SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73954; File No. SR-FINRA-2014-037)

December 30, 2014

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to FINRA Rules 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation) and 2040 (Payments to Unregistered Persons) in the Consolidated FINRA Rulebook, and Amend FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar)

I. Introduction

On September 10, 2014, Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to streamline provisions of NASD Rule 2410 (Net Prices to Persons Not in Investment Banking or Securities Business), NASD Rule 2420 (Dealing with Non-Members), NASD IM-2420-1 (Transactions Between Members and Non-Members), NASD IM-2420-2 (Continuing Commissions Policy), Incorporated NYSE Rule 353 (Rebates and Compensation), Incorporated NYSE Rule Interpretation 345(a)(i)/01 (Compensation to Non-Registered Persons) and Incorporated NYSE Rule Interpretation 345(a)(i)/02 (Compensation Paid for Advisory Solicitations), which would be deleted from the current FINRA rulebook. The proposed rule change would also adopt the requirements of NASD Rule 1060(b) (Persons Exempt from Registration) and Incorporated NYSE Rule Interpretation 345(a)(i)/03 (Compensation to Non-Registered Foreign Persons Acting as Finders), as FINRA Rule 2040(c) (Nonregistered Foreign Finders) in the consolidated FINRA rulebook without

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

material change. In addition, the proposed rule change would amend FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar), add new Supplementary Material .01 (Remuneration Accrued Prior to Effective Date of Sanction or Disqualification), and adopt the requirements of NASD IM-2420-1(a) (Non-members of the Association), as FINRA Rule 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation).

The proposed rule change was published for comment in the Federal Register on October 1, 2014.[3] The Commission received seven comment letters in response to the Notice of Filing.[4] On November 10, 2014, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the

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[3] Exchange Act Release No. 73210 (Sept. 25, 2014), 79 FR 59322 (Oct. 1, 2014) (Notice of Filing of a Proposed Rule Change to Adopt FINRA Rules 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation) and 2040 (Payments to Unregistered Persons) in the Consolidated FINRA Rulebook, and Amend FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar)) ("Notice of Filing"). The comment period closed on October 22, 2014.

[4] William A. Jacobson, Clinical Professor of Law, Cornell Law School, and Director, Cornell Securities Law Clinic (Oct. 17, 2014) ("Cornell"); Peter J. Chepucavage, Esq., GC Plexus Consulting Group (Oct. 21, 2014) ("Plexus"); William Beatty, President, North American Securities Administrators Association and Washington Securities Commissioner (Oct. 22, 2014) ("NASAA"); Howard Spindel, Senior Managing Director, and Cassondra E. Joseph, Managing Director, Integrated Management Solutions USA LLC (Oct. 22, 2014) ("IMS"); Paul J. Tolley, Senior Vice President, Chief Compliance Officer, Commonwealth Financial Network (Oct. 22, 2014) ("Commonwealth"); Kevin Zambrowicz, Associate General Counsel & Managing Director, Securities Industry and Financial Markets Association (Oct. 22, 2014) ("SIFMA"); and Catherine T. Dixon, Chair, Federal Regulation of Securities Committee, Business Law Section, American Bar Association (Nov. 5, 2014) ("ABA").

proposed rule change to December 30, 2014.[5] On December 23, 2014, FINRA filed a letter responding to these comments.[6]

This order approves the proposed rule change.

II. Description of the Proposed Rule

As part of the process of developing a new consolidated rulebook ("Consolidated FINRA Rulebook"),[7] FINRA is proposing to adopt FINRA Rule 2040 (Payments to Unregistered Persons) regarding the payment of transaction-based compensation by members to unregistered persons, and Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act). The proposed rule change would streamline provisions of NASD Rule 2410 (Net Prices to Persons Not in Investment Banking or Securities Business), NASD Rule 2420 (Dealing with Non-Members), NASD IM-2420-1 (Transactions Between Members and Non-Members), NASD IM-2420-2 (Continuing Commissions Policy), NYSE Rule 353 (Rebates and Compensation), NYSE Rule Interpretation 345(a)(i)/01 (Compensation to Non-Registered Persons) and NYSE Rule Interpretation 345(a)(i)/02 (Compensation Paid for

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5 Letter from Kosha K. Dalal, Associate Vice President and Associate General Counsel, FINRA to Katherine England, Assistant Director, Division of Trading and Markets, Securities and Exchange Commission, dated Nov. 10, 2014.

6 Letter from Kosha K. Dalal, Associate Vice President and Associate General Counsel, FINRA to Brent J. Fields, Secretary, Securities and Exchange Commission, dated Dec. 23, 2014 ("FINRA Response").

7 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE ("Incorporated NYSE Rules"). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE ("Dual Members"). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice, March 12, 2008 (Rulebook Consolidation Process). For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

Advisory Solicitations), which would be deleted from the current FINRA rulebook. The proposed rule change also would adopt the requirements of NASD Rule 1060(b) (Persons Exempt from Registration) and NYSE Rule Interpretation 345(a)(i)/03 (Compensation to Non-Registered Foreign Persons Acting as Finders), as FINRA Rule 2040(c) (Nonregistered Foreign Finders) in the Consolidated FINRA Rulebook without material change. In addition, the proposed rule change would amend FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar), add new Supplementary Material .01 (Remuneration Accrued Prior to Effective Date of Sanction or Disqualification), and adopt the requirements of NASD IM-2420-1(a) (Non-members of the Association), as FINRA Rule 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation).

A. Background

NASD Rule 1060(b) (Persons Exempt from Registration), NASD Rule 2410 (Net Prices to Persons Not in Investment Banking or Securities Business), NASD Rule 2420 (Dealing with Non-Members), NASD IM-2420-1 (Transactions Between Members and Non-Members), and NASD IM-2420-2 (Continuing Commissions Policy) (collectively, the "NASD Non-Member Rules") govern payments by members to unregistered persons. The NASD Non-Member Rules (other than NASD Rule 1060(b)) were developed in an era when a registered broker-dealer could engage in an over-the-counter securities business and elect not to be a member of a registered securities association.[8] An original

[8] See Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070, which added Section 15A of the Exchange Act to provide for the establishment of national securities associations with authority, subject to SEC review, to supervise the over-the-counter securities market and promulgate rules governing voluntary membership of broker-dealers.

purpose of the NASD Non-Member Rules was to encourage non-members to become members by generally prohibiting members from providing commissions or discounts/concessions to non-members.[9] Since the adoption of the NASD Non-Member Rules, the laws governing broker-dealers have changed, and today virtually all broker-dealers doing business with the public are FINRA members.[10]

As a result, FINRA generally has interpreted the provisions of the NASD Non-Member Rules, through interpretive letters and other guidance, to prohibit the payment of commissions or fees derived from a securities transaction to any non-member that may be acting as an unregistered broker-dealer. Section 15(a)(1) of the Exchange Act generally requires any broker-dealer effecting transactions in securities to be registered with the SEC. FINRA has refrained from providing interpretive guidance on whether a person is

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[9] Section 15A(e)(1) of the Exchange Act states that "[t]he rules of a registered securities association may provide that no member thereof shall deal with any nonmember professional (as defined in paragraph (2) of this subsection) except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public." Section 15A(e)(2) of the Exchange Act defines "nonmember professional" as "(A) with respect to transactions in securities other than municipal securities, any registered broker or dealer who is not a member of a registered securities association, except such a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, and commercial bills, and (B) with respect to transactions in municipal securities, any municipal securities dealer (other than a bank or division or department of a bank) who is not a member of any registered securities association and any municipal securities broker who is not a member of any such association." The legislative reports from Congress on this provision state that exclusion from membership would in effect be a form of economic sanction on such non-members. See S. Rep. No. 1455 and H. R. Rep. No 2307, 75th Cong., 3rd Sess. (1938).

[10] Section 15(b)(8) of the Exchange Act provides that "[i]t shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to Section 15A of this title or effects transactions in securities solely on a national securities exchange of which it is a member."

acting as an unregistered broker-dealer, as the authority to interpret Section 15(a) of the Exchange Act rests with the SEC. Registration as a broker-dealer provides a framework of rules to regulate the conduct of persons who receive transaction-based compensation, the receipt of which can create potential incentives for abusive sales practices. SEC guidance states that receipt of securities transaction-based compensation is an indication that a person is engaged in the securities business and that such person generally should be registered as a broker-dealer.

B. Proposed FINRA Rule 2040

FINRA is proposing to adopt new FINRA Rule 2040 (Payments to Unregistered Persons), which eliminates the current NASD Non-Member Rules and related NYSE Non-Member Rules (discussed further below) and replaces them with a more straightforward rule. The proposed rule expressly aligns with Section 15(a) of the Exchange Act and its related guidance to determine whether registration as a broker-dealer is required for certain persons to receive transaction-related compensation. As further discussed in Item II.C. below, the proposed rule change was published for comment in Regulatory Notice 09-69.[11] FINRA received seven comment letters. A significant number of the commenters expressed concern regarding the potential regulatory burden of obtaining SEC no-action letters to determine whether particular activities would require registration of persons as broker-dealers under Section 15(a) of the Exchange Act, and the proposed deletion of NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 relating to payments to foreign finders. In an effort to respond to these concerns, FINRA is proposing to adopt Supplementary Material .01 (Reasonable

[11] See Regulatory Notice 09-69 (December 2009).

Support for Determination of Compliance with Section 15(a) of the Exchange Act) to proposed FINRA Rule 2040 to provide guidance to members regarding the manner in which they can reasonably support a determination that an unregistered person is not required to be registered under Section 15(a) of the Exchange Act by reason of receiving payments from the member and the activities related thereto. FINRA is also proposing to retain NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 relating to foreign finders as proposed FINRA Rule 2040(c). The proposed rule sets forth the following requirements:

- Payments to Unregistered Persons

FINRA is proposing to adopt new FINRA Rule 2040(a), which prohibits members or associated persons from, directly or indirectly, paying any compensation, fees, concessions, discounts, commissions or other allowances to:

(1) any person that is not registered as a broker-dealer under Section 15(a) of the Exchange Act but, by reason of receipt of any such payments and the activities related thereto, is required to be so registered under applicable federal securities laws and Exchange Act rules and regulations; or

(2) any appropriately registered associated person, unless such payment complies with all applicable federal securities laws, FINRA rules and Exchange Act rules and regulations.

The proposed change would make the rule consistent with FINRA staff interpretations under NASD Rule 2420 and SEC rules and regulations under Section

15(a) of the Exchange Act.[12] Under the proposal, persons would look to SEC rules and regulations to determine whether the activities in question require registration as a broker-dealer under Section 15(a) of the Exchange Act. Persons may also rely on related published guidance issued by the SEC or its staff in the form of releases, no-action letters or interpretations. The proposal would align the rule with SEC staff guidance that states that receipt of securities transaction-based compensation is an indication that a person is engaged in the securities business and that such person generally should be registered as a broker-dealer. The proposed change also prohibits payments to appropriately registered associated persons unless such payments comply with applicable federal securities laws, FINRA rules and Exchange Act rules and regulations.

FINRA is proposing to adopt Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act) to proposed FINRA Rule 2040 to provide guidance to members. In applying the proposed rule, FINRA will expect members to determine that their proposed activities would not require the recipient of the payments to register as a broker-dealer and to reasonably support such determination. Members that are uncertain as to whether an unregistered person may be required to be registered under Section 15(a) of the Exchange Act by reason of receiving payments from the member and the activities related thereto can derive support for their

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12 See FINRA Interpretative Letters issued under NASD Rule 2420: Letter to Richard Schultz, Triad Securities Corp., dated December 28, 2007; Letter to Jonathan K. Lagemann, Esq., Law Offices of Jonathan Kord Lagemann, dated June 27, 2001; Letter to Jay Adams Knight, Esq., Musick, Peeler & Garrett LLP, dated March 8, 2001; and Letter to Michael R. Miller, Esq., Kunkel Miller & Hament, dated May 31, 2000 (available at http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/ConductRules/index.htm).

determination by, among other things, (1) reasonably relying on previously published releases, no-action letters or interpretations from the Commission or Commission staff that apply to their facts and circumstances; (2) seeking a no-action letter from the Commission staff; or (3) obtaining a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area. The member's determination must be reasonable under the circumstances and should be reviewed periodically if payments to the unregistered person are ongoing in nature. In addition, a member must maintain books and records that reflect the member's determination.

- Retiring Representatives

FINRA is also proposing to adopt new FINRA Rule 2040(b), which codifies existing FINRA staff guidance on the payment by members of continuing commissions to retiring registered representatives.[13] The proposal permits members to pay continuing commissions to retiring registered representatives of the member, after they cease to be associated with the member, that are derived from accounts held for continuing customers of the retiring registered representative regardless of whether customer funds or securities are added to the accounts during the period of retirement, provided that: (1) a bona fide contract between the member and the retiring registered representative providing for the payments was entered into in good faith while the person was a registered representative of the member and such contract, among other things, prohibits

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13 See FINRA Interpretative Letters issued under NASD IM-2420-2: Letter to Name Not Public, dated November 27, 2012; Letter to Ted A. Troutman, Esquire, Muir & Troutman, dated February 4, 2002; Letter to Joe Tully, Commonwealth Financial Network, dated August 9, 2001; and Letter to Peter D. Koffer, Esq, Twenty-First Securities Corporation, dated January 21, 2000 (available at http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/ConductRules/index.htm).

the retiring registered representative from soliciting new business, opening new accounts or servicing the accounts generating the continuing commission payments; and (2) the arrangement complies with applicable federal securities laws and SEA rules and regulations.

The proposal defines the term "retiring registered representative" to mean an individual who retires from a member (including as a result of a total disability) and leaves the securities industry.[14] In the case of death of the retiring registered representative, the retiring registered representative's beneficiary designated in the written contract or the retiring registered representative's estate if no beneficiary is so designated may be the beneficiary of the respective member's agreement with the deceased representative.

FINRA believes this proposal is consistent with staff guidance on the payment of compensation to retiring representatives.[15]

- Nonregistered Foreign Finders

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14 See SEC No-Action Letter to the Securities Industry and Financial Markets Association, 2008 SEC No-Act. LEXIS 695, November 20, 2008. The letter provides that "[t]he retiring representative must sever association with the Firm and with any municipal securities dealer, government securities dealer, investment adviser or investment company affiliates (except as may be required to maintain any licenses or registrations required by any state) and, is not permitted to be associated with any other broker, dealer, municipal securities dealer, government securities dealer, investment adviser or investment company, during the term of his or her agreement. The retiring representative also may not be associated with any bank, insurance company or insurance agency (affiliated with the Firm or otherwise) during the term of his or her agreement if the retiring representative's activities relate to effecting transactions in securities." See also SEC No-Action Letter to Amy Lee, Chief Compliance Officer, Co-CEO, Packerland Brokerage Services, 2013 SEC No-Act. LEXIS 237, March 18, 2013.

15 See supra note 14.

In light of comments raised in response to Regulatory Notice 09-69, FINRA is proposing to transfer NASD Rule 1060(b) (Persons Exempt from Registration) and NYSE Rule Interpretation 345(a)(i)/03 (Compensation to Non-Registered Foreign Persons Acting as Finders) with minor technical changes into the Consolidated FINRA Rulebook as FINRA Rule 2040(c).[16] As approved by the SEC in 1993 and 1995, respectively, NYSE Rule Interpretation 345(a)(i)/03 and NASD Rule 1060(b) are largely identical provisions and provide that members and persons associated with a member may pay transaction-related compensation to nonregistered foreign finders, based upon the business of customers such persons direct to members, subject to identified conditions. FINRA is proposing non-substantive, technical changes to the proposed rule text to make it easier to read. Specifically, proposed FINRA Rule 2040(c) would provide that a member may pay to a nonregistered foreign finder (the "finder") transaction-related compensation based upon the business of customers the finder directs to the member if the following conditions are met ("foreign finders exception"):

(1) the member has assured itself that the finder who will receive the compensation is not required to register in the United States as a broker-dealer nor is subject to a disqualification as defined in Article III, Section 4 of FINRA's By-Laws, and has further assured itself that the compensation arrangement does not violate applicable foreign law;

(2) the finder is a foreign national (not a U.S. citizen) or foreign entity domiciled abroad;

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16 See supra note 11.

(3) the customers are foreign nationals (not U.S. citizens) or foreign entities domiciled abroad transacting business in either foreign or U.S. securities;

(4) customers receive a descriptive document, similar to that required by Rule 206(4)-3(b) of the Investment Advisers Act of 1940 ("Investment Advisers Act"), that discloses what compensation is being paid to finders;

(5) customers provide written acknowledgment to the member of the existence of the compensation arrangement and such acknowledgment is retained and made available for inspection by FINRA;

(6) records reflecting payments to finders are maintained on the member's books, and actual agreements between the member and the finder are available for inspection by FINRA; and

(7) the confirmation of each transaction indicates that a referral or finders fee is being paid pursuant to an agreement.

The rule provides that if all the conditions set forth in the rule are satisfied, members can pay transaction-related compensation to nonregistered foreign finders based on the business of non-U.S. customers that finders refer to members. Specifically, the rule permits compensation to "be made on an ongoing basis and tied to such variables as the level of business generated or assets under control, notwithstanding the fact that the foreign finders' sole involvement would be the initial referral to a member."[17] The SEC

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[17] See Securities Exchange Act Release No. 32431 (June 8, 1993), 58 FR 33128 (June 15, 1993) (Order Approving File No. SR-NYSE-92-33 Relating to an Interpretation to NYSE Rule 345 (Employees - Registration, Approval, Records)) ("SEC Approval Order of NYSE Rule 345 Interpretation"). See also Securities Exchange Act Release No. 35361 (February 13, 1995), 60 FR 9417 (February 17, 1995) (Order Approving File No. SR-NASD-94-51) ("SEC Foreign Finders Approval Order").

Foreign Finders Approval Order states that "[t]he provision was intended to give members the opportunity to enhance their competitive position in foreign countries where new accounts are frequently opened on a referral basis with ongoing compensation for such referral."[18]

Proposed FINRA Rule 2040(c) would have the same scope as the current rule and continue to allow ongoing transaction-based payments to nonregistered foreign finders under the limited circumstances set forth in the current rule. As in the current rule, "[w]hile the foreign finders' sole involvement would be the initial referral to a member or member organization [of non-U.S. customers to the firm], compensation could be made on an ongoing basis and tied to such variables as the level of business generated or assets under control. All accounts referred by such foreign finders would be carried on the books of the member."[19] Similar to NASD Rule 1060(b), any activities beyond the initial referral of non-U.S. customers and payment of transaction-based compensation for any such activities would not be within the permissible scope of the foreign finders exception as set forth in proposed FINRA Rule 2040(c). Based solely on its activities in compliance with proposed FINRA Rule 2040(c), the foreign finder would not be considered an associated person of the member. However, unless otherwise permitted by the federal securities laws or FINRA rules, a person who receives commissions or other transaction-based compensation in connection with securities transactions generally has to be a registered broker-dealer or an appropriately registered associated person of a broker-dealer who is supervised by a broker-dealer. Members that engage foreign finders

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18 See supra note 13.

19 See Securities Exchange Act Release No. 34941 (November 4, 1994), 59 FR 56102 (November 10, 1994) (Notice of Filing of File No. SR-NASD-94-51). See also SEC Approval Order of NYSE Rule 345 Interpretation.

would be required to have reasonable procedures that appropriately address the limited scope of activities permissible under such arrangements.[20]

C. Amendments to FINRA Rule 8311

- FINRA Rule 8311

FINRA is proposing amendments to FINRA Rule 8311 to eliminate duplicative provisions in NASD IM-2420-2 and to clarify the scope of the rule on payments by members to persons subject to suspension, revocation, cancellation, bar (each a "sanction") or other disqualification. The proposed rule provides that if a person is subject to a sanction or other disqualification, a member may not allow such person to be associated with it in any capacity that is inconsistent with the sanction imposed or disqualified status, including a clerical or ministerial capacity. The proposed rule further provides that a member may not pay or credit to any person subject to a sanction or disqualification, during the period of the sanction or disqualification or any period thereafter, any salary, commission, profit, or any other remuneration that the person might accrue, not just earn, during the period of the sanction or disqualification. However, a member may make payments or credits to a person subject to a sanction that are consistent with the scope of activities permitted under the sanction where the sanction solely limits an associated person from conducting specified activities (such as a suspension from acting in a principal capacity) or to a disqualified person that has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to associate with a member.

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[20] See SEC Foreign Finders Approval Order. FINRA notes that the scope of permissible activities and associated regulatory requirements differ between foreign finders and foreign associates, who are registered persons of the member. See also NASD Rule 1100 (Foreign Associates).

Specifically, the proposal clarifies that:

(1) other disqualifications, not just suspensions, revocations, cancellations or bars, are subject to the rule (and the rule is not limited to orders issued by FINRA or the SEC);

(2) a member may not allow a person subject to a sanction or disqualification to "be" associated with such member in any capacity that is inconsistent with the sanction imposed or disqualified status, including a clerical or ministerial capacity, not simply "remain" associated as provided in the current rule;

(3) a member may not pay any remuneration to a person subject to a sanction or disqualification, not just payments that result directly or indirectly from any securities transaction; and

(4) the rule applies to any salary, commission, profit or remuneration that the associated person might "accrue," not just "earn" during the period of a sanction or disqualification, not just suspension.

FINRA is also proposing to add a new paragraph to the rule that would expressly permit a member to pay to any person subject to a sanction or disqualification 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. FINRA believes that these exceptions strike the correct balance by permitting certain key payments.

- <u>Proposed Supplementary Material .01</u>

In addition, FINRA is proposing to add new Supplementary Material .01 (Remuneration Accrued Prior to Effective Date of Sanction or Disqualification) that

relates to commissions accrued by a person prior to the effective date of a sanction or disqualification. The proposed supplementary material 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. However, a member may not pay any remuneration that accrued to the person that relates to or results from the activity giving rise to the sanction or disqualification, and any such payment or credit must comply with applicable federal securities laws. FINRA believes that adopting this new provision is necessary to address questions by the industry on a member's ability to pay commissions and other remuneration that was accrued by the person prior to a sanction or disqualification going into effect. FINRA also believes the supplementary material, together with the proposed amendments discussed above, clarify that a member may not pay trail commissions to a person that may accrue during the period of the sanction or disqualification; rather, the member can only make such payments where the member can evidence that they accrued to the person prior to the effective date of the sanction or disqualification.

D. Adoption of New General Standard – FINRA Rule 0190

In addition, FINRA is proposing to adopt a new general standard, proposed FINRA Rule 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation), that is based largely on provisions of NASD IM-2420-1(a) and 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.

E. NASD and NYSE Rules To Be Deleted

FINRA proposes to eliminate the following NASD and NYSE Rules and related interpretations because FINRA believes that proposed FINRA Rule 2040 simplifies and clarifies the meaning of such rules consistent with Section 15(a) of the Exchange Act. Specifically, NASD Rule 2410, NASD Rule 2420, NASD IM-2420-1, NASD IM-2420-2, NYSE Rule 353, NYSE Rule Interpretation 345(a)(i)/01 and NYSE Rule Interpretation 345(a)(i)/02 will be consolidated into proposed FINRA Rule 2040, providing members with one concise rule that outlines the applicable requirements for payments to non-members.

- NASD Rule 2410

NASD Rule 2410 (Net Prices to Persons Not in Investment Banking and Securities Business) prohibits payments or concessions by members to "any person not actually engaged in the investment banking or securities business."

- NASD Rule 2420

NASD Rule 2420 (Dealing with Non-Members) generally prohibits members from dealing with, or making payments to, non-member broker-dealers, except at the same prices, fees or concessions offered to the general public. NASD Rule 2420(b) specifically prohibits members from joining any non-member broker-dealer syndicate or group in connection with the sale of securities. NASD Rule 2420(c) provides that members may pay concessions and fees to a non-member broker or dealer in a foreign country who is not eligible for membership, provided the member obtains an agreement

from such foreign broker or dealer in making sales of securities within the United States that such foreign broker or dealer will act in accordance with the general requirements of the rule to prohibit the payment of concessions or discounts to non-members that are not allowed to the general public. NASD Rule 2420(d) provides restrictions on payments by or to persons that have been suspended or expelled.

- NASD IM-2420-1

NASD IM-2420-1 (Transactions between Members and Non-Members) provides certain exemptions from the general prohibition on arrangements with non-members set forth in NASD Rule 2420. For example, the rule provides exemptions for arrangements with certain non-members relating to transactions in "exempted securities," or transactions on a national securities exchange. The rule further clarifies that a firm that is suspended or expelled from FINRA membership, or whose registration is revoked by the SEC, is to be considered a non-member for purposes of the rule.

- NASD IM-2420-2

NASD IM-2420-2 (Continuing Commissions Policy) allows members to pay continuing commissions to former registered representatives after they cease to be employed by a member, if, among other things, a bona fide contract between the member and the registered representative calling for the payments was entered into in good faith while the person was a registered representative of the employing member. The rule states that such contracts cannot permit the solicitation of new business or the opening of new accounts by persons who are not registered, and must conform with all applicable laws and regulations. The rule also provides that NASD Rule 2830(c) (Investment Company Securities, Conditions for Discounts to Dealers) should not be interpreted to

require a sales agreement for a dealer to receive commissions on direct payments by clients or automatic dividend reinvestments. The rule further contains a prohibition on the payment of any kind by a member to any person who is not eligible for FINRA membership or eligible to be associated with a member because of any disqualification, such as revocation, expulsion or suspension that is still in effect. The rule recognizes the validity of contracts entered into in good faith to allow retired representatives to receive continuing compensation on their accounts or to designate a widow or other beneficiary; however, the rule states that members are not required to enter into such contracts and FINRA will not specify the terms of such contracts.

- NYSE Rule 353

NYSE Rule 353 (Rebates and Compensation) prohibits a member, principal executive, registered representative or officer from, directly or indirectly, rebating to any person any part of the compensation he receives from the solicitation of orders for the purchase or sale of securities or other similar instruments for the accounts of customers of the member, or pay such compensation, or any part thereof, as a bonus, commission, fee or other consideration for business sought or procured for him or for any other member. NYSE Rule 353(b) further provides that a member, principal executive, registered representative or officer cannot be compensated for business done by or through his employer after the termination of his employment except as may be permitted by the NYSE.

- NYSE Rule Interpretations 345(a)(i)/01 and /02

NYSE Rule Interpretation 345(a)(i)/01 (Compensation to Non-Registered Persons) prohibits a member from paying to nonregistered persons compensation based

upon the business of customers they direct to the member if such compensation is, among other things, formulated as a direct percentage of commissions generated and is other than on an isolated basis.

NYSE Rule Interpretation 345(a)(i)/02 (Compensation Paid for Advisory Solicitations) provides that a member that is also registered with the SEC as an investment adviser may enter into arrangements that comply with Rule 206(4)-3 (Cash Payments for Client Solicitations) of the Investment Advisers Act.

III. Description of Comments on the Proposal and FINRA's Response

As noted above, the Commission received seven comment letters in response to the Notice of Filing.[21] Four commenters generally supported FINRA's efforts to consolidate and streamline rules relating to payments to unregistered persons.[22] Several commenters suggested changes to the proposed rules, which are discussed further below.

A. Proposed FINRA Rule 2040(a) and the Focus on Receipt of Transaction Based Compensation

One commenter stated that it supports proposed Rule 2040(a) but seeks clarity on proposed Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act), which is discussed in detail in Section III.D. below.[23] One commenter expressed concern that, without a clear regulatory framework in place, the receipt of transaction-based compensation will lead to abusive practices.[24] As such, the commenter believed that registration should be required for individuals that receive transaction-based compensation because "such registration is

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21 See note 4, supra.

22 SIFMA, NASAA, Cornell and ABA.

23 SIFMA.

24 NASAA.

integral to the regulation of firms and individuals…and exceptions to this principle should be rare, and when implemented they should be highly prescriptive."[25]

One commenter disagreed with FINRA's focus on the "receipt of transaction-based compensation" as the main factor for determining whether registration as a broker-dealer is required.[26] The commenter specifically cited recent case law pointing to other factors.[27] The commenter stated that FINRA should consider all of the relevant factors before FINRA and the SEC adopt any new rule by which a firm can determine whether a person must register in accordance with Section 15(a) of the Exchange Act.[28] The commenter suggested that FINRA either withdraw the proposed rule change or make substantial modifications to it to address these concerns.[29]

FINRA disagrees that the proposed rule focuses only on the receipt of transaction-based compensation as the determinative factor for who is required to register as a broker-dealer under the Exchange Act.[30] FINRA states that while the proposed rule change does specifically include "receipt of any such payments," as a factor, the proposed text also expressly includes "and the activities related thereto."[31] FINRA recognizes that SEC guidance in this area provides that certain activities may be deemed

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25 Id.

26 Commonwealth.

27 Id. (citing SEC v. Kramer, 778 F. Supp. 2nd 1320 (M.D. Fla. 2011) and SEC v. John J. Bravata, et al., Civil Action No. 09-cv-12950 (E.D. Mich.) (Lawson, J.).

28 Commonwealth.

29 Id.

30 FINRA Response at 4.

31 Id.

(alone or in combination) to confer "broker" status,[32] and the receipt of transaction-based compensation coupled with these activities may trigger the requirement to register as a broker-dealer under the Exchange Act.[33] FINRA believes the proposed rule change is consistent with current SEC rules and guidance.[34]

B. Proposed FINRA Rule 2040(b) – Retiring Representatives

Three commenters supported FINRA's proposed creation of a concise regulatory framework regarding the payment of continuing commissions to retiring registered representatives by member firms and noted that the proposed rule effectively consolidates existing guidance.[35] In contrast, one commenter stated that the proposal should be more explicit on the restrictions surrounding continuing compensation that can be paid to retired representatives.[36] The commenter noted that FINRA makes reference to and asserts a similarity between its current proposal and the prior SEC no-action letter issued to SIFMA on the topic, but NASAA believed that the staff guidance contains a more detailed discussion of the topic.[37] While the proposed rule does not expressly list each condition set forth in prior SEC no-action letters, FINRA believes that the proposed rule change incorporates the prior guidance issued by the SEC staff by expressly requiring

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32 See Paul Anka, SEC No-Action Letter (available July 24, 1991). See also Muni Auction Inc., SEC No-Action Letter (available March 13, 2000) and Bond Globe, Inc., SEC No-Action Letter (available February 6, 2001).

33 FINRA Response at 4.

34 Id.

35 SIFMA, ABA and IMS.

36 NASAA.

37 Id.

that any proposed arrangement with a retiring representative must comply with federal securities laws and Exchange Act rules and regulations.[38]

C. Proposed FINRA Rule 2040(c) – Non Registered Foreign Finders

1. Support for Retaining NASD Rule 1060(b)

In Regulatory Notice 09-69, FINRA had initially proposed to delete NASD Rule 1060(b) because it believed the activity should be governed by the general requirements of proposed FINRA Rule 2040(a). However, based on the comments received in response to Regulatory Notice 09-69, FINRA proposed to transfer NASD Rule 1060(b) unchanged into the consolidated FINRA rulebook. One commenter largely supported the proposed rule change, but seeks clarification of certain language.[39] Three commenters expressed concern that FINRA missed the opportunity to provide much needed clarity in the area of foreign finders and the compensation they can be paid.[40] One commenter expressed concern that proposed Rule 2040(c) and Supplementary Material .01 "create overly broad and vaguely defined safe havens for nonregistered individuals that receive payments related to securities transactions."[41]

2. Clarification That Foreign Finder Under Rule 2040(c) is not a "Person Associated with a Member"

One commenter urged FINRA to clarify that a foreign finder is not a "person associated with a member," as that term is defined under the FINRA By-Laws.[42] The commenter expressed concern that by relocating this provision, which is currently

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38 FINRA Response at 4.

39 SIFMA.

40 IMS, Plexus and Commonwealth.

41 Cornell.

42 ABA.

contained in NASD Rule 1060(b) to new FINRA Rule 2040, FINRA may not have fully incorporated existing guidance and may have "changed the character of the provision from a registration 'safe harbor' to a prescriptive rule that sets forth the only permissible basis on which transaction-based compensation may be paid to a foreign finder."[43]

3. Proposed Changes to Rule Text

One commenter recommended that proposed Rule 2040(c)(1) be amended to eliminate the use of a subjective "assurance" standard by revising the language to read: "the finder who will receive the compensation is not required to register in the United States as a broker dealer nor is subject to disqualification as defined in Article III, Section 4 of FINRA's By-Laws, and the compensation arrangement does not violate applicable foreign law."[44] The commenter stated that the "assurance" standard is unacceptably subjective because it depends on a specific member's knowledge, resources, and discretion and institutional investment firms may be able to hire outside counsel to determine whether a given transaction would violate foreign law, whereas a smaller firm may perform its own research and (incorrectly) conclude that the same transaction does not violate foreign law.[45]

One commenter suggested that proposed Rule 2040(c)(2) and (3) should be amended to permit members to focus on the residency, instead of the citizenship, of customers as this provides a "brighter and more enforceable line for all concerned and that the Commission has recognized residency as a better policy guide for the proper application of the broker-dealer registration requirements, except in very limited

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43 Id.

44 Cornell.

45 Id.

circumstances."[46] The commenter believed that the requirements in the proposed rule change that finders not be U.S. citizens and customers be foreign nationals (not U.S. citizens) impose an undue burden.[47]

One commenter stated that the conditions a firm must satisfy to rely on proposed Rule 2040(c) (e.g., determining whether the finder is not required to register as a U.S. broker-dealer and not subject to a disqualification under FINRA's By-Laws, the compensation arrangement does not violate applicable foreign law, etc.) will increase compliance costs for firms, particularly when outside counsel has to be retained.[48] In addition, the commenter noted that the additional disclosure requirements and recordkeeping requirements would be costly for firms, especially for small firms.[49]

3. Scope of Foreign Finders Proposal Is Not Comprehensive

Two commenters expressed concern that the scope of the proposed rule change appears to be too restrictive.[50] Both commenters stated that as a result of language in the Proposing Release that proposed Rule 2040(c) permits compensation when the foreign finder's sole involvement is the initial referral to the member, any activities beyond the initial referral of non-U.S. customers and payment of transaction-based compensation for any such activities "would not be within the permissible scope of the foreign finders exception as set forth in proposed FINRA Rule 2040(c)."[51]

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46 ABA.

47 Id.

48 IMS.

49 Id.

50 SIFMA and ABA.

51 Id.

One commenter stated that the Existing Nonregistered Foreign Finder Rules include NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 as a safe harbor, not as an exclusive means of compliance with the Existing Nonregistered Foreign Finder Rules, and requested that the proposed rule language be clarified with the use of the phrase "unless otherwise permitted by the federal securities laws or FINRA rules," because there may be other permissible activities, beyond the initial referral, that would be within the permissible scope of the foreign finders exception.[52] One commenter recommended that FINRA clarify the proposed rule text to permit the payment of compensation to foreign finders so long as the activities of the foreign finder are otherwise permitted.[53] The commenter also argued that the inclusion of the word "sole" in the Proposing Release is unnecessarily restrictive and anti-competitive.[54]

One commenter requested additional guidance to assist in the implementation and operation of proposed Rule 2040(c).[55] Specifically, the commenter noted that proposed Rule 2040(c)(4) requires that "customers receive a descriptive document, similar to that required by Rule 206(4)-3(b) of the Investment Advisers Act, that discloses what compensation is being paid to finders."[56] The commenter stated that investment advisers must disclose the additional amount that will be charged to the investment advisory fee (normally expressed as a percent of assets under management) and the differential attributable to the finder arrangement and, in general, the nature of fees between an

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52 SIFMA.

53 ABA.

54 Id.

55 SIFMA.

56 Id.

investment adviser and its clients differ from the nature of fees between a broker-dealer and its customers.[57] Therefore, the commenter believed that it would be useful to have examples of how the condition would operate.[58]

One commenter believed that the proposed rule would provide the SEC with an opportunity to provide clarity in the area of finders and, moreover, argued that allowing FINRA to adopt the SEC's standard is not efficient.[59] The commenter expressed concern about the certain staff guidance, in particular the Paul Anka SEC no-action letter, which it argued narrowed the issue to whether a transaction fee is paid.[60] The commenter further stated that the industry believes it is safe to pay fixed fees to employees or finder/consultants and urged the Commission to provide clarity on the Paul Anka letter and the transaction fee test.[61]

4. FINRA Response

FINRA responds that it has proposed to transfer NASD Rule 1060(b) unchanged into the consolidated rulebook in response to comments it received on Regulatory Notice 09-69.[62] FINRA states that the proposed rule change does not seek to address all circumstances under which payments may be made by U.S. broker dealers to foreign finders.[63] In addition, the proposed rule carries over a narrow safe harbor that permits a firm to pay on-going compensation to a foreign finder under the conditions set forth in

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57 Id.

58 Id.

59 Plexus.

60 Id.

61 Id.

62 FINRA Response at 7.

63 Id.

the provision.[64] FINRA recognizes that the proposed rule change does not address all open issues with respect to the payment of transaction-based compensation to foreign finders, but believes that this type of comprehensive rulemaking or guidance is outside the scope of this proposal.[65] To the extent that additional interpretive issues remain, FINRA plans to work with SEC staff on issuing related guidance, as appropriate.[66]

FINRA declines to amend the proposed rule text or provide examples as suggested by the commenters as it is not proposing to make any substantive changes to the provision.[67] FINRA does not intend to change the meaning or scope of the proposed provision or its related guidance by relocating the provision from the Series 1000 rules of the NASD rulebook to the Series 2000 rules of the FINRA rulebook. Similar to NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03, proposed Rule 2040(c) is not intended to be the only means by which a member may pay compensation to a foreign finder. FINRA states that members may rely on other applicable federal securities laws and regulations where the activities of a foreign finder go beyond the scope permitted by the proposed rule (e.g., the initial referral of a customer to the member).[68]

FINRA also reiterates that, as stated in the Proposing Release, based solely on its activities in compliance with proposed FINRA Rule 2040(c), the foreign finder would not be considered an associated person of the member.[69] Further, FINRA believes the word "solely" is critical and that any activities by the foreign finder beyond the initial referral

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64 Id.

65 Id.

66 Id.

67 FINRA Response at 8.

68 Id.

69 Id.

of the customer would no longer allow a firm to rely on the "safe harbor" established by the proposed rule and may require registration under Section 15(a) of the Exchange Act or result in association with the member under the FINRA By-Laws.[70] Therefore, FINRA maintains that the inclusion of this restriction is not new and has always been understood to be part of the provision.

D. Proposed FINRA Rule Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act)

1. Requests to Clarify Scope and Terms

Four commenters had concern with the scope and requirements of proposed Supplementary Material .01.[71] Specifically, these commenters expressed concern with the third prong of the proposed rule that allows a firm to obtain a "legal opinion" from independent and reputable U.S. licensed counsel.[72] The commenters stated that seeking SEC no-action letters or opinions of "outside" "reputable" and "knowledgeable" counsel will be burdensome and costly, especially for small firms. One commenter argued that, among other burdens, the proposal would mean that in-house counsel is automatically disqualified from rendering such an opinion, even if that counsel is prepared and qualified, by reputation and knowledge, to issue an objective opinion.[73] One commenter urged FINRA to provide greater flexibility in the range of measures that a member firm may rely on to "reasonably support" its determination and suggested that proposed Rule 2040(a)(3) be amended to provide that a member firm support its determination based on

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70 Id.

71 See ABA, SIFMA, IMS and Cornell.

72 Id.

73 IMS.

"advice of knowledgeable outside counsel" and make clear that the enumerated bases for determining that the necessary "reasonable support" exists are not exclusive.[74]

One commenter stated that determining whether counsel is "reputable" or "knowledgeable in the area" depends on the market in which he or she practices and the member's discretion and requested clarification as to whether "area" refers to geography or legal practice.[75] One commenter stated that the concepts of "reputable" and "knowledgeable" are subjective and the costs of implementing "these mandates are likely prohibitive and disproportionate to any economic benefit the firm might receive."[76] One commenter requested further guidance to illustrate the standard "reasonable under the circumstances" as well as guidance on the expected frequency of the periodic review.[77]

2. Other Comments

Three commenters believed that FINRA should provide greater clarity on when and under what circumstances payments to unregistered foreign finders are permitted.[78] One commenter objected to the proposed rule arguing that, instead of providing clarity, FINRA has imposed five additional conditions by proposing Supplementary Material .01.[79] The commenter further argued that FINRA did not address the impact of the proposed rule change on several activities that may be exempt from broker-dealer registration through SEC or FINRA guidance.[80]

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74 ABA.

75 Cornell.

76 IMS.

77 SIFMA.

78 IMS, Commonwealth, and Plexus.

79 IMS

80 Id.

One commenter asserted that the addition of this Supplementary Material .01 mitigates some of the concerns previously raised by them in response to Regulatory Notice 09-69, but they remain concerned with the complex issues surrounding the compensation of unregistered persons that they stated is largely unaddressed by the current proposal.[81]

One commenter stated that the "reasonable reliance" standard in Supplementary Material .01 depends almost entirely on the judgment of broker-dealers that have a financial incentive to interpret materials broadly.[82] Further, the commenter stated that although the Supplementary Material is intended to mitigate the burden of determining whether Section 15(a) requires registration, the uncertainty of a "reasonable reliance" standard invites a much costlier alternative: private dispute resolution, administrative hearings, or litigation.[83]

3. FINRA's Response

FINRA states that it is proposing to adopt Supplementary Material .01 because it recognizes the potential costs and burdens of obtaining a firm-specific, no-action letter from the SEC.[84] The proposed supplementary material is intended to clarify that firms may rely on other means to demonstrate compliance and provides firms with the flexibility to rely on other options that may be less costly and time consuming.[85]

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81 NASAA.

82 Cornell.

83 Id.

84 FINRA Response at 9.

85 FINRA Response at 9-10.

FINRA does not intend proposed Supplementary Material .01 to be an exhaustive list by which firms can make a reasonable determination.[86] FINRA states that a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area is not the only means available to firms. FINRA notes that firms may continue to rely on the advice of in-house counsel or foreign counsel under prong 1 that permits a firm to make a determination by "reasonably relying on previously published releases, no-action letters or interpretations from the Commission or Commission staff that apply to its facts and circumstances."[87]

FINRA declines to define how frequently a firm must review its determination under the proposed rule because the review must be reasonable based on the nature and scope of the activity in question and therefore requires a factual review. FINRA believes, however, that an annual review for on-going payments generally would be reasonable, absent evidence of activities by the recipient of the payments that raise red flags.[88]

IV. Discussion and Commission Findings

The Commission has carefully considered the proposal, the comments received, and FINRA's responses to the comments. Based on its review of the record, the Commission finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[89]

In particular, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things,

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86 FINRA Response at 10.

87 Id.

88 Id.

89 In approving the proposal, as amended, the Commission has considered the impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

that FINRA's rules be designed to prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; and, in general, protect investors and the public interest.[90]

The proposed rule change will clarify and streamline several NASD and NYSE rules relating to payments to unregistered persons for adoption as FINRA Rules in the new Consolidated FINRA Rulebook. Specifically, proposed FINRA Rule 2040(a) aligns with Section 15(a) of the Exchange Act and its related guidance to determine whether registration as a broker-dealer is required for certain persons to receive transaction-related compensation; proposed FINRA Rule 2040(b) codifies existing FINRA guidance on the payment by members of continuing commissions to retiring registered representatives consistent with the Commission's guidance in this area; and proposed FINRA Rule 2040(c) adopts the foreign finders provisions of NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 with technical changes. The amendments to FINRA Rule 8311 eliminate duplicate provisions in NASD IM-2420-2 and clarify the scope of the rule on payments by members to persons subject to sanctions. Commenters' suggestions that the SEC (or FINRA) provide additional guidance on "finders" are outside the scope of this rule filing, and thus outside the scope of this order.

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90 15 U.S.C. 78o-3(b)(6).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[91] that the proposed rule change (SR-FINRA-2014-037) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[92]

Brent J. Fields
Secretary

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91 15 U.S.C. 78s(b)(2).

92 17 CFR 200.30-3(a)(12).