

Payments to Unregistered Persons

SEC Approves Consolidated FINRA Rules 2040 (Payments to Unregistered Persons) and 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation), and Amendments to FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar)

Effective Date: August 24, 2015

Executive Summary

The SEC approved FINRA's rule change¹ to adopt rules relating to payments to unregistered persons for the consolidated FINRA rulebook,² FINRA Rules 2040 (Payments to Unregistered Persons) and 0190 (Effective Date of Revocation, Cancellation, Expulsion, or Resignation). The new rules replace provisions of the NASD and NYSE rules and include new provisions.³ FINRA also has amended FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar). The new rules and amendments become effective on August 24, 2015.

The text of the amendments is available at www.finra.org/notices/15-07.

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 or Kosha.Dalal@finra.org.

Background & Discussion

FINRA Rule 2040 governs the payment of transaction-based compensation by member firms to unregistered persons, and FINRA Rule 0190 establishes a new general standard describing when a member firm will be treated as a non-member of FINRA. The amendments to FINRA Rule 8311 clarify the scope of the rule on payments by member firms to persons subject to suspension, revocation, cancellation, bar or other disqualification.

March 2015

Notice Type

- ▶ Consolidated Rulebook
- ▶ Rule Amendment

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
- ▶ NYSE Rule Interpretation 345(a)(i)/01
- ▶ NYSE Rule Interpretation 345(a)(i)/02
- ▶ NYSE Rule Interpretation 345(a)(i)/03

FINRA Rule 2040 (Payments to Unregistered Persons)

FINRA Rule 2040 expressly aligns the rule with Section 15(a) of the Securities Exchange Act of 1934 (SEA or Exchange Act) and its related guidance to determine whether registration as a broker-dealer is required for persons to receive transaction-related compensation and to engage in related activities.

a. FINRA Rule 2040(a) (General)

Rule 2040(a) prohibits member firms 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 SEA Section 15(a) 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.

Rule 2040(a) directs persons to look to SEC rules to determine whether the activities in question require registration as a broker-dealer under SEA Section 15(a). The provision also prohibits payments to appropriately registered associated persons unless such payments comply with applicable federal securities laws, FINRA rules, and SEA rules and regulations.

b. Supplementary Material.01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act)

Supplementary Material .01 provides guidance to member firms that are uncertain as to whether an unregistered person may be required to be registered under SEA Section 15(a) by reason of receiving payments from the member firm and the activities related thereto. Member firms can derive support for their determination by, among other things:

- (1) reasonably relying on previously published releases, no-action letters or interpretations from the SEC staff that apply to their facts and circumstances;
- (2) seeking a no-action letter from the SEC staff; or
- (3) obtaining a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area.

FINRA does not intend Supplementary Material .01 to be an exhaustive list by which firms can make a reasonable determination of compliance with Section 15(a). Among other things, firms may rely on the advice of in-house counsel or foreign counsel under prong 1 that permits firms to make a determination by “reasonably relying on previously published releases, no-action letters or interpretations from the Commission or Commission staff that apply to their facts and circumstances.” As stated in Supplementary Material .01, the member firm’s determination must be reasonable under the circumstances and should be reviewed periodically if payments to the unregistered person are ongoing in nature. While the rule does not specify the frequency of such reviews, FINRA believes that an annual review for ongoing payments generally would be reasonable, absent evidence of activities by the recipient of the payments that raise red flags. In addition, a member firm is required to maintain books and records that reflect the member firm’s determination.

c. FINRA Rule 2040(b) (Retiring Representatives)

Rule 2040(b) replaces NASD IM-2420-2 (Continuing Commission Policy) and codifies existing FINRA and SEC staff guidance on the payment by member firms of continuing commissions to retiring registered representatives. Under Rule 2040(b), a member firm can pay continuing commissions to its retiring registered representatives, after they cease to be associated with the firm, 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 firm and the retiring registered representative providing for the payments was entered into in good faith while the person was a registered representative of the firm 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.

The term “retiring registered representative” is defined to mean an individual who retires from a member firm (including as a result of a total disability) and leaves the securities industry.⁴ 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.

d. FINRA Rule 2040(c) (Nonregistered Foreign Finders)

Rule 2040(c) replaces NASD Rule 1060(b) and NYSE Interpretation 345(a)(i)/03, and provides that a member firm and persons associated with a member firm may pay transaction-related compensation to non-registered foreign finders where the finders' sole involvement is the initial referral to the member firm of non-U.S. customers, and the member firm complies with all the conditions set forth in the rule (foreign finders exemption):

- (1) the member firm 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;
- (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, that discloses what compensation is being paid to finders;
- (5) customers provide written acknowledgment to the member firm 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 firm's books, and actual agreements between the member firm and the finder are available for inspection by FINRA; and
- (7) the confirmation of each transaction indicates that a referral or finders fee is being paid pursuant to an agreement.

If all the conditions set forth in Rule 2040(c) are satisfied, member firms can pay ongoing transaction-related compensation to non-registered foreign finders based on the business of non-U.S. customers that finders refer to member firms, and all accounts referred by such foreign finders would be carried on the books of the member firm.⁵ 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 exemption as set forth in Rule 2040(c).

Based solely on its activities in compliance with Rule 2040(c), a foreign finder would not be considered an associated person of the member firm. 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. Member firms that engage foreign finders would be required to have reasonable procedures that appropriately address the limited scope of activities permissible under such arrangements.⁶

FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar) and Supplementary Material .01 (Remuneration Accrued Prior to Effective Date of Sanction or Disqualification)

The amendments to Rule 8311 eliminate duplicative provisions in NASD IM-2420-2 and clarify the scope of the rule on payments by member firms to persons subject to suspension, revocation, cancellation, bar (each a sanction), or other disqualification.⁷

Rule 8311 provides that if a person is subject to a sanction or other disqualification, a member firm 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. A member firm 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 firm 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 firm.

Specifically, the rule 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 firm may not allow a person subject to a sanction or disqualification to “be” associated with such firm 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 firm 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.

New paragraph (b) to Rule 8311, however, expressly permits a member firm 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.

Supplementary Material .01 allows a member firm to pay or credit to a person subject to a sanction or disqualification, salary, commission, profit or other remuneration that the firm can evidence accrued to the person prior to the effective date of the sanction or disqualification, unless the remuneration relates to or results from the activity that gave rise to the sanction or disqualification. A member firm must be able to demonstrate that the remuneration accrued prior to the effective date of the sanction or disqualification in order to pay or credit the remuneration to the individual.

FINRA Rule 0190 (Effective Date of Revocation, Cancellation, Expulsion, or Resignation)

Rule 0190 is based largely on NASD IM-2420-1(a) (Transactions Between Members and Non-Members; Non-members of the Association) and provides that a member firm will be considered 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 firm will be automatically reinstated to membership in FINRA at the termination of the suspension period.

Endnotes

1. See Securities Exchange Act Release No. 73954 (December 30, 2014), 80 FR 553 (January 6, 2015) (Order Approving File No. SR-FINRA-2014-037).
2. 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 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 03/12/08* (Rulebook Consolidation Process).

3. Effective August 24, 2015, 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), 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), Incorporated NYSE Rule Interpretation 345(a)(i)/02 (Compensation Paid for Advisory Solicitations) and Incorporated NYSE Rule Interpretation 345(a)(i)/03 (Compensation to Non-Registered Foreign Persons Acting as Finders) will be eliminated from the Transitional Rulebook.
4. 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 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.
5. 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 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)).
6. See Securities Exchange Act Release No. 35361 (February 13, 1995), 60 FR 9417 (February 17, 1995) (Order Approving File No. SR-NASD-94-51). 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 firm. See also NASD Rule 1100 (Foreign Associates).
7. Rule 8311 is not in any way intended to 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 FINRA Rule 1250 (Continuing Education Requirements).