BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Respondent.	DECISION Complaint No. CAF030014 Dated: October 12, 2007

Member firm found not liable for sharing profits with customers in violation of NASD Rules 2330 and 2110. Held, findings affirmed.

Appearances

For the Complainant: David R. Sonnenberg, Esq., Lane A. Thurgood, Esq., and Jeffrey P. Bloom, Esq., Department of Enforcement, FINRA.[1]

For the Respondent: Allan A. Martin, Esq., Theodore N. Mirvis, Esq., David Gruenstein, Esq., and George T. Conway III, Esq., Wachtell, Lipton, Rosen & Katz

1 As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA shall include, by reference and where appropriate, references to NASD.

Decision

Pursuant to NASD Rule 9312(a)(1), we called for review a March 3, 2006 Hearing Panel decision. In this decision, the Hearing Panel found that FINRA's Department of Enforcement ("Enforcement") failed to prove by a preponderance of the evidence that a FINRA member firm ("Respondent" or the "Firm") violated Rule 2330 ("Rule 2330") by sharing profits with its customers. The scope of our call for review is limited to considering the Hearing Panel's construction of the term "profits" under Rule 2330.

Specifically, we focus our review on two legal conclusions made by the Hearing Panel. First, we question whether Rule 2330 requires that the allegedly shared profits be "realized" profits within the customer's account. Second, we question whether Rule 2330 requires that the profits shared with the member be paid to the member from funds "within" the customer's account.

After a thorough consideration of these issues, we find that the Hearing Panel's construction of the term "profits" was erroneous. We, however, do not disturb the Hearing Panel's finding that Enforcement failed to prove by a preponderance of the evidence that the Firm violated Rule 2330.

I. Background

The Firm is a broker-dealer located in New York City and has been an FINRA member since August 1971. From October 1, 1999, to March 31, 2000, the Firm participated in the underwriting of several initial public offerings ("IPOs"). During this period, the Firm allocated IPO shares to a number of its customers.[2]

It is industry practice for broker-dealers like the Firm to allocate IPO shares to their best customers. Broker-dealers traditionally determine who their best customers are by measuring the aggregate commissions paid by the customer. Customers that do a substantial volume of business typically generate the highest aggregate commissions and are therefore considered to be the best customers. Customers that do not trade in large volumes, however, often pay higher commission rates in order to increase their aggregate commissions and their chances of receiving IPO shares.

This case stems from Enforcement's investigation into whether the Firm wrongfully obtained higher than normal commission rates from its customers in exchange for allocations of IPO shares.

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[2] Enforcement's investigation of the Firm focused on 695 transactions involving IPO allocations to approximately 35 of the Firm's customers.

II. Procedural History

On April 15, 2003, Enforcement filed a six-cause complaint against the Firm. The first cause of the complaint, and the only one relevant to our discussion, alleged that the Firm violated Rule 2330 by accepting higher than normal commission rates from its customers in exchange for allocations of IPO shares.[3]

On May 23, 2003, the Firm filed an answer denying any wrongdoing and requested a hearing.[4] The Hearing Officer issued an Amended Notice of Hearing on June 9, 2004, and on July 7, 2004, the parties submitted a Joint Stipulation of undisputed facts in anticipation of the hearing. Between January 19, 2005, and February 24, 2005, the Hearing Panel heard 17 days of testimony from both parties, including testimony from a number of expert witnesses.

In a decision dated March 3, 2006, the Hearing Panel dismissed all six causes of action against the Firm. On April 11, 2006, we called this matter for review.

III. Facts

Our call for review focuses on whether the Hearing Panel properly applied the law governing Rule 2330 to the facts in the record. The facts are largely undisputed.

For example, it is undisputed that from October 1, 1999, to March 31, 2000, at least 35 of the Firm's customers voluntarily paid higher than normal commission rates to the Firm to compete with other customers for allocations of IPO shares. Enforcement conceded that the commissions at issue were unilaterally set by the Firm's customers.

It is also undisputed that Enforcement presented no evidence that the Firm or its brokers coerced, urged, or demanded that its customers pay higher commission rates in exchange for

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[3] The second cause of action alleged that the Firm violated FINRA's ethical standards by improperly receiving inflated commission payments designed to influence the firm's IPO allocations. The third cause alleged that the Firm violated FINRA's corporate finance rules by failing to disclose the Firm's profit sharing involving its customers' accounts. The fourth cause alleged that the Firm failed to maintain accurate books and records that reflected such profit sharing. The fifth cause alleged that the Firm failed to supervise its registered representatives by ignoring several "red flags" indicating that its representatives were facilitating improper profit sharing. The sixth and final cause alleged that the Firm failed to establish, maintain and enforce an adequate supervisory system and written supervisory procedures regarding the allocation of IPO shares, the receipt of commissions, and the supervision of the Firm employees who allocated IPO shares.

[4] The Hearing Officer granted this request and on December 8, 2003, issued a Notice of Hearing. The Hearing Officer appointed a Hearing Panel to adjudicate this matter on December 12, 2003.

receiving IPO shares. Enforcement also did not allege that the Firm's customers paid higher commission rates pursuant to a profit-sharing or quid pro quo agreement between the Firm and its customers.[5] Consequently, the Hearing Panel found that Enforcement failed to prove by a preponderance of the evidence that the Firm violated Rule 2330's profit-sharing provisions.[6]

In reaching this conclusion, the Hearing Panel construed the term "profits" under Rule 2330 to be limited to profits "realized" in the account of a broker-dealer's customer, and also emphasized that Enforcement did not present any evidence as to whether the Firm shared in profits that had been distributed from profits made in its customers' accounts.

In sum, the Hearing Panel found that in order to violate Rule 2330's prohibition against profit sharing between a broker-dealer and a customer, the improperly shared "profits" must be actual funds *realized* within the customer's account, and these profits must be paid to the broker-dealer *solely from* the customer's account.

IV. Discussion

After reviewing the record, we do not overturn the Hearing Panel's finding that Enforcement failed to prove by a preponderance of the evidence that the Firm shared profits with its customers in violation of Rule 2330. We find, however, that the Hearing Panel's interpretation of Rule 2330 creates artificial and unintended limitations on the rule. These limitations are not supported by the text of the rule, the cases interpreting Rule 2330, or the rule's underlying purpose. As discussed below, we reject the Hearing Panel's narrow construction of the term "profits" under the rule.

A. Rule 2330's Profit-Sharing Prohibition Is Not Limited to Realized Profits

Rule 2330 prohibits FINRA members from sharing profits with their customers. Specifically, Rule 2330 provides that "no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member." *See* Rule 2330(f). On its face, Rule 2330 makes no distinction between realized or unrealized profits. Nevertheless, the Hearing Panel adopted a narrow construction of the term "profits" under the rule, concluding that only a showing that a FINRA member shared the actual or "realized" profits of a customer account would establish a violation.

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5 In addition, Enforcement did not produce evidence tying the profits generated in the Firm's customer accounts with the higher commission rates paid by the customers and stipulated that such evidence was not necessary to establish a Rule 2330 violation.

6 The Hearing Panel concluded that a violation of Rule 2330 required an intentional act by a broker-dealer to share profits and that a broker-dealer could not be held liable under the rule for the mere receipt of high commissions. The Hearing Panel therefore found that in the absence of a quid pro quo or other agreement between the Firm and its customers to share profits, the Firm's receipt of such commissions alone did not establish a Rule 2330 violation.

We find that the Hearing Panel's narrow construction of "profits" was based on an erroneous view of the law. Our analysis reveals that the cases the Hearing Panel cited as authority for its conclusion that only the sharing of "realized" profits can establish a Rule 2330 violation do not support this conclusion. These cases made no discernable distinction between realized and unrealized profits under the rule. Moreover, none of these cases specifically addressed the issue of whether a profit-sharing violation under Rule 2330 could be established where the profits at issue have not yet been realized through a sale of securities. In fact, the Hearing Panel simply inferred that because these cases involved situations where a member or associated person attempted to share in "realized" profits, all violations of Rule 2330 must involve the sharing of realized profits. We address the Hearing Panel's analysis of each of these cases in turn.

First, the Hearing Panel's holding that Rule 2330 only prohibits the sharing of "realized" profits in a customer account was rooted in its overly restrictive reading of FINRA's decision in *Dist. Bus. Conduct Comm. v. Doshi*, 1999 NASD Discip. LEXIS 6 (NASD NAC Jan. 20, 1999). In *Doshi*, FINRA found a broker liable for profit sharing under Rule 2330 where the broker entered into an agreement to receive a percentage of profits that had been realized in his customer's account and were to be paid to the broker in cash from the account.[7]

The Hearing Panel concluded that because the profit-sharing violation in the *Doshi* case involved the sharing of "realized" (or cash) profits, Enforcement could only show that the Firm violated Rule 2330 if the Firm shared profits realized in its customers' accounts. This conclusion is unfounded. It does not follow that simply because the Rule 2330 violation in the *Doshi* case was established by evidence of an agreement to share "realized" profits, a violation of Rule 2330 cannot be proven by evidence of an agreement to share in profits that have not yet been realized. More importantly, the *Doshi* decision did not contain *any* discussion of unrealized profits or even address the issue of whether a profit-sharing violation under Rule 2330 can only be found when there is an attempt to share in realized profits. Under these facts, it was inappropriate for the Hearing Panel to rely on *Doshi* to support its narrow interpretation of Rule 2330.

The Hearing Panel also cited to *Dist. Bus. Conduct Comm. v. Amsel*, 1995 NASD Discip. LEXIS 215 (NASD NBCC June 26, 1995), *aff'd*, Exchange Act Rel. No. 37092, 1996 SEC LEXIS 1054 (Apr. 10, 1996) to support its conclusion that Rule 2330 only prohibits the sharing of "realized" profits. The *Amsel* case involved a trader who was acting as an account executive for several customer accounts that earned more than $55,000 in realized profits from his trading activity. The trader then issued checks drawn on these accounts and obtained the proceeds from these checks for his personal use. In *Amsel*, the National Business Conduct Committee ("NBCC")[8] found that the trader's conduct did not violate Section 19(f) of the Rules of Fair

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[7] *Doshi*, 1999 NASD Discip. LEXIS 6, at *1. The broker was recorded on tape making an offer to guarantee losses in a customer's account in exchange for receiving 25 percent of the account's profits. *Id*. at *2-3.

[8] The *Amsel* case was decided by the NBCC, an adjudicatory body that was our predecessor and previously handled FINRA disciplinary actions.

Practice (the predecessor to Rule 2330), reasoning that the rule was only "intended to address instances where registered individuals seek to share in profits generated in customer accounts, rather than instances . . . where a registered person . . . withdraws money from their accounts at will." *Amsel*, 1995 NASD Discip. LEXIS 215, at *54.

The *Amsel* case did not make a finding that a violation of Section 19(f) could only occur when there was an improper sharing of realized profits in a customer account. In fact, *Amsel* did not even discuss whether Section 19(f) applied when there was an attempt to share in profits that had not yet been realized in a customer account. As in the *Doshi* case, the most that can be taken from *Amsel* is that a violation of Rule 2330 can be established when a broker seeks to share profits realized in a customer account. However, there is no support in either the *Doshi* or *Amsel* case for the Hearing Panel's conclusion that a profit-sharing violation under Rule 2330 *cannot* be established by a showing that a broker sought to share profits in a customer account that had not yet been realized. In sum, both *Doshi* and *Amsel* made no distinction between realized or unrealized profits in the analysis of Rule 2330, and we decline to infer such a distinction when the issue was not addressed in either case.

Finally, we disagree with the Hearing Panel's reading of *Dist. Bus. Conduct Comm. v. Davidson*.[9] The Hearing Panel cited *Davidson* to support its conclusion that there must be evidence that the Firm shared "realized" profits in order to establish a violation of Rule 2330.

In *Davidson*, the respondent had set up an account to trade commodity futures on behalf of 14 customers.[10] The respondent and his customers agreed that they would each contribute to the account and share in the account's profits. According to the respondent, the customers were also aware that the respondent would receive some of the commissions generated by the account.[11] When the account was closed, however, instead of receiving a proportional share of the account balance, the respondent received a portion of the commissions generated by the trading in the account. The District Business Conduct Committee ("DBCC") sanctioned the respondent for violating Section 19(f), finding that his receipt of the commissions allowed him to receive "profits" in excess of the proportionate share of his contribution to the account.

On appeal, the Board of Governors reversed the DBCC, concluding that the commissions received by the respondent did not constitute "profits" for purposes of Section 19(f). *Davidson*, 1988 WL 868052, at *3. In reaching this conclusion, the Board of Governors stated that Section 19(f) "was not intended to prohibit a representative who contributed to an account from receiving agreed-upon commissions in excess of his proportional share of the account's trading profits or losses." *Id*.

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[9] 1988 WL 858062 (NASD Bd. of Governors, Aug. 30, 1988).

[10] *Id.* at *2.

[11] *Id*.

As noted above, the *Davidson* decision merely held that the commissions agreed to and received by the respondent in connection with the account he opened for his customers did not constitute "profits" for the purpose of Section 19(f).[12] From this holding, however, the Hearing Panel inferred that the Board of Governors did not consider these commissions in *Davidson* to be "profits" under Rule 2330 because the commissions did not represent gains that had been "realized" within a customer account. The Hearing Panel's expansive reading of the *Davidson* holding is misplaced.

In *Davidson*, the Board of Governors gave no indication that the reason they did not consider the commissions paid to the respondent to be "profits" under Section 19(f) was that these commissions were not "realized" profits in a customer account. Indeed, as in the *Doshi* and *Amsel* cases, there was no discussion at all in *Davidson* distinguishing realized profits from unrealized profits under Rule 2330. Because *Davidson* did not address the issue of unrealized profits as they relate to the application of Rule 2330, we find that the Hearing Panel erred in relying on *Davidson* to exclude unrealized profits from the term "profits" under Rule 2330.[13]

B. <u>Rule 2330's Profit-Sharing Prohibition Is Not Limited to "Profits" Paid Solely from a Customer's Account</u>

We also find that the Hearing Panel erred in concluding that a profit-sharing violation under Rule 2330 requires that the improperly shared "profits" be paid to a member or associated person solely from the customer's account. The Hearing Panel's interpretation of Rule 2330 was based on its consideration of the rule's language that prohibits broker-dealers from sharing

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[12] We note that under Rule 2330, there are some situations where payments disguised as commissions may be considered "profits" shared in violation of the rule. For example, a Rule 2330 violation may be established when there is evidence that customers have been coerced into paying commissions to a broker-dealer as part of a quid pro quo arrangement to share in the account's profits. *Davidson* did not involve such an arrangement. Moreover, there was no evidence in *Davidson* that the commissions at issue were tied to the performance of the account.

[13] Moreover, the Hearing Panel's artificial exclusion of unrealized profits from the term "profits" under Rule 2330 prevents adjudicators from finding violations of Rule 2330 where a broker-dealer and a customer share profits generated from trading in a customer account, but those profits have not been realized through the sale of the securities in the account. This interpretation is particularly unreasonable in cases where, as here, it is alleged that the Firm was sharing in profits resulting from the firm's allocation of "hot" IPO shares to its customers' accounts during the IPO "bubble" of the late 1990s and 2000. This is because during this period, even though the customers' accounts had not realized an actual profit from the Firm's IPO allocations, it was almost certain that the accounts would realize a profit when the IPO shares were liquidated. *See NYSE/NASD IPO Advisory Committee Report and Recommendations* 1 (2003) (discussing the "instant profits" available to underwriters to distribute during the IPO bubble and the guaranteed profit that "hot" IPOs came to represent).

profits in the "account" of a customer.[14] We do not adopt this narrow interpretation. Instead, we broadly construe Rule 2330 to prohibit a broker-dealer from being paid compensation that is tied to or based on the performance of a customer account, regardless of its source.[15]

As an initial matter, we note that the Hearing Panel's application of Rule 2330 allows the indirect sharing of profits generated in a customer account simply by paying the broker-dealer its share of the profits from an outside source. This contradicts the express language of Rule 2330, which prohibits both the "direct" and "indirect" sharing of profits between a broker-dealer and its customers. *See* Rule 2330(f). We therefore reject the Hearing Panel's conclusion that a profit-sharing violation under Rule 2330 requires that the shared "profits" come directly from the customer's account. In addition, our examination of Rule 2330's purpose fully supports our rejection of the Hearing Panel's conclusion.

Rule 2330 was drafted to be in conformity with the Investment Advisers Act of 1940 ("Advisers Act"). In proposing Rule 2330, FINRA acknowledged that the rule was adopted by the Board of Governors in light of the Commission's enactment of Advisers Act Rule 205.[16] Advisers Act Rule 205 provides an exemption to the Advisers Act's general prohibition against performance-based compensation or "performance fees" for investment advisers.[17]

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[14] *See* Rule 2330(f)(1)(A) (stating that a broker-dealer may not "share directly or indirectly in the profits or losses *in any account* of a customer") (emphasis added).

[15] Our construction of Rule 2330 does not invalidate the exemptions set forth in the rule that permit such compensation under certain conditions. *See* Rule 2330(f). In this case, the parties do not claim that these exemptions are applicable and we are not faced with interpreting them. As noted from the outset, our review is limited to the Hearing Panel's erroneous construction of the term "profits" under Rule 2330.

[16] *See Self-Regulatory Organizations: Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Performance-Type Fees*, Exchange Act Rel. No. 34-24355, 1987 SEC LEXIS 2041, at *2 (Apr. 16, 1987). FINRA proposed Rule 2330 to allow its members and associated persons to receive performance-based compensation under circumstances similar to those permitted by the Commission for investment advisers under Advisers Act Rule 205. *Id*. at *3. Prior to the enactment of these two rules, Congress prohibited such compensation.

[17] A contract with a performance fee is one that allows an investment adviser who is managing a customer account to receive compensation based on a share of the gains made in the account. Both Rule 2330 and Advisers Act Rule 205 contain exemptions allowing investment advisers to enter into contracts paying them a performance fee where the contracts are with customers who are financially experienced and able to bear the risks associated with performance fee contracts. *See* Rule 2330(f)(2); Adviser's Act Rule 205-3.

At the time that the Commission proposed Advisers Act Rule 205, it specifically stated that where this exemption did not apply, the Advisers Act prohibited investment advisers from receiving compensation that would be calculated "on the basis of a share of capital gains upon or capital appreciation" of a customer account. *See* Investment Advisers Act of 1940, Rel. No. IA-961, 1985 SEC LEXIS 1951, at *4 (Mar. 15, 1985). This statement is consistent with our conclusion that Rule 2330—which mirrors Advisers Act Rule 205—prohibits broker-dealers from sharing in a customer's profits by receiving payments tied to the performance of a customer's account, even if those payments do not come directly from the customer's account.

In addition, an alternative interpretation would be at odds with the purpose of Rule 2330. FINRA adopted Rule 2330 to prevent the conflict of interest that arises between broker-dealers and their customers when they agree to share profits through performance-based compensation. The conflict exists because of the possibility that the broker-dealer in charge of the customer's account may have a much greater tolerance for risk than the customer and may subject the customer to undue risks simply to obtain greater compensation.[18]

The Hearing Panel's restrictive reading of Rule 2330 does not protect customers from this conflict because it would allow a broker-dealer to share in the profits generated in a customer's account as long as the broker-dealer is paid its share of the profits from a source other than the customer's account. Under this construction of Rule 2330, the broker-dealer does not violate the rule because it is not technically sharing funds or profits "within" the customer's account. The compensation received by the broker-dealer, however, is still based on the performance of the customer's account. Consequently, the broker-dealer may still be tempted to take unnecessary risks in managing the account in order to obtain a larger fee. The Hearing Panel's reading of Rule 2330 therefore ignores the conflict of interest associated with performance fees that the rule was intended to address. We reject this reading of Rule 2330.

C. The Record Does Not Support a Finding that the Firm Violated Rule 2330

Although we find that the Hearing Panel incorrectly construed Rule 2330, we do not disturb the Hearing Panel's finding that Enforcement failed to prove that the Firm violated Rule 2330. As the Hearing Panel acknowledged, a violation of Rule 2330 requires an intentional act by a broker-dealer to share profits. The record contains no evidence of the Firm's intent to share profits with its customers.

Here, Enforcement conceded that the commissions at issue were unilaterally set by the Firm's customers. Enforcement also offered no evidence that the Firm demanded that its

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[18] Rule 2330 and Advisers Act Rule 205 were enacted because Congress believed that performance-based compensation might encourage investment advisers to take undue risks in managing client funds. *See* Investment Advisers Act of 1940, Rel. No. IA-961, 1985 SEC LEXIS 1951, at *5 (Mar. 15, 1985) (discussing Congress's fear that allowing performance fee contracts would encourage investment advisers to engage in speculative trading practices to increase their compensation under such contracts).

customers pay higher commission rates in exchange for receiving IPO shares, and there was no evidence, circumstantial or otherwise, that the Firm's customers paid higher commission rates as part of a profit-sharing or quid pro quo agreement.[19] In sum, Enforcement's theory of the Firm's liability under Rule 2330 was based on the Firm's receipt of higher than normal commissions that were voluntarily paid to the Firm by its customers. This alone does not establish the intent required to establish a Rule 2330 violation.

Further, there is not sufficient evidence in the record that the Firm was paid compensation that was based on profits generated in its customers' accounts regardless of whether these profits are defined to include both realized and unrealized profits. Here, the record does not contain evidence connecting the higher commission rates paid to the Firm by its customers with the profits generated in those customer's accounts.[20] On appeal, Enforcement also conceded that including unrealized profits in the construction of the term "profits" under Rule 2330 would not alter the Hearing Panel's finding that Enforcement had not established a Rule 2330 violation. Consequently, we do not disturb the Hearing Panel's finding that Enforcement failed to prove by a preponderance of the evidence that the Firm violated Rule 2330's profit-sharing provisions.

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[19] We note that an agreement to share profits may be proven by circumstantial evidence. The use of circumstantial evidence to prove a profit-sharing violation is appropriate because, as in cases involving conspiracy or fraud, it may be difficult to prove such a violation with direct evidence. *See United States v. Redwine*, 715 F.2d 315, 319 (7th Cir. 1983) (stating that "[b]ecause of the secretive character of conspiracies, direct evidence is elusive, and hence the existence [of a conspiracy] and the defendant's participation can usually be established only by circumstantial evidence"); *see also United States v. Ethridge*, 948 F.2d 1215, 1217 (11th Cir. 1991) (commenting that proof of intent to defraud is difficult to obtain and often requires the use of circumstantial evidence).

[20] Enforcement litigated this case under the presumption that it was not necessary under Rule 2330 for it to show that commissions paid by the Firm's customers be linked to the amount of profits (actual or unrealized) resulting from the Firm's IPO allocations. Consequently, Enforcement did not present evidence sufficient to show how the commissions paid to the Firm by its customers were tied to the profits allegedly shared in the accounts where these shares were allocated.

V. Conclusion

After calling this matter for review, we reject the Hearing Panel's narrow interpretation of "profits" under Rule 2330. Instead, we conclude that the term "profits" under Rule 2330 may include both realized and unrealized profits. We also conclude that "profits" under Rule 2330 are not limited to profits that come directly from a customer account. We find, however, that Enforcement still failed to establish by a preponderance of the evidence that the Firm violated Rule 2330 under our construction of the rule. We therefore do not disturb the Hearing Panel's finding that the Firm is not liable for violating Rule 2330.[21]

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President and Corporate Secretary

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[21] We have also considered and reject without discussion all other arguments advanced by the parties.