was too broad—citing a case that the court could not square with the issue at hand—and that Congress "could not have intended to delegate a decision of such significance to an agency." This seemed to the court to amount to an argument that provisions of the later-enacted Federal Election Campaign Act of 1971 (FECA) impliedly repealed the SEC's authority to regulate pay-to-play activity. The Supreme Court has directed, however, that when statutes are capable of coexisting, the courts must regard each as effective absent a clearly expressed Congressional intention to the contrary.

Indeed, *POM Wonderful LLC v. Coca-Cola Co.* (U.S. 2014) weighed heavily in the SEC's favor; there, as in the instant case, the statutes in question had coexisted for decades and neither limited the reach of the other. The Supreme Court also reasoned that the statutes complemented each other in major ways. Similarly, the FECA and Exchange Act can peacefully coexist. The D.C. Circuit accordingly rejected the petitioners' argument that FECA's general $2700 contribution limit served as a "safe haven" making it incompatible with the Exchange Act.

The rule's adoption was not arbitrary and capricious. The petitioners next argued that the SEC's approval of the rule was arbitrary and capricious in violation of the Administrative Procedure Act because the SEC had not shown the rule goes further than federal and state anti-bribery laws to target corruption. The court disagreed with this premise, stating that the anti-bribery laws deal only with blatant and specific attempts to use money to influence government action and do not adequately address pay-to-play activity. The FECA is also not a solution to the problem, as demonstrated by the SEC's adoption of Rule 2030 to address real situations in which a placement agent's lawful contribution to a government official influenced the official's decision to award an advisory contract.

The SEC was not required to show that quid pro quo arrangements were "rampant" because a contribution is corrupting even if it cannot be traced to a subsequent award of a contract—a contribution gives the donor the chance to be seriously considered, but does not assure a contract.

The rule does not violate the First Amendment. Finally, the court applied the "closely drawn" standard in reviewing whether the rule passed Constitutional muster. Noting that it had upheld an MSRB rule that was "identical in every constitutionally relevant way to FINRA Rule 2030," the court said this precedent compelled its holding in favor of the SEC. The petitioners quoted dicta from two cases for the proposition that the rule had a disparate impact on candidates running for the same seat where one candidate is a covered official and the other is not. The reasoning of these cases did not support the petitioners' argument. In contrast, the Supreme Court has recognized that the prevention of corruption and the appearance of corruption can justify a "closely drawn" abridgement of First Amendment rights.

The case is No. 18-1111.

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