

NASD NOTICE TO MEMBERS 97-11

NASD Regulation
Requests Comment On
Proposed Rule Restricting
Payment Of Referral Fees
By NASD Members;
**Comment Period
Expires April 30, 1997**

Suggested Routing

- Senior Management
- Advertising
- Corporate Finance
- Government Securities
- Institutional
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- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registration
- Research
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- Systems
- Trading
- Training

Executive Summary

In the following document, NASD Regulation, Inc. (NASD RegulationSM) requests comment on new NASD[®] Rule 2460 that would restrict the payment of “finders” or referral fees by NASD members to unregistered third parties for the referral of retail business.

Questions concerning this Request For Comment should be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325; or Mary N. Revell, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8203.

Request For Comment

The NASD encourages all interested parties to comment on the proposed new Rule. Comments should be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com.

Comments must be received **by April 30, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

NASD REGULATION REQUEST FOR COMMENT 97-11

Executive Summary

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Background

On December 28, 1995, the NASD filed with the Securities and Exchange Commission (SEC) a proposed rule change that specifies requirements for broker/dealer conduct on the premises of a financial institution (proposed bank broker/dealer rule).¹ The purpose of the proposed bank broker/dealer rule was to address concerns about customer confusion over the distinction between the insured products of financial institutions and the uninsured securities products of broker/dealers operating on the premises of financial institutions and to provide a regulatory framework for regulating bank broker/dealer activities.

The SEC published the proposal in the *Federal Register* on March 22, 1996, requesting comments by May 21, 1996.² The SEC received 87 comments on the proposed bank broker/dealer rule, many of which objected to the referral fee provision in the rule. That provision would have prohibited members from paying referral fees to employees of a financial institution who are not registered with an NASD member in connection with locating, introducing, or referring customers of the

financial institution to the member. The commenters objected to the provision as anti-competitive, since it would have applied only to brokerage operations on the premises of a financial institution. As a result, the provision regarding referral fees has been deleted from the proposed bank broker/dealer rule, and the NASD Regulation Board of Directors (Board) has approved the solicitation of comment on a proposed referral fee rule that would apply to all NASD members.

The NASD believes that it is important to be able to regulate the flow of securities-related compensation from its members to unregistered persons in connection with the solicitation of securities transactions. Therefore, the NASD consistently has taken the position in published interpretations that it is improper for a member or a person associated with a member to make payments of “finders” or referral fees to third parties who introduce or refer prospective brokerage customers to the firm, unless the recipient is registered as a representative of an NASD member firm.³ This position is based on the definition of “representative” in the NASD rules and the definition of “associated person” in the NASD By-Laws. In particular, Rule 1031(b) defines a representative of a member firm as:

[A person] associated with a member ... who [is] engaged in the investment banking or securities business for the member including the functions of supervision, **solicitation** or conduct of business in securities. (Emphasis added.)

The NASD By-Laws define a “person associated with a member” as “any natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by such member...”⁴

The NASD interprets these provisions to mean that persons who introduce or refer prospective customers and receive compensation for such activities are engaged in the securities business for the member in the form of solicitation.⁵ NASD disciplinary decisions have stated that solicitation is the first step in the consummation of a securities transaction and must be regarded as part of the conduct of business in securities.⁶ NASD Regulation believes that persons who receive compensation from a member for soliciting securities transactions are engaged in the securities business under the control of a member firm and should be subject to NASD qualification and registration requirements.

Although the NASD, on an informal basis, has permitted “one-time” fees not tied to the completion of a transaction or the opening of an account, it has consistently taken the position that the activities of locating, introducing, or referring potential retail customers come within the definition of representative and that persons who receive compensation for performing such activities are acting on behalf of the member and should be registered with the firm. The NASD has stated that the following situations raise the presumption that a finder should be registered:

- The finder repeatedly refers prospective customers to the member;
- The finder makes a sales pitch or a recommendation concerning the investment purchased;
- Direct transaction-based compensation is paid to the finder.⁷

The SEC also has taken a position on the regulatory obligations associated with the acceptance of referral fees. Over the years, the SEC has established, through “no action letters,” an

exemption from broker/dealer registration requirements under the Securities Exchange Act for individuals whose function is that of a “finder.” This exemption is usually conditioned upon representations that the “finder” will have no involvement in negotiations, will not discuss details or make recommendations regarding securities transactions, and will not receive transaction-based compensation.⁸ Although it might be argued that an individual who does no more than refer or introduce a prospective retail customer to a broker/dealer is performing essentially the same function, the NASD always has taken the position that this function is encompassed by the definition of “representative,” particularly where compensation is involved.

The NASD has received a large number of inquiries regarding the propriety of paying referral fees to third parties who introduce or refer prospective brokerage customers to the firm, including questions about whether such payments may be made to bank employees. To clarify the NASD’s position and make it available to all members, the Board has approved the solicitation of comment on the proposed rule.

Description

The proposed new referral fee rule, NASD Rule 2460, would prohibit a member or a person associated with a member from paying cash or non-cash compensation to any person (other than persons who are registered with the member or persons who are themselves NASD members) in connection with locating, introducing, or referring prospective brokerage account customers to the member. As drafted, the Rule would apply to payments directed to any “person.” NASD Rule 0120(j) defines the term “person” to include “any natural person, partnership, corporation, association, or other legal

entity.” Because only natural persons can be associated persons and thus subject to the requirement to register with a member firm, comment is requested on whether the Rule should be limited in application to payments to natural persons for referrals of retail brokerage business.

The proposed Rule prohibits both direct and indirect referral pay payments. Thus, the Rule prohibits both compensation through payments made directly to an unregistered person as well as payments made indirectly to an individual or an organization that are specifically earmarked for subsequent payment to an unlicensed person. The proposed Rule would not, however, prohibit non-NASD member financial institutions from paying referral fees to their own employees as permitted by the Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994).

The proposed Rule differs from the published interpretation described above by not including an exception from the prohibition for the payment of a nominal fee for a referral where the payment is occasional, not determined by the outcome of the referral, and where the recipient does not regularly engage in activity that might reasonably be expected to result in continued referrals.⁹ NASD Regulation preliminarily does not believe that there is a need for such an exception for a rule that is limited in application to referrals of brokerage account customers. Comment is requested on whether such an exception is necessary and, if so, what types of payments should be permissible under the exception.

NASD Regulation believes that it is important to be able to regulate the flow of compensation related to securities transactions from its members to unregistered persons, and that compliance with a referral fee rule,

as described above, would significantly reduce the risks attendant to the solicitation of securities transactions by unregistered persons.

Request For Comment

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Comments must be received by **April 30, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

Text Of Proposed Rule

(Note: All language is new.)

Rule 2460. Referral Fees

No member or person associated with a member shall, directly or indirectly, give or permit to be given cash or non-cash compensation to any person (other than persons registered with the member and other members) in connection with locating, introducing, or referring prospective brokerage account customers to the member.

Endnotes

¹ File No. SR-NASD-95-63.

² Release No. 34-36980; 61 FR 11913.

³ See *NASD Notice to Members 89-3*; *NASD Guide to Rule Interpretations* (May 1994), p. 108.

⁴ Article I(9).

⁵ See note 3, *supra*.

⁶ See, e.g., *In the Matter of District Business Conduct Committee for District No. 2 vs. Hanmi Securities et al.* (National Business Conduct Committee Decision, May 9, 1996).

⁷ *NASD Guide to Rule Interpretations* (May 1994), p. 108.

⁸ See, e.g., International Business Exchange Corp., SEC No-Action Letter (December 12, 1986); Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter (July 9, 1987). *But see* Charles Schwab & Co., Inc., SEC No-Action Letter (November 27, 1996).

⁹ See *NASD Guide to Rule Interpretations, supra*, note 3: "On an informal basis, the [NASD] has permitted 'one time' fees not tied to the completion of a transaction or opening of an account." See also *Notice to Members 89-3, supra* note 3. The rule proposed in *Notice to Members 89-3* would have permitted members "to pay fixed fees for referrals on an occasional basis, provided that the fee is minimal and neither the entitlement to nor the amount of the fees are linked to the opening of an account, the execution of transactions, the volume of business, or in any other way tied to the outcome of the referral."

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