

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-73210; File No. SR-FINRA-2014-037]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; 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)

September 25, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on September 10, 2014, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

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), 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 also would 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 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 text of the proposed rule change is available on FINRA’s Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

#### II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

As part of the process of developing a new consolidated rulebook (“Consolidated FINRA Rulebook”),<sup>3</sup> 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

<sup>3</sup> 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.

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 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.<sup>4</sup> An original

<sup>4</sup> See Maloney Act of 1938, Public Law 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.

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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.<sup>5</sup> 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.<sup>6</sup>

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 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.<sup>7</sup> 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 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 SEA rules and regulations; or

(2) any appropriately registered associated person, unless such payment complies with all applicable federal securities laws, FINRA rules and SEA 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.<sup>8</sup> 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 SEA 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 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

<sup>5</sup> 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).

<sup>6</sup> 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.”

<sup>7</sup> See *Regulatory Notice* 09–69 (December 2009).

<sup>8</sup> 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>).

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.<sup>9</sup> 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 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.<sup>10</sup> 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 SEC guidance on the payment of compensation to retiring representatives.<sup>11</sup>

• *Nonregistered Foreign Finders*

As further discussed in Item II.C. below, 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).<sup>12</sup> 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 exemption"):

(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;

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.

<sup>11</sup> See *supra* note 10.

<sup>12</sup> See *supra* note 7.

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

(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 finder's 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."<sup>13</sup> The SEC 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."<sup>14</sup>

Proposed FINRA Rule 2040(c) would have the same scope as the current rule and continue to allow on-going 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

<sup>9</sup> 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>).

<sup>10</sup> 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

<sup>13</sup> 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").

<sup>14</sup> See *supra* note 13.

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.”<sup>15</sup> 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 would be required to have reasonable procedures that appropriately address the limited scope of activities permissible under such arrangements.<sup>16</sup>

### 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.

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;

(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.

#### • Proposed Supplementary Material .01

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. FINRA believes this is consistent with the current provisions of NASD IM-2420-1(a) and should be retained in the FINRA rulebook.

### 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

<sup>15</sup> 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.

<sup>16</sup> 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).

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.

FINRA will announce the effective date of the proposed rule change in a *Regulatory Notice* to be published no later than 90 days following Commission approval. The effective date will be no later than 240 days following Commission approval.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Exchange Act,<sup>17</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will clarify and streamline current 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) 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; proposed FINRA Rule 2040(b) codifies existing FINRA guidance on the payment by members of continuing commissions to retiring registered representatives consistent with SEC 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. Proposed 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.

### B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA believes the proposed rule change is consistent with Section 15(a) of the Exchange Act and its related guidance, and will promote the goal of clarity concerning the rules applicable to payments of transaction-based compensation to unregistered persons. Specifically, the proposed rule change will clarify and streamline current

<sup>17</sup> 15 U.S.C. 78o-3(b)(6).

NASD and NYSE rules relating to payments to unregistered persons for adoption as FINRA Rules in the new Consolidated FINRA Rulebook. Proposed FINRA Rule 2040(a) 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; proposed FINRA Rule 2040(b) codifies existing FINRA guidance on the payment by members of continuing commissions to retiring registered representatives consistent with SEC 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.

As the proposed rule change aligns FINRA's requirements with the requirements of Section 15(a) of the Exchange Act, FINRA believes that the proposed rule change is appropriately tailored to minimize the burden and cost of complying with the proposed rule change. Moreover, FINRA believes that any burden from the proposal will be minimal because, while the proposal streamlines the current rule to make it more concise, the obligation of firms to analyze payment arrangements for compliance with Section 15(a) of the Exchange Act is not new. In addition, proposed Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act) to proposed FINRA Rule 2040 aims to assist compliance efforts by firms by providing 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. Proposed Supplementary Material .01 (Remuneration Accrued Prior to Effective Date of Sanction or Disqualification) to FINRA Rule 8311 also provides guidance to firms regarding permissible payments.

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

The proposed rule change was published for comment in *Regulatory Notice* 09-69 (December 2009) ("Notice"). Seven comment letters were received in response to the Notice.<sup>18</sup> A

copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Below is a summary of the comments and FINRA's responses.

Most commenters appreciated the intent of the proposed rule change to more directly align the rules on payments made by FINRA members to unregistered persons with SEC positions regarding broker-dealer registration requirements. However, the commenters had concerns with a number of the proposed changes. Specifically, the comments focused on the following issues: (a) The proposed deletion of NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 relating to payments to foreign finders; (b) the proposed adoption of FINRA Rule 2040(b) to replace NASD IM-2420-2 (Continuing Commissions Policy); (c) the proposed deletion of NASD Rule 2420(c) relating to transactions with foreign non-members; (d) the proposed deletion of NYSE Rule Interpretation 345(a)(i)/02 (Compensation Paid for Advisory Solicitations); (e) the potential regulatory burden of obtaining SEC no-action letters to determine whether particular activities would require registration as a broker-dealer; (f) the concern that the proposal does not recognize state law statutory exemptions for the payment of compensation in limited circumstances; and (g) the proposed amendments to FINRA Rule 8311 regarding payments to sanctioned persons.

As further discussed below, in light of the comments, 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 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).

### *(a) Foreign Finders (Proposed Deletion of NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03)*

In the Notice, FINRA proposed deleting NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 ("Existing Foreign Finders Rules"), which permit members to pay transaction-based compensation to nonregistered foreign finders under specified conditions. The Notice indicated that these largely identical rules would be deleted and the activity would be subject to the general requirement in proposed FINRA Rule 2040(a) that would require firms to look to SEC rules and regulations to determine whether the activity in question requires registration as a broker-dealer under Section 15(a) of the Exchange Act. Six commenters raised concerns regarding the proposed deletion of these rules and argued strongly that FINRA retain the Existing Foreign Finders Rules.<sup>19</sup> Specifically, the commenters stated that the proposed elimination of these rules would harm U.S. business by reducing competitiveness and that SEC guidance in this area is not clear and, therefore, the conditions set forth in the Existing Foreign Finders Rules provide necessary clarity to the industry.<sup>20</sup>

### *• Harm Business/Reduce Competitiveness*

Several commenters expressed concern regarding the potential harm to current business models if NASD Rule 1060(b) is eliminated.<sup>21</sup> One commenter stated that foreign "finders provide an important and necessary service in that they have introduced foreign customers to U.S. markets, which is consistent with the transition of the financial markets to be international in nature."<sup>22</sup> Another commenter stated that the proposed elimination of the standard established by the NASD and NYSE rules "may reduce the competitiveness of FINRA members outside the United States."<sup>23</sup> The commenter further stated that the rules present low risk to the securities markets and investors

Ramos, President, Monex Securities, to Marcia E. Asquith, Corporate Secretary, FINRA, dated January 29, 2010 ("Monex"); Daniel E. LeGaye, The LeGaye Law Firm P.C., received February 1, 2010 ("LeGaye Law"); Peter J. Chepucavage, Executive Director, CFAW, General Counsel, Plexus Consulting LLC, on behalf of the International Association of Small Broker-Dealers and Advisers, received February 1, 2010 ("Plexus"); Cliff Kirsch and Eric Arnold, Sutherland Asbill & Brennan LLP for The Committee of Annuity Insurers, to Marcia E. Asquith, Corporate Secretary, FINRA, dated February 1, 2010 ("CAI"); Ethan W. Johnson, Partner, Morgan, Lewis & Bockius LLP, to Marcia E. Asquith, Corporate Secretary, FINRA, dated February 1, 2010 ("Morgan Lewis"); and Rex A. Staples, General Counsel, North American Securities Administrators Association, Inc., to Marcia E. Asquith, Corporate Secretary, FINRA, dated February 16, 2010 ("NASAA").

<sup>18</sup> See comment letters from Everarado Vidaurre, Chief Executive Officer, Intercom Securities, Inc., received January 21, 2010 ("Intercom"); Jorge

<sup>19</sup> See Intercom, Monex, LeGaye Law, Plexus, Morgan Lewis and NASAA.

<sup>20</sup> See *supra* note 19.

<sup>21</sup> See Intercom, Monex, LeGaye Law and Morgan Lewis.

<sup>22</sup> See Monex.

<sup>23</sup> See Morgan Lewis.

because, according to the commenter, “the sole involvement of the referring foreign person is to make a referral to the member firm or to obtain execution, clearing or settlement services from such member and they do not permit broader contact with U.S. persons.”<sup>24</sup> Another commenter noted that the main activity in Miami and South Florida is to provide International Private Banking Services in the U.S. to non-U.S. citizens, primarily domiciled in Latin America, and elimination of the rules would “have a very negative impact in our industry, our labor market and to the U.S. economy as a whole.”<sup>25</sup> This commenter believed the proposal to eliminate the Existing Foreign Finders Rules would destroy completely the business model in which firms have been operating under for many years under NASD Rule 1060(b). Two commenters noted that foreign finders provide a valuable service to firms because they have an integral knowledge of their customers that are referred to firms, including suitability and investment needs.<sup>26</sup>

• *SEC Guidance Relating to Foreign Finder Relationships is Not Clear*

Four commenters noted that the SEC’s position on payments to foreign finders is not clear, and as such, will result in additional confusion for regulatory compliance professionals and members.<sup>27</sup> One commenter stated “that SEC rules and staff interpretations in this area are sparse and fact specific and do not give adequate guidance on the question when a non U.S. person is required to register with the SEC as a broker-dealer as a result of a relationship with a U.S. member firm.”<sup>28</sup> Two commenters noted that SEA Rule 15a–6 does not contemplate a foreign broker-dealer introducing its non-U.S. customers to a member to make recommendations and effect transactions on behalf of the customers, while simultaneously paying the foreign broker-dealer compensation for such referral.<sup>29</sup>

Several commenters urged FINRA to work with the SEC to develop comprehensive guidance on this matter.<sup>30</sup> One commenter noted that the existing framework provides adequate

protection to referred clients in the forms of additional disclosure mandated by the existing rules.<sup>31</sup> Other commenters noted that foreign finders are subject to regulation in their respective countries.<sup>32</sup> One commenter recommended that FINRA “ask that the [C]ommission clarify its position including the numerous no-action letters issued over the last 30 years . . . it would help the investment community understand the current status of the issue and may inform the [C]ommission as to how widespread a problem exists.”<sup>33</sup>

• *Existing Foreign Finders Rules Provide Necessary Clarity*

Several commenters expressed concern that the proposed elimination of the Existing Foreign Finders Rules would eliminate rules that the industry has relied on for decades to pay transaction-based compensation to foreign finders.<sup>34</sup> One commenter stated that the Existing Foreign Finders Rules have “generally allowed FINRA members, under the enumerated conditions, to pay transaction-based compensation to a non-U.S. finder that solicits non-U.S. business for the member.”<sup>35</sup> The same commenter further stated that “there were a number of critical components that had to be met with respect to the rule, two of the fundamental conditions with respect to the payment of compensation to a foreign finder was: (1) That the foreign finder limit its activities so that the finder was not required to register in the U.S. as a broker-dealer; and (2) that the compensation arrangement not violate applicable foreign law.” As a result, the commenter contended that “FINRA member firms should be able to rely on clear guidance with respect to these activities, and the current rules gave that guidance to members.”<sup>36</sup> Another commenter stated that “the existing rules with respect to foreign referrals and dealing with non-member firms are helpful and provide adequate protection to foreign customers that are referred to FINRA members.”<sup>37</sup>

• *FINRA Response to Comments on Existing Foreign Finders Rules*

In response to the commenters’ concerns, FINRA is proposing to adopt the Existing Foreign Finders Rules, with minor technical changes, as new FINRA Rule 2040(c) in the Consolidated FINRA Rulebook. As in the current rule, a

member could pay transaction-related compensation to nonregistered foreign finders where the finders’ sole involvement is the initial referral to the member of non-U.S. customers to the member, and the member complies with all the conditions set forth in the rule.

(b) *Continuing Commission Payments to Retiring Registered Representatives (Proposed FINRA Rule 2040(b)(2))*

Proposed Rule 2040(b)(2) would permit FINRA members to pay continuing commissions to retiring registered representatives of the member after they cease to be associated with the member 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 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, SEA rules and regulations. In the *Notice*, the proposed rule included text that provided that the arrangement also must comply with “published guidance issued by the SEC or its staff in the form of releases, no-action letters or interpretations.” Based on concerns raised by commenters described hereinafter, FINRA has deleted this language from the proposed rule text in this rule filing.<sup>38</sup> However, FINRA believes that members should review applicable SEC and SEC staff guidance in the form of releases, no-action letters and interpretations because they contain helpful interpretative information regarding the Commission’s and the SEC staff’s views on the application of SEA rules and regulations.

One commenter stated it is unclear whether the proposal is intended to add any substantive restrictions or requirements, or if it merely forbids members from making payments that are already otherwise prohibited.<sup>39</sup> The commenter noted that FINRA members are already subject to SEC rules and regulations, so FINRA rules containing blanket references to SEC rules and published guidance is problematic, especially when SEC guidance is extremely fact specific. The commenter further states “such positions do not allow for the notice and comment period that accompanies formal rulemaking and, would in effect give such positions the force and effect of a

<sup>24</sup> See Morgan Lewis. As noted above, if a foreign finder’s activities go beyond an initial referral of non-U.S. customers to the member, the foreign finders provisions in proposed FINRA Rule 2040(c) would not be applicable.

<sup>25</sup> See Monex.

<sup>26</sup> See Monex and LeGaye Law.

<sup>27</sup> See Intercam, Monex, LeGaye Law and Morgan Lewis.

<sup>28</sup> See Morgan Lewis.

<sup>29</sup> See Monex and LeGaye Law.

<sup>30</sup> See Monex, LeGaye Law and Morgan Lewis.

<sup>31</sup> See Morgan Lewis.

<sup>32</sup> See Monex and LeGaye Law.

<sup>33</sup> See Plexus.

<sup>34</sup> See Intercam, Monex, Morgan Lewis and LeGaye Law.

<sup>35</sup> See Monex.

<sup>36</sup> See *supra* note 35.

<sup>37</sup> See Morgan Lewis.

<sup>38</sup> See CAI.

<sup>39</sup> See *supra* note 38.



rule.”<sup>40</sup> The same commenter further requested clarification from FINRA that a retiring registered representative who receives compensation payable under a group variable annuity contract may receive compensation on individuals who become certificate holders under such contract after the registered representative has retired.

Another commenter raised concerns regarding the open-ended nature of this provision.<sup>41</sup> The commenter expressed concern regarding the extent of hidden fee arrangements between shadow parties who trade consumers’ accounts and questioned, “[h]as there been consideration as to potential trigger points wherein these types of post ‘retirement’ payment pose potential and/or actual conflicts of interest, the dangers to the underlying account holder whose assets are being used to generate fees that are split by multiple parties, and is full disclosure to consumers being provided?”<sup>42</sup>

FINRA believes that the SEC guidance in this area combined with current FINRA guidance are accurately summarized in the proposal and, as such, declines to make any substantive changes to the proposal. Guidance regarding the permissibility of payments to retiring registered representatives primarily focuses on compliance with Section 15(a) of the Exchange Act. In November 2008, the staff of the Division of Trading and Markets of the Commission issued a no-action letter in which it stated that it would “not recommend enforcement action to the Commission under Section 15(a) of the Securities Exchange Act of 1934 against a retiring representative of a registered broker-dealer (“Firm”) if the retiring representative, the Firm, and the receiving representative, comply with the terms and conditions described in [the] letter, without the retiring representative maintaining his or her status as a registered associated person of the Firm upon retirement.”<sup>43</sup> The no-action letter was based on the use of procedures described in the letter with respect to the circumstances by which a retiring representative may be compensated after the termination of employment for business done by or through his or her employer before the termination of employment. The staff of the Division of Trading and Markets has issued several other prior no-action

letters regarding payments to retiring registered representatives.<sup>44</sup>

Consistent with such SEC no-action letters, FINRA has issued guidance in the form of interpretative letters under NASD IM-2420-2 that specifically notes that members need to be aware of SEC no-action letters that address the conditions under which a former, retired registered representative, who is no longer employed by a broker-dealer, may continue to receive commissions without being required to register as a broker-dealer under Section 15 of the Exchange Act.<sup>45</sup> Such FINRA interpretative letters have expressly stated that “[t]he determination of whether a person should be registered as a broker/dealer rests with the Securities and Exchange Commission (the “SEC”). In this regard, [the firm] may wish to direct [its] inquiry to the SEC’s Division of [Trading and Markets] for guidance. To the extent that [the member] receives no-action relief from the SEC to make such payments, [the member’s] payment of continuing commissions to [the retiring registered representative] would not violate NASD Rule 2420 so long as the requirements of NASD IM-2420 are satisfied.”<sup>46</sup>

*(c) Transactions with Foreign Non-Members (Proposed Deletion of NASD Rule 2420(c))*

NASD Rule 2420(c) generally provides that payments can be made to any non-member broker-dealer in a foreign country who is not eligible for membership in a registered securities association provided that, in any transaction with any such non-member broker-dealer where a selling concession, discount, or other allowance is allowed, the member making the payment secures from the foreign broker-dealer an agreement that, in making any sales to purchasers within the U.S. of securities acquired as a result of such transactions, the foreign broker-dealer will comply with paragraphs (a) and (b) of NASD Rule 2420 to the same extent the member must in connection with the transaction.

One commenter stated that “[w]hile this rule does not expressly address the relationship between U.S. clearing firms and their non-U.S. correspondents, it is frequently cited as confirmation that the FINRA rules permit members to enter into a variety of clearing and sub-clearing agreements and other brokerage

arrangements with foreign non-members and to share fees or pay other forms of compensation without requiring the foreign firms or their personnel to register with the SEC.”<sup>47</sup> The same commenter recommended that NASD Rule 2420(c) be retained in its current form, but suggested one clarification whereby the “eligible for membership in a national securities association” is changed to “not being required to be a registered broker-dealer in the United States and member of a national securities association,” because the commenter believed it is difficult to determine when a foreign firm would not be eligible for membership and further eligibility is not a relevant determinant of whether a foreign firm should register. In the alternative, assuming the Existing Foreign Finders Rules and NASD Rule 2420(c) are not retained in their current forms, the same commenter recommended the following changes to the proposed rule text: (i) Eliminate “or offer to pay” from the introductory clause in paragraph (a) since determining whether and when an offer to pay has been made would add a level of subjectivity that would undercut the effort to bring clarity to this area; (ii) eliminate “appropriately” from the beginning of paragraph (a)(2) as a requirement in the paragraph will need to be satisfied even if the person is “inappropriately” registered (if, according to the commenter, that is even possible); and (iii) narrow the scope of the pre-conditions in paragraph (a)(2) to just those of verifying that the person is registered and not subject to any statutory disqualifications, as the burden of checking all the laws, rules and regulations cited in the proposed rule will be a strong disincentive against members ever making such payments.<sup>48</sup>

FINRA declines to retain NASD Rule 2420(c) because, as discussed in detail above, proposed FINRA Rule 2404(a) 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 persons to receive transaction-related compensation. In this regard, FINRA notes the commenter’s suggestion that, if FINRA were to retain NASD Rule 2420(c), FINRA should replace the phrase “eligible for membership in a national securities association” with “not being required to be a registered broker-dealer in the United States and member of a national securities association.” FINRA believes that proposed FINRA Rule 2404(a) is consistent with such

<sup>40</sup> See *supra* note 38.

<sup>41</sup> See NASAA.

<sup>42</sup> See *supra* note 41.

<sup>43</sup> See *supra* note 10.

<sup>44</sup> See SEC No-Action Letters: Gruntal & Co., L.L.C., 1998 SEC No-Act. LEXIS 1146, October 14, 1998, Prudential Securities Incorporated, 1994 SEC No-Act. LEXIS 750, October 11, 1994 and Shearson Lehman Brothers Inc., 1993 SEC No-Act. LEXIS 548, March 25, 1993.

<sup>45</sup> See *supra* note 9.

<sup>46</sup> See *supra* note 9.

<sup>47</sup> See Morgan Lewis.

<sup>48</sup> *Id.*



recommendation. FINRA further does not agree with the commenter's implication that NASD Rule 2420(c) can validly be used as confirmation that FINRA rules permit members to enter into a variety of brokerage arrangements with foreign non-members and to share fees or pay other forms of compensation without requiring the foreign firms or their personnel to register with the SEC. FINRA is considering guidance on circumstances where such arrangements may comply with FINRA rules.

FINRA also declines to eliminate the word "appropriately" and to narrow the scope of the pre-conditions in proposed FINRA Rule 2040(c) to require that the member only determine that a person receiving transaction-related compensation is registered and not subject to any statutory disqualification because FINRA believes that members need to determine that the person receiving the transaction-related compensation is registered in the appropriate category necessary to receive the type of compensation being paid, and that the payments are permissible under applicable laws, consistent with SEC guidance in this area. In response to the commenter, however, FINRA is proposing to eliminate the phrase "or offer to pay" from proposed FINRA Rule 2040(a) as it agrees that the language may add uncertainty and subjectivity to the proposed rule and is not needed to achieve the regulatory purpose of the proposed rule.

*(d) Compensation Paid for Advisory Solicitations (Proposed Deletion of NYSE Rule Interpretation 345(a)(i)/02)*

One commenter stated "there has been substantial confusion related to the regulation of broker-dealers and investment advisers that were dually registered with the SEC ('Dual Registrants') in recent history."<sup>49</sup> The commenter stated that members face uncertainty where definitions or guidelines differ between the Investment Advisers Act and the Exchange Act, and by proposing to eliminate NYSE Rule Interpretation 345(a)(i)/02, FINRA is creating further confusion for Dual Registrants. NYSE Rule Interpretation 345(a)(i)/02<sup>50</sup>

generally provides that a broker-dealer that is registered with the SEC as an investment adviser under the Investment Advisers Act may enter into arrangements that comply with Rule 206(4)-3 (Cash Payments for Client Solicitations) of the Investment Advisers Act, and that such arrangements will not be deemed contrary to the registration requirements of NYSE Rule 345.<sup>51</sup> The commenter stated, for example, that while Rule 206(4)-3 of the Investment Advisers Act allows for the cash payment to a solicitor under certain circumstances, the proposal would require the payment to comply with all applicable federal securities laws, including FINRA rules.<sup>52</sup>

FINRA does not believe that it is necessary to retain the content of NYSE Rule Interpretation 345(a)(i)/02. It is FINRA's view that proposed FINRA Rule 2040 does not narrow the scope of Rule 206(4)-3 under the Investment Advisers Act, which applies to cash payments by investment advisers for client solicitations for advisory business. Where Rule 206(4)-3 payments to an investment adviser by a dually registered broker-dealer do not require the solicitor to register under Section 15(a) of the Exchange Act, proposed FINRA Rule 2040 would continue to permit them. The question of whether activities permissible under Rule 206(4)-3 under the Investment Advisers Act would require the solicitor to be registered as a broker-dealer under Section 15(a) of the Exchange Act is determined by the SEC.<sup>53</sup>

*(e) Burden of Obtaining SEC No-Action Relief*

Two commenters raised concerns regarding the requirement in proposed FINRA Rule 2040 to look to SEC no-action letters to determine compliance

to check on the applicability of any state registration requirements for member organizations and associated persons."

<sup>51</sup> See Rule 206(4)-3 (Cash Payments for Client Solicitations) of the Investment Advisers Act, which generally makes it unlawful for any investment adviser that is required to be registered under the Investment Advisers Act to pay a cash fee, directly or indirectly, to a solicitor with respect to solicitation activities unless certain specified conditions are met.

<sup>52</sup> See *supra* note 49.

<sup>53</sup> See Mayer Brown LLP, 2008 SEC No-Act. LEXIS 515, July 15, 2008 and Response of the Office of Chief Counsel, Division of Investment Management, 2008 SEC No-Act. LEXIS 524, July 28, 2008, which state that "[Firm has] not asked, and this letter does not address, whether a person's receipt of cash compensation from an investment adviser of an investment pool for soliciting or referring investors or prospective investors to invest in the pool would result in the person being considered a 'broker' under Section 3(a)(4) of the Securities Exchange Act of 1934."

with Section 15(a) of the Exchange Act.<sup>54</sup> Specifically, one commenter stated "FINRA is placing additional regulatory uncertainty on FINRA member firms and further hampering their efforts to obtain meaningful compliance."<sup>55</sup> Several commenters were concerned that it will be expensive and cumbersome to seek no-action relief and such no-action relief would be subject to continuous revision.<sup>56</sup> In addition, one commenter raised concerns that since there is no "reasonable belief" standard for reliance on specific SEC no-action relief, members will need to hire attorneys to support their positions that the SEC rules, regulations and other guidance are applicable to their arrangement.<sup>57</sup> Moreover, the commenter stated that the SEC has declined to consider the matter in prior no-action letters, noting that the SEC does not as "a matter of practice," provide no-action relief in this context and questioned how a firm can meaningfully comply with the proposed rule.<sup>58</sup>

FINRA believes that interpretation of Section 15(a) of the Exchange Act is a critical component in determining whether payments to unregistered persons are permissible under the federal securities laws. FINRA acknowledges that while Section 15(a) of the Exchange Act does not specifically address the numerous and varying arrangements that may exist with respect to payments to unregistered persons, SEC guidance is controlling in this area.

As described in Item 3 above, 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 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. Members can derive support for their 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

<sup>54</sup> See Monex and LeGaye Law.

<sup>55</sup> See Monex.

<sup>56</sup> See Monex, LeGaye Law, Morgan Lewis and NASAA.

<sup>57</sup> See *supra* note 55.

<sup>58</sup> See *supra* note 55.

<sup>49</sup> See LeGaye Law.

<sup>50</sup> NYSE Rule Interpretation 345(a)(i)/02 (Compensation Paid for Advisory Solicitations) reads as follows: "A member organization, registered with the SEC as an investment adviser, may enter into any arrangement that fully complies with Rule 206(4)-3 ('Cash Payments for Client Solicitations') of the Investment Advisers Act of 1940. Such arrangements will not be deemed contrary to the registration requirements of Rule 345 (see also Rule 10 'Definition of Registered Representative'). Member organizations are advised

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.

*(f) Proposal Does Not Recognize State Law Exemptions*

One commenter expressed concern that the proposal does not address those FINRA members that engage in primarily an intra-state business, and the state of their domicile recognizes statutory exemptions for the payment of compensation in limited circumstances for certain finders.<sup>59</sup> FINRA acknowledges that state rules and regulations may permit different types of payment arrangements, and where such payments are permissible under the federal securities laws and SEC rules, regulations or guidance, such payments would be in compliance with proposed FINRA Rule 2040.

*(g) Payments to Sanctioned Persons (FINRA Rule 8311)*

The proposed rule change prohibits FINRA members from allowing persons subject to suspension, revocation, cancellation of registration, bar from association with a member or other disqualification to be associated with the member in any capacity inconsistent with the sanction. The proposal also would prohibit payment to a person during the period of sanction or anytime thereafter if the payment might accrue during the time of sanction.

One commenter believed the proposal is unclear as to whether registered representatives subject to sanctions would be permitted to continue to receive compensation earned as a result of automatic payments to a variable annuity contract made during the period of sanction.<sup>60</sup> The commenter recommended that registered representatives be permitted to receive these automatic payments, where such payments were arranged for during a time period that preceded the sanctions.

FINRA believes that proposed Supplementary Material .01 (Remuneration Accrued Prior to Effective Date of Sanction or Disqualification) to FINRA Rule 8311 addresses this question. Proposed Supplementary Material .01 provides that a member can pay or credit a

person subject to a sanction salary, commission, profit or other remuneration that the member can evidence accrued to the person prior to the effective date of the sanction, unless such remuneration relates to results from the activity giving rise to the sanction. Accordingly, a member would need to demonstrate that the remuneration accrued prior to the effective date of the sanction in order to pay or credit the remuneration to the sanctioned individual.

The commenter also requested that FINRA clarify that the sanctions identified under the proposal do not in any way impact the current FINRA rules and guidance regarding registered representatives who are deemed to be "inactive" due to failure to complete the regulatory element of continuing education requirements in a timely manner under NASD Rule 1120 (now FINRA Rule 1250).<sup>61</sup> FINRA notes that the proposal is not intended to alter existing guidance under FINRA Rule 1250 with respect to registered representatives who are deemed to be "inactive" due to failure to complete the regulatory element of continuing education requirements in a timely manner.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2014-037 on the subject line.

#### *Paper Comments*

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2014-037. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2014-037 and should be submitted on or before October 22, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>62</sup>

**Kevin M. O'Neill,**

*Deputy Secretary.*

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**BILLING CODE 8011-01-P**

<sup>61</sup> The SEC approved the adoption of NASD Rule 1120 (Continuing Education Requirements) as new FINRA Rule 1250 (Continuing Education Requirements), subject to certain amendments, effective on October 17, 2011. See Securities Exchange Act Release No. 64687 (June 16, 2011); 76 FR 36586 (June 22, 2011) (Order Approving File No. SR-FINRA-2011-013).

<sup>62</sup> 17 CFR 200.30-3(a)(12).

<sup>59</sup> See LeGaye Law.

<sup>60</sup> See CAI.