

Regulatory Notice

09-69

Payments to Unregistered Persons

FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Payments to Unregistered Persons

Comment Period Expires: February 1, 2010

Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on a proposed FINRA rule regarding payments to unregistered persons. Proposed FINRA Rule 2040 (Payments to Unregistered Persons) would be a new consolidated rule that streamlines the provisions of current:

- NASD Rule 1060(b) (Persons Exempt from Registration); Rule 2410 (Net Prices to Persons Not in Investment Banking or Securities Business); Rule 2420 (Dealing with Non-Members); IM-2420-1 (Transactions Between Members and Non-Members); and IM-2420-2 (Continuing Commissions Policy);
- NYSE Rule 353 (Rebates and Compensation); NYSE Rule Interpretations 345(a)(i)/01 (Compensation to Non-Registered Persons); /02 (Compensation Paid for Advisory Solicitations); and /03 (Compensation to Non-Registered Foreign Persons Acting as Finders); and
- FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar).

The text of the proposed rule is set forth in Attachment A.

Questions concerning this *Notice* should be directed to Kosha K. Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-6903.

December 2009

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Executive Representatives
- Legal
- Registered Representatives
- Registration
- Senior Management

Key Topics

- Broker-Dealer Registration
- Compensation
- Disqualification
- Retiring Registered Representative
- Sanctions

Referenced Rules & Notices

- FINRA Rule 8311
- Information Notice 03/12/08
- NASD Rule 1060(b)
- NASD Rule 2410
- NASD Rule 2420
- NASD IM-2420-1
- NASD IM-2420-2
- NYSE Rule 353
- Regulatory Notice 09-34

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by February 1, 2010.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes

The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.²

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.³

Background

NASD Rules 1060(b) (Persons Exempt from Registration); 2410 (Net Prices to Persons Not in Investment Banking or Securities Business); 2420 (Dealing with Non-Members); IM-2420-1 (Transactions Between Members and Non-Members); and IM-2420-2 (Continuing Commissions Policy (collectively, the NASD Non-Member Rules)) govern payments by members to unregistered persons. These NASD Non-Member Rules were developed in an era when a registered broker-dealer could engage in an over-the-counter securities business and elect whether to be a member of a registered securities association.⁴ An original 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.⁵ Since the adoption of these 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.⁶

As a result, FINRA has generally 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.⁷ FINRA has refrained from opining 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. Section 15(a)(1) of the Exchange Act generally requires any broker-dealer effecting transactions in securities to be registered 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.⁸

Proposal

Proposed FINRA Rule 2040

FINRA is proposing to establish 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. The proposed rule sets forth the following requirements:

► **Payments to Unregistered Persons**

FINRA is proposing to establish new FINRA Rule 2040(a), which prohibits members or associated persons from, directly or indirectly, paying or offering to pay 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, is required to be so registered under applicable federal securities laws and SEC rules, regulations and published guidance by the SEC or its staff in the form of releases, no-action letters or interpretations; or

- (2) any appropriately registered associated person, unless such payment complies with all applicable federal securities laws, FINRA rules and SEC rules, regulations and published guidance by the SEC or its staff in the form of releases, no-action letters or interpretations.

The proposed change makes the rule consistent with FINRA staff interpretations under NASD Rule 2420 and SEC rules and regulations under Section 15(a) of the Exchange Act. The proposal also aligns the rule with SEC staff guidance that states that receipt of certain securities transaction-based compensation requires registration as a broker-dealer. Therefore, 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. In cases where a member represents that the proposed activities would not require the recipient of the payments to register as a broker-dealer, and can support such position through SEC rules, regulations or other guidance, such as a no-action letter, the proposed rule does not prohibit the member from making the payments to such person.

The proposed change also clarifies that payments to associated persons are not prohibited by this rule where such payments are otherwise permissible.

► Retiring Representatives

FINRA is also proposing to establish new FINRA Rule 2040(b), which codifies existing FINRA staff guidance on the payment by members of continuing commissions to retiring registered representatives. The proposal permits members to pay continuing commissions to retiring registered representatives of the member, after they cease to be employed by 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 (1) a bona fide contract between the member and the retiring registered representative calling for the payments was entered into in good faith while the person was a registered representative of the employing 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 SEC rules, regulations and published guidance by the SEC or its staff.

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. In the case of the death of the retiring registered representative, the retiring 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 agreements with the deceased representative.

FINRA believes this proposal is consistent with SEC guidance on the payment of compensation to retiring representatives.⁹

Amendments to 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 a person subject to a sanction or disqualification, during the period of the sanction or disqualification or any period thereafter, any remuneration that the person might have accrued 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, cancellation 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 have “accrued,” not just “earned” 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.

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. 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 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 have accrued 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.

Adoption of New General Standard

In addition, FINRA is proposing to adopt a new general standard that is based largely on provisions of NASD IM-2420-1 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 IM-2420-1 and should be retained in the FINRA rulebook.

NASD and NYSE Rules To Be Deleted

FINRA proposes to eliminate the following NASD and Incorporated NYSE Rules and related interpretations:

- NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03

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) are identical provisions and provide that member firms and persons associated with a member may pay transaction-related compensation to non-registered foreign finders, based upon the business of customers such persons direct to member firms, subject to certain conditions (foreign finder exemption).

➤ 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 Rule 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 Rule 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.¹⁰ 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 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 Interpretation 345(a)(i)/01 and /02

NYSE Rule Interpretation 345(a)(i)/01 (Compensation to Non-Registered Persons) prohibits a member from paying to non-registered 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 of 1940.

Endnotes

- 1 The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, 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 member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, *see Information Notice 3/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. *See* Exchange Act Section 19 and rules thereunder.
- 4 *See* Maloney Act of 1938. Pub. L. No. 75-719, 52 Stat. 1070, which added Section 15A to 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.
- 5 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).
- 6 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.”

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Endnotes continued

- 7 See FINRA Interpretative Letters under NASD Rule 2420 and IM-2420-2 at www.finra.org/interpretiveletters/conduct to: Richard Schultz, Triad Securities Corp. (12/28/07); Jonathan K. Lagemann, Esq., Law Offices of Jonathan Kord Lagemann (6/27/01); Jay Adams Knight, Esq., Musick, Peeler & Garrett LLP (3/8/01); Kathleen A. Wieland, William Blair & Company (9/27/00); Michael R. Miller, Esq., Kunkel Miller & Hament (5/31/00); Gordon C. Ogden, III, Profinancial, Inc. (1/18/00); Trish Stone-Damen, Investors Retirement & Management Company, Inc. (1/29/99); Leslie D. Smith, Berthel Fisher & Company (12/9/98); Victoria Bach-Fink, Wall Street Financial Group (12/7/98); Brian C. Underwood, A.G. Edwards & Sons, Inc. (9/16/98); Daniel Schloendorn, Willkie Farr & Gallagher (6/18/98); David M. Katz, Sidley & Austin (9/25/97); Peter D. Koffler, Twenty-First Securities Corporation (8/20/97); Interpretive Letter to Name Not Public (4/11/97); Ted. A. Troutman, Esquire, Muir & Troutman (2/4/02); Joe Tully, Commonwealth Financial Network (8/9/01); Name Not Public (5/25/01); Peter D. Koffler, Esq., Twenty-First Securities Corporation (1/21/00); Leslie D. Smith, Berthel Fisher & Company (12/9/98); Name Not Public (12/23/96); Name Not Public (11/20/96).
- 8 See, e.g., Birchtree Financial Services, Inc. SEC No-Action Letter (pub.avail. Sept 22, 1988); 1st Global, Inc., SEC No-Action Letter (pub.avail. May 7, 2001).
- 9 See Securities Industry and Financial Markets Association, SEC No-Action Letter (pub.avail. Nov. 20, 2008).
- 10 NASD Rule 2830(c) prohibits investment company underwriters from selling the fund's securities to a retail broker-dealer at a price other than the public offering price unless, among other things, the sale is in conformance with NASD Rule 2420. FINRA has proposed to adopt new FINRA Rule 2341, based largely on NASD Rule 2830, which would eliminate the reference to NASD Rule 2420. See *Regulatory Notice 09-34*.

Attachment A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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Text of Proposed New FINRA Rule

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0100. General Standards

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0180. Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation

(a) A member shall 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 shall be automatically reinstated to membership in FINRA at the termination of the suspension period.

(b) A member shall be treated as a non-member of FINRA from the date of acceptance by FINRA of any resignation of such member.

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2000. Duties and Conflicts

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2040. Payments to Unregistered Persons

(a) General

No member or associated person shall, directly or indirectly, pay or offer to pay 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, is required to be so registered under applicable federal securities laws and SEA rules, regulations and published guidance issued by the SEC or its staff in the form of releases, no-action letters or interpretations; or

(2) any appropriately registered associated person unless such payment complies with all applicable federal securities laws, FINRA rules and SEA rules, regulations and published guidance issued by the SEC or its staff in the form of releases, no-action letters or interpretations.

(b) Retiring Representatives

(1) A member may pay continuing commissions to a retiring registered representative of the member, after he or she ceases to be associated with such 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:

(i) a bona fide contract between the member and the retiring registered representative calling 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

(ii) the arrangement complies with applicable SEA rules, regulations and published guidance issued by the SEC or its staff in the form of releases, no-action letters or interpretations.

(2) The term “retiring registered representative,” as used in this Rule shall mean an individual who retires from a member (including as a result of a total disability) and leaves the securities industry. 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.

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Text of Proposed Amendments to FINRA Rule 8311

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8000. Investigations and Sanctions

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8300. Sanctions

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8311. Effect of a Suspension, Revocation, Cancellation, [or] Bar or Other Disqualification

(a) [If FINRA or the SEC issues an order that imposes]If a person is subject to a suspension, revocation, [or] cancellation of [the] registration, bar from association with a member (each a “sanction”) or other disqualification [of a person associated with a member or bars a person from further association with any member], a member shall not allow such person to [remain] be associated with it in any capacity that is inconsistent with the sanction imposed or disqualified status, including a clerical or ministerial capacity. [If FINRA or the SEC suspends a person associated with a member, the]A member also shall 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, [or any] commission, profit, or any other remuneration [that results directly or indirectly from any securities transaction,] that the person [associated with a member] might have [earned] accrued during the period of [suspension] 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.

(b) Notwithstanding paragraph (a) of this Rule, a member may pay to a person that is subject to a sanction or disqualification described in paragraph (a) of this Rule, 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.

• • • Supplementary Material: -----

.01 Remuneration Accrued Prior to Effective Date of Sanction or Disqualification.

Notwithstanding this Rule, a member may pay or credit to a person that is subject of a sanction or disqualification salary, commission, profit or any other remuneration that the member can evidence accrued to the person prior to the effective date of such sanction or disqualification; provided, however, the member may not pay any salary, commission, profit or any other remuneration that accrued to the person that relates to or results from the activity giving rise to the sanction or disqualification.

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