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SEC Requests Comment on Proposed FINRA Rules Regarding Payments to Unregistered Persons

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On September 25, 2014, the U.S. Securities and Exchange Commission (the “SEC”) solicited public comment on proposed FINRA rule changes (the “proposal”) that would substantively amend existing NASD and NYSE rules regarding payments to unregistered persons.¹ Notably, the proposal would preserve important existing NASD and NYSE exemptions for payments to non-U.S. finders.

History of the Proposal: Regulatory Notice 09-69

In Regulatory Notice 09-69,² FINRA, as part of its rulebook consolidation process, proposed to replace the handful of NASD and NYSE rules and interpretations governing payments to unregistered persons³ with a single rule, which was intended to provide more streamlined regulation, leveraging the broker-dealer registration requirement of Section 15(a) of the U.S. Securities Exchange Act of 1934 (the “Exchange Act”) and related SEC guidance.

¹ The SEC’s solicitation of public comment is available at <http://www.sec.gov/rules/sro/finra/2014/34-73210.pdf>.

² FINRA Regulatory Notice 09-69 is available at <https://www.finra.org/Industry/Regulation/Notices/2009/P120481>.

³ These rules and interpretations include NASD Rule 2410 (prohibition on extending concessions or discounts to persons not in the investment banking or securities business), NASD Rule 2420 (prohibition on dealing with non-members except on terms accorded to the general public), IM-2420-1 (providing definitions and clarification relevant to, and exemptions from, NASD Rule 2420), IM-2420-2 (continuing commissions), and NASD Rule 1060(b) (permitting payments to non-U.S. finders subject to conditions). Among legacy NYSE rules, prohibitions are found at NYSE Rule 353 (rebates and compensation), NYSE Rule Interpretation 345(a)(i)/01 (compensation to non-registered persons), NYSE Rule Interpretation 345(a)(i)/02 (cash payments for client solicitations), and NYSE Rule Interpretation 345(a)(i)/03 (compensation to non-registered non-U.S. finders).

The (then) proposed rule would prohibit payments to any non-registered person who by virtue of the receipt of such payment would be required to register with the SEC as a broker-dealer.

The rule proposed in Regulatory Notice 09-69 would have eliminated the exemptions permitting payments to non-U.S. finders found in NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 (the “non-U.S. finder exemptions”).

The Revised 2014 Proposal

In September 2014, FINRA filed the proposal with the SEC, which filing contained some important changes to the rules first proposed in Regulatory Notice 09-69. The most notable aspects of the current proposal are described below.

Payments to Unregistered Persons

The proposal retains the general approach proposed in Regulatory Notice 09-69, eliminating the existing NASD and NYSE rules and interpretations on payments to unregistered persons in favor of referencing the Exchange Act registration requirement in proposed Rule 2040(a). However, FINRA heeded commenters’ concerns and incorporated the non-U.S. finder exemptions into the proposal as proposed Rule 2040(c). Specifically, proposed Rule 2040 provides the following:

- 2040(a): prohibits any associated person from paying any compensation, fees, concessions, discounts, commissions or other allowances to any unregistered person who would be required to register as a broker-dealer under Section 15(a) of the Exchange Act by reason of receipt of any such payments.
- 2040(c): incorporates, with non-substantive technical revisions, the non-U.S. finder exemptions, providing that a FINRA member may pay to a non-U.S. finder transaction-related compensation if certain conditions are met:
 - 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 statutory disqualification, and has further assured itself that the compensation arrangement does not violate applicable non-U.S. law;⁴
 - the finder is a non-U.S. national or non-U.S. entity domiciled abroad;
 - the customers are non-U.S. nationals or non-U.S. entities domiciled abroad transacting business in either non-U.S. or U.S. securities;
 - customers receive a descriptive document, similar to that required by Rule 206(4)-3(b) of the U.S. Investment Advisers Act of 1940 (the “Advisers Act”), that discloses what compensation is being paid to finders;
 - 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;
 - 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,
 - the confirmation of each transaction indicates that a referral or finder fee is being paid pursuant to an agreement.

⁴ The requirement that the non-U.S. finder not be subject to a statutory disqualification was part of NASD Rule 1060(b), but not NYSE Rule Interpretation 345(a)(1)/03.

Consideration of Comments

Although FINRA generally heeded industry concerns with respect to the non-U.S. finder exemption, FINRA declined one commenter's request to preserve the substance of NYSE Rule Interpretation 345(a)(i)/02, which permits FINRA members that are also registered investment advisers to make cash payments to solicitors that comply with Rule 206(4)-3 of the Advisers Act. If the proposal is adopted, such payments will be subject to the determination required by proposed Rule 2040(a) as to whether broker-dealer registration would be required by the recipient due to such payment.

Commenters also noted the difficulty of determining whether the receipt of a payment would require broker-dealer registration, given that SEC guidance in no-action letters is necessarily fact-specific. In its SEC submission, FINRA proposed to adopt Supplementary Material .01 to proposed Rule 2040. Supplementary Material .01, captioned "Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act," provides that FINRA members can derive support for their determination by relying on published SEC releases, no-action letters, and interpretations; by obtaining an SEC no-action letter; or by obtaining a legal opinion from US legal counsel.⁵

Payments to Retiring Representatives

Proposed Rule 2040(b) would replace existing rules and guidance regarding payments to retired representatives. The proposed rule permits payments of continuing commissions to retiring registered representatives, provided that:

- there is a bona fide contract between the FINRA member and the retiring registered representative providing for the payments that was entered into in good faith while the person was a registered representative of the member and such contract prohibits the retiring registered representative from soliciting new business, opening new accounts, or servicing the accounts generating the continuing commission payments; and,
- the arrangement complies with applicable federal securities laws, Exchange Act rules, and Exchange Act regulations.

In Regulatory Notice 09-69, FINRA proposed 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." In response to comments, FINRA has deleted this language from the proposed rule text in the proposal, but the relevant SEC no-action guidance remains applicable to SEC-registered broker-dealers.⁶

⁵ Given the fact-specific nature of previously published SEC no-action letters, FINRA members will need to consider whether it may be necessary to seek specific no-action relief or a legal opinion of U.S. legal counsel. It is not clear if in practice a formal legal opinion will be required to comply with Supplementary Material .01, or if a memorandum stating advice of counsel will be sufficient.

⁶ In the SEC Staff's no-action letter to SIFMA of Nov. 20, 2008, the Staff provided no-action relief from registration requirements if certain procedures are followed with respect to payments to retiring representatives, which procedures require the representative's continuous association with the firm or a team for a threshold number of years, absence of statutory disqualification, low incidence of certain customer complaints, arbitration or litigation, prohibition of solicitation of former clients, prohibition on association with any broker-dealer, investment adviser, investment company and certain other entities, a written annual certification by the retiring representative of compliance with all procedures, and the firm's confirmation with a sample of account holders that the retiring representative has not solicited them. *Packerland Brokerage Services* (Mar. 18, 2013) provides that the no-action relief of *SIFMA* can apply to new accounts opened by a continuing customer of a retiring representative.

Amendments to FINRA Rule 8311 Regarding Effect of Sanctions, Including on Compensation of Sanctioned Persons

FINRA Rule 8311 creates certain obligations for members with respect to associated persons who are suspended, revoked, cancelled, barred or otherwise disqualified, including ensuring that the person's association with the member is consistent with such sanction, and with respect to payments made to such person. The proposal would amend the rule by providing that:

- The rule is not limited to sanctions imposed by the SEC and FINRA;
- Other disqualifications, not just suspensions, revocations, cancellations or bars, are subject to the rule;
- 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 in a clerical or ministerial capacity, not only "remain" associated (as is the formulation in current FINRA Rule 8311);
- 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
- The rule applies to any salary, commission, profit or remuneration that the associated person might have "accrued," not just "earned" during the period of a sanction or disqualification, not just suspension.

The proposal also adds a new paragraph to Rule 8311 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. In addition, FINRA is proposing to add new Supplementary Material .01 to Rule 8311 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, provided that the member can show that the payment 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.

Conclusion

The SEC's review of the proposal includes a public comment period that will conclude on October 22, 2014.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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