

Client Alert

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Referral Fees and Commission Sharing When May Broker-Dealers Share Their Fees with Non-Brokers?

By Hillel Cohn

FINRA recently filed [proposed rule changes](#) with the SEC addressing when broker-dealers may pay referral fees or otherwise share compensation with persons who are not registered as broker-dealers. The proposed rule changes are subject to the SEC's approval. If approved, new Rule 2040 and related conforming changes to other FINRA rules will go into effect 45 to 90 days after publication in the Federal Register.

THE REGISTRATION REQUIREMENTS

Under the Securities Exchange Act of 1934 (the "Exchange Act"), persons who receive transaction-based compensation in connection with the purchase or sale of securities must generally be registered as broker-dealers or licensed as associated persons of a registered broker-dealer. In most cases, registered broker-dealers are not permitted to share their transaction-based compensation with persons who are not properly registered or licensed.

Over the years, the NYSE, NASD and FINRA have issued multiple rules and interpretations enforcing registration requirements and creating several important exceptions. The proposed rule changes would consolidate these rules and interpretations into new FINRA Rule 2040. While the proposed rule would not implement any substantive changes from the current set of rules and interpretations, it does include a few features which may have significant implications.

THE PROPOSED RULE

Proposed FINRA Rule 2040 starts with the general principle that no member firm or associated person may, directly or indirectly, pay compensation to an unregistered firm or unlicensed person, if the receipt of such compensation would cause the recipient to be subject to the broker-dealer registration requirements of the Exchange Act. In the rule proposal, FINRA makes it clear that it is the SEC, and not FINRA or other self-regulatory organizations, which is responsible for defining what conduct triggers the broker-dealer registration requirements of the Exchange Act. The SEC has repeatedly emphasized that the receipt of transaction-based compensation in connection with the purchase or sale of securities most likely means that the recipient must be registered as a broker-dealer. Thus, commission sharing or the payment of referral fees calculated as a percentage of the broker-dealer's transaction-based compensation, will in almost all cases be prohibited. On the other hand, compensation which is clearly not transaction-based, such as an hourly consulting fee paid to an IT consultant, would be permitted.

RESOLVING UNCERTAINTIES

Of course, compensation arrangements may come in all sizes and flavors and sometimes it is not readily apparent if a proposed compensation arrangement would require the recipient to be registered as a broker-dealer. For example, what about a referral arrangement which pays the finder a flat fee of \$1,000 for every successful referral, irrespective of the size of the account or the value of commissions generated by the account?

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To assist broker-dealers in resolving the question of whether a particular compensation arrangement requires registration, FINRA has included supplementary material with proposed Rule 2040. The supplementary material advises that broker-dealers should document the basis for their determination that a payment may be made to an unlicensed person. Where there is uncertainty, member firms are advised to seek support for their conclusion by (i) relying on published SEC no-action letters and interpretations, (ii) seeking no-action relief from the SEC or (iii) obtaining a legal opinion from independent legal counsel. Although the supplementary material indicates that the foregoing methods of supporting a conclusion are non-exclusive, it would not be surprising if the enumerated methods become the industry standard most compliance departments will require in order to avoid second-guessing by the regulators. These registration issues are often difficult to analyze and in many cases it may not be practical or cost-effective to seek no-action relief or an independent legal opinion. This uncertainty may push broker-dealers to adopt a conservative position when confronted with any question as to whether payment to an unlicensed person is permitted.

PROPOSED EXCEPTIONS

There are two important exceptions to the general prohibitions set forth in proposed Rule 2040 that would both continue to support existing practices permitted under the current rules. The first exception allows broker-dealers to pay referral fees to foreign persons for the referral of foreign nationals. Based on comments received by FINRA on its first draft of proposed Rule 2040, the ability to compensate foreign brokers for referrals is viewed as very important by many U.S. broker-dealers. In order for this exception to apply, the U.S. broker-dealer must determine that the foreign recipient of the referral fee is not required to register as a broker-dealer in the U.S. The foreign recipient should be conducting its business entirely outside the U.S., except as permitted under SEC Rule 15a-6. The U.S. broker-dealer must also determine that the payment would not violate the laws of the country in which the recipient is located and that the foreign recipient is not a "disqualified" person under the Exchange Act. See Section 3(a)(39) of the Exchange Act. Finally, written disclosure of the fact that a referral fee is being paid must be made to and acknowledged in writing by the client. This exception is presumably predicated on the theory that foreign nationals operating outside the U.S. would not be subject to U.S. broker-dealer registration requirements.

The second exception would permit the payment of commissions to retired account executives or registered representatives ("representatives"). This exception is designed to incentivize retiring representatives to transition their business to other representatives at the firm. Under this exception, a retired representative may continue to share in commissions and other compensation generated by accounts he or she serviced at the firm even after the representative has retired and is no longer licensed as an associated person. In order to be eligible for this exception, the representative must enter into a contract prior to retirement with the member firm that provides for the post-retirement payments. Following retirement, the retired representative will not be able to solicit new business, open new accounts or service any existing accounts.

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