

FINRA Files New Rules Governing Member Payments to Unregistered Persons

October 13, 2014

On September 25, 2014, the Financial Industry Regulatory Authority (“**FINRA**”) filed a **proposed rule change** with the Securities and Exchange Commission (“**SEC**”) to modify existing rules that govern FINRA members’ ability to make payments to unregistered persons. The proposal also addresses payments to non-registered foreign finders, retired registered representatives, and persons subject to disqualification or sanction. Initially proposed for comment in December 2009 (the “**Regulatory Notice**”),¹ the proposal would consolidate and codify certain existing rules and interpretations of the National Association of Securities Dealers, Inc. (“**NASD**”) and the New York Stock Exchange (“**NYSE**”) and create a general prohibition on making a transaction-based payment to persons that are not registered as broker-dealers with the SEC, but by reason of such payment would be required to register.

Unlike the Regulatory Notice, FINRA’s current proposal would not eliminate the so-called foreign finder exemption, which allows certain payments to be made to unregistered persons referring foreign customers to FINRA members. In addition, in response to comments, FINRA proposes to import a reasonable belief standard to members’ determination that an unregistered person is permitted to receive transaction-based payment and provides several bases for supporting that determination.

Comments on the proposed rules are due by October 22, 2014.

Payments to Unregistered Persons

Background

With limited exceptions, NASD Rules 2410 and 2420 currently restrict the ability of FINRA members to: deal with persons who are not members on terms other than those available to the general public; share with such non-members selling concessions or discounts; join in certain underwriting syndicates with non-members; or offer any security, or confirm any securities transaction, to persons not engaged in the investment banking or securities business at a price that reflects a discount, concession or other allowance. In general, these rules have been interpreted to prohibit the sharing of securities-related compensation with non-members (other than registered representatives of the member), and also to limit the ability of FINRA members to pay continuing commissions to persons formerly registered with them.

According to FINRA, these rules were originally developed to encourage membership in FINRA’s predecessor, the NASD, by prohibiting members from making certain payments to non-member broker-dealers. The Securities Exchange Act of 1934 (the “**Exchange Act**”) has since been amended to require most registered broker-dealers to maintain membership in FINRA, and, over time, NASD Rule 2420 has been interpreted to prohibit members from paying transaction-based compensation to persons that may be acting as unregistered broker-dealers in violation of Section 15(a) of the Exchange Act. However, in cases where members requested formal guidance that a payment or arrangement would not violate NASD Rule 2420 or related rules, the NASD required members to procure a no-action letter from the SEC

¹ The related regulatory notice, FINRA Regulatory Notice 09-69, *Payments to Unregistered Persons*, is available [here](#), and a Davis Polk Client Memorandum is available [here](#).

to the effect that the non-member recipient of any compensation or payment would not be required to register with the SEC as a broker-dealer. This requirement has proven to be difficult to satisfy.

Proposed FINRA Rule 2040

Like the Regulatory Notice, Proposed FINRA Rule 2040 would prohibit member firms or associated persons from paying “any compensation, fees, concessions, discounts, commissions or other allowances” (collectively, “**Payments**”) to any person not registered with the SEC as a broker-dealer under Section 15(a) of the Exchange Act, but that would be required to register by reason of receiving Payments. In its rule filing, FINRA explained that it believes the proposed rule is consistent with previously issued FINRA staff interpretations under existing NASD Rule 2420 and SEC rules and regulations under Section 15(a) of the Exchange Act.

In response to concerns raised by prior commenters that it can be difficult to determine with certainty—without the time and expense of obtaining a formal SEC no-action relief—that a person is permitted to receive a Payment without being registered as a broker-dealer, FINRA proposes to adopt Supplementary Material .01 to Proposed FINRA Rule 2420. Supplementary Material .01 would clarify that a no-action letter is not *necessarily* required, but that members must be able to “reasonably support” their determination that their making a Payment did not require the recipient to register as a broker-dealer. Under FINRA’s proposal, “reasonable support” may include existing SEC and SEC staff guidance in the form of releases, no-action letters or interpretations or the receipt of a legal opinion from “independent, reputable U.S. licensed counsel knowledgeable in the area.” Members would be expected to periodically review their determination if payments to the unregistered person are ongoing in nature and must maintain books and records that reflect the member’s determination.

As in the Regulatory Notice, Proposed FINRA Rule 2040 would also include a peculiar provision prohibiting Payments, even to appropriately registered associated persons, unless the Payment “complies with all applicable securities laws, FINRA rules and [Exchange Act] rules and regulations.” Neither the Regulatory Notice nor FINRA’s SEC rule filing elaborate on the purpose of this provision; it remains unclear whether the provision is intended to add any substantive restrictions or requirements, as it appears to merely forbid members from making Payments that are already otherwise prohibited.

Exceptions to Prohibition on Payments

Retiring Registered Representatives

Notwithstanding the general prohibition on Payments to unregistered persons, Proposed FINRA Rule 2040 would codify existing FINRA staff guidance on the payment of continuing commissions by members to a retired representative (*i.e.*, an individual who retires from a member and leaves the securities industry). In particular, the proposal would permit members to continue paying commissions to a retired representative (or the retired representative’s estate), after the person ceases to be associated with a member, if:

1. the commissions are derived from accounts held for continuing customers of the retired representative (regardless of whether the funds or securities are added to the account during the representative’s retirement);
2. a *bona fide* contract between the member and the retiring representative calling for the payments was entered into in good faith while the person was a registered representative;
3. the contract prohibits the retired representative from soliciting new business, opening new accounts or servicing the accounts generating the continuing payments; and
4. the arrangement otherwise complies with applicable federal securities laws and Exchange Act rules and regulations.

Non-registered Foreign Finders

In the Regulatory Notice, FINRA had proposed to delete NASD Rule 1060(b) and the equivalent Incorporated NYSE Rule that currently permit members and their associated persons to pay transaction-related compensation to non-registered foreign finders (*i.e.*, foreign persons referring foreign customers), based upon referred foreign customer business. In response to comments, FINRA has reversed course and revised its proposal to incorporate the substance of NASD Rule 1060(b), with limited technical revisions, as exceptions to Proposed FINRA Rule 2040. As such, Payments to non-registered foreign finders would continue to be permitted subject to the same conditions that currently apply to the foreign finder exemption.

Like the current rule, any activities beyond the initial referral of non-U.S. customers and payment of initial or ongoing transaction-based compensation would not be within the permissible scope of the foreign finders exemption. Additionally, members that engage foreign finders would be required to have reasonable procedures in place to appropriately address the limited scope of permissible activities.

Association with or Payments to Sanctioned Persons

FINRA is also proposing to amend FINRA Rule 8311, which restricts members from associating with or making payments—including salary, commission, profit or any other remuneration—to persons subject to disqualification sanctions. The amendments would clarify that the rule applies to any relevant sanctions, rather than solely those imposed by FINRA or SEC orders or suspensions. The proposed amendment would also codify certain exceptions and eliminate duplicative provisions in NASD IM-2420-2.

Specifically, as proposed to be amended, a member would not be permitted to allow a person subject to a sanction or disqualification to be associated with the member in any capacity that is inconsistent with the sanction imposed or the disqualification status, including a clerical or ministerial capacity. In addition, a member would only be permitted to make (or accrue) payments to a person subject to a sanction if those payments are consistent with the scope of activities permitted under the sanction, such as, for example, (i) if the sanction only limits an associated person from conducting specified activities or (ii) if a person is statutorily disqualified, but has been approved to continue associating with a member firm.

Notably, FINRA proposes to add two new express exceptions to Rule 8311. First, Proposed Rule 8311(b) would permit members to pay a person any remuneration pursuant to an insurance or medical plan, indemnity agreement relating to legal fees or as required by an arbitration award or court judgment—notwithstanding any sanction or disqualification. Additionally, new Supplementary Material .01 to Rule 8311 would permit a member to pay a person that is subject to a sanction or disqualification remuneration that the member can evidence accrued to the person prior to the effective date of the sanction or disqualification (so long as the payment does not arise out of the activity giving rise to the sanction or disqualification).

Effective Dates of Suspensions and Revocations

FINRA is also proposing to adopt FINRA Rule 0190, largely based on current NASD IM-2420-1(a), as the general standard addressing effective dates for revocation, cancellation, expulsion, suspension or resignation. Proposed FINRA Rule 0190 would provide that a member will be treated as a non-member of FINRA from the effective date of any order or notice from FINRA or the SEC issuing a revocation, cancellation, expulsion or suspension of its membership. In the case of suspension, a member will be automatically reinstated to membership in FINRA at the termination of the suspension period.

Timing and Implementation

The proposed rules must be approved by the SEC, following the comment period, before they become effective.

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