

## FINRA Proposes New Rules Governing Member Payments to Unregistered Broker-Dealers

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On December 2, 2009, the Financial Industry Regulatory Authority (“**FINRA**”) proposed for public comment new rules that would govern FINRA members’ ability to make payments to persons that are not associated with the member and persons subject to discipline or sanction.<sup>1</sup>

The proposal would consolidate and codify certain existing rules and interpretations of the NASD and NYSE and create a general prohibition on transaction-based payments to persons that are not registered as broker-dealers with the Securities and Exchange Commission (“**SEC**”), but by reason of such payment would be required to register. Proposed FINRA Rule 2040 and a proposed amendment to FINRA Rule 8311 (together, the “**Proposed Rules**”) would replace several current rules relating to the permissibility of payments to non-members and eliminate certain exemptions currently in place, such as for payments to foreign finders and payments that would be permissible under the “cash solicitation rule” under the Investment Advisers Act of 1940 (the “**Advisers Act**”).<sup>2</sup>

### Payments to Unregistered Persons

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 which shows 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’s Regulatory Notice, 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 a national securities association, such as FINRA,<sup>3</sup> and, over time, Rule 2420 has been interpreted by the NASD to prohibit members from paying transaction-based compensation to persons that are not registered as broker-dealers with the SEC in potential violation 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 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.<sup>4</sup> This has proven to be a difficult requirement for some members.<sup>5</sup>

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<sup>1</sup> FINRA Regulatory Notice 09-69, *Payments to Unregistered Persons*, available at <http://www.finra.org/Industry/Regulation/Notices/2009/P120481> (the “**Regulatory Notice**”). The proposal is part of FINRA’s rulebook consolidation process, which seeks to harmonize and consolidate the rules of the National Association of Securities Dealers, Inc. (“**NASD**”) and the New York Stock Exchange (“**NYSE**”).

<sup>2</sup> The proposal would eliminate NASD Rules 1060(b), 2410, 2420, IM-2420-1, IM-2420-2, NYSE Rule 353 and NYSE Rule Interpretations 345(a)(i)/03, 345(a)(i)/02 and 345(a)(i)/03.

<sup>3</sup> See Exchange Act Section 15(b)(8).

<sup>4</sup> See, e.g., Letter from Philip A. Shaikun, Office of the General Counsel, NASD Regulation, Inc., to Jay Adams Knight, Esq., Musick, Peeler & Garrett LLP (Mar. 8, 2001), available at <http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P002592>; Letter from Rachael Grad, Counsel, NASD, to Richard Schultz, President, Triad Securities Corp. (Dec. 28, 2007),

Proposed Rule 2040 would prohibit members from paying or offering to pay, directly or indirectly, “any compensation, fees, concessions, discounts, commissions or other allowances” (collectively, “**Payments**”) to any person that is 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 the Payment.<sup>6</sup> The Proposed Rule clarifies that in determining whether a Payment would trigger a registration requirement, the member should consider the SEC’s published guidance, releases, no-action letters and interpretations (“**Guidance**”). Proposed Rule 2040 would not require a member to obtain a specific no-action letter from the SEC. However, since the proposal focuses on the receipt of payment as the potential trigger of the registration requirement, this may present challenging interpretive issues for FINRA members in determining whether a payment may be made to an unregistered person. Specifically, while SEC guidance generally views receipt of transaction-based compensation as a powerful indicator that a person is “engaged in the business of effecting transactions in securities” and therefore required to register as a broker-dealer, the SEC and courts give this factor and others varying weight in different situations.<sup>7</sup>

Proposed Rule 2040 also includes a peculiar provision that would prohibit Payments to “any appropriately registered associated person” unless the Payment complies with all applicable securities laws, rules and Guidance.<sup>8</sup> It is unclear if 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.

## Elimination of Certain Rules and Exemptions

The proposal would eliminate a number of rules and interpretations that relate to the broader topic of permissible payments. The Regulatory Notice gives little explanation for the proposed deletions, and while most of the eliminated provisions may be unnecessary,<sup>9</sup> some useful exceptions may be discarded in the process.

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available at <http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P037818>; Letter from Mary N. Revell, NASD, to Daniel Schloendorn, Willkie Farr & Gallagher (June 18, 1998), available at <http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/p002603>.

<sup>5</sup> See, e.g., Dinosaur Securities, LLC, SEC No-Action Letter (June 23, 2006), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/dinosaur062306.htm> (SEC staff declining to consider whether intended payment recipients would be exempt from registration for the purposes of satisfying NASD rules and noting that the SEC does not “as a matter of practice” provide no-action relief in this context, despite the NASD advising members that they obtain such relief).

<sup>6</sup> Proposed FINRA Rule 2040(a)(1).

<sup>7</sup> See SEC Guide to Broker-Dealer Registration (April 2008), <http://www.sec.gov/divisions/marketreg/bdguide.htm> (listing various factors to be considered in determining whether registration is required). Generally, a person is a broker and required to register if it is “engaged in the business of effecting transactions in securities for the accounts of others.” See Exchange Act §§ 3(a)(4)(A), 15(a). Numerous cases, no-action letters and interpretations have considered the role of compensation in the broker-dealer determination under various circumstances. See, e.g., Country Business, Inc., SEC No-Action Letter (Nov. 8, 2006), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/cbi110806.htm>; Davenport Management, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 624 (Apr. 13, 1993) (declining to issue no-action relief where applicant “would receive compensation tied directly to transactions in securities”); and Paul Anka, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 925 (July 24, 1991).

<sup>8</sup> Proposed FINRA Rule 2040(a)(2).

<sup>9</sup> The proposal does not eliminate all existing provisions that may touch on compensation sharing in its various potential forms. For example, subparagraph (f)(2)(L) of FINRA Rule 5110 (the Corporate Financing Rule) prohibits members from participating in certain distributions of securities that involve persons not associated with a registered broker-dealer in violation of SEC rules or state laws. This provision is left unchanged, though its specific requirements may be inconsistent with the proposed rule’s general standard. The proposal would also not affect NASD Rule 2740, which prohibits discounting securities in a fixed price offering to “anyone other than a broker or dealer actually engaged in the investment banking or securities business.” Rule 2740 has a somewhat different policy rationale than Rule 2420, and is intended to prevent discounting in fixed price offerings. FINRA has previously proposed to eliminate Rule 2740 and adopt a new FINRA rule in its place, see FINRA Regulatory Notice 09-45, *Fixed Price Offerings*, available at <http://www.finra.org/Industry/Regulation/Notices/2009/P119722>, although that proposal has since been withdrawn.

## *Foreign Finders Exemption*

Under the proposal, NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 would be eliminated. These rules allow a member firm, under certain enumerated conditions, to pay transaction-based compensation to a non-U.S. finder that solicits non-U.S. business for the member. The Regulatory Notice does not provide a specific explanation, however, and the removal may indicate that FINRA intends that Payments to foreign finders be subject to the new general standard in Proposed Rule 2040. If so, the Payments would be permitted so long as they did not trigger a requirement that the foreign persons register as a broker-dealer under the Exchange Act.<sup>10</sup> In many cases, a FINRA member might satisfy itself, as a practical matter, through certificates or opinions of counsel, that a foreign finder's activities are exempt from registration pursuant to Rule 15a-6 under the Exchange Act.<sup>11</sup> However, because the Proposed Rule does not contain a "reasonable belief" standard, absolute comfort may be difficult to attain without receiving a specific no-action letter.

## *Cash Solicitation Rule Exemption*

The proposal would also eliminate NYSE Rule Interpretation 345(a)(i)/02, which provides an exemption from NYSE rules requiring registration of associated persons. Under this Interpretation, an NYSE member that is dually-registered as both a broker-dealer and investment adviser may enter into arrangements to pay persons for solicitation of certain business that may otherwise violate NYSE Rule 345, if the arrangement complies with Rule 206(4)-3 under the Advisers Act.<sup>12</sup> Although FINRA might believe that the Interpretation may be eliminated as unnecessary, in fact, it may be difficult in some cases for a FINRA member investment adviser to assure itself that the activities of a solicitor do not amount to "effecting" transactions in securities, which is the touchstone for requiring broker-dealer registration.

## **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 certain sanctions. The amendments would clarify the scope of sanctions subject to the rule and codify certain exceptions, but leave some questions unanswered.

Under the proposal, a member may not allow a person subject to suspension, revocation, cancellation of registration, bar from association with a member or other disqualification (collectively, "**Sanctions**") to be associated with the member in any capacity inconsistent with the Sanction.<sup>13</sup> The amended rule would also prohibit any payments to a person during either the period of the Sanction or anytime thereafter if the payments might have accrued during the period of the Sanction. Payments may be permitted if they are consistent with the scope of a limited Sanction.

The amendment would allow payments to Sanctioned persons pursuant to an insurance or medical plan, agreement to indemnify for legal fees, or that may be required by an arbitration award or court judgment. A proposed supplement to the amended rule would also allow payments to Sanctioned persons that the "member can evidence accrued ... prior to the effective date" of the Sanction and that does not relate to

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<sup>10</sup> See, e.g., Bear, Stearns & Co., SEC No-Action Letter, 1976 SEC No-Act. LEXIS 281 (Feb. 6, 1976) (confirming that under certain circumstances a foreign broker-dealer introducing its foreign customers to a U.S. broker-dealer for execution, clearance and settlement of U.S. securities transactions on a fully-disclosed basis would not trigger a requirement that the foreign firm register as a broker-dealer with the SEC); *but see* Letter from Sarah J. Williams, Assistant General Counsel, NASD Regulation, Inc., to Bob E. Lehman, Esq., Lehman & Eilen LLP (Aug. 7, 2001), available at <http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P002551> (determining that the foreign finder exception would not be available under a similar arrangement and questioning whether a foreign introducing broker would be required to register with the SEC under the facts presented).

<sup>11</sup> Exchange Act Rule 15a-6.

<sup>12</sup> Advisers Act Rule 206(4)-3.

<sup>13</sup> Proposed Amendment to FINRA Rule 8311.

the activity that gave rise to the Sanction.<sup>14</sup> In practice, however, it may be difficult for a member to determine with precision what specific activity each payment relates to.

The proposal is not clear regarding the effective time of Sanctions for purposes of the rule. For example, no guidance is provided as to whether a Sanction that has been issued but subsequently stayed or is pending appeal would be considered to be in effect.

## Payments to Retired Representatives

The Proposed Rules would codify existing FINRA guidance with regard to members continuing to pay commissions to representatives after they have retired and cease to be associated with the firm. Under Proposed Rule 2040(b), members may continue to pay a retired representative (or their estate) commissions derived from accounts of continuing customers of the retired representative if: (i) the representative retires and “leaves the securities industry;” (ii) the firm and the retired representative entered into a bona fide contract requiring the payments; (iii) the contract was entered into while the representative was registered with the member; (iv) the contract prohibits the retired representative from soliciting new business, opening new accounts or continuing to service the accounts that are generating the commissions; and (v) the arrangement otherwise complies with applicable Exchange Act rules and SEC guidance.<sup>15</sup>



FINRA requests comments on the proposal by February 1, 2010. The Proposed Rules will not become effective, and the existing rules will not be eliminated, until the rule changes are filed with and approved by the SEC following a second comment period.

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<sup>14</sup> Proposed Supplementary Material .01 to FINRA Rule 8311.

<sup>15</sup> The SEC has recently issued guidance on payments to retired representatives. See Securities Industry and Financial Markets Association, SEC No-Action Letter (Nov. 20, 2008), available at <http://www.sec.gov/divisions/marketreg/mrnoaction/2007/sifma112008-19h1.pdf>.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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