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October 17, 2014

Via Electronic Filling

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F. Street NE
Washington DC 20549-1090

Re: File No. SR-FINRA-2014-037, Proposed Rule Change to Adopt FINRA Rules 0190 and 2040 in Consolidated FINRA Rulebook, and Amend FINRA Rule 8311

Dear Mr. Fields,

The Cornell Securities Law Clinic (the "Clinic") submits this comment letter in response to the proposed rule change (the "Rule Proposal") to adopt FINRA Rules 190 and 2040 in the Consolidated FINRA Rulebook (the "FINRA Rulebook") and to amend FINRA Rule 8311. The Clinic is a Cornell Law School curricular offering, in which law students provide public investors with representation and education in the largely rural "Southern Tier" region of upstate New York. For more information, please see http://securities.lawschool.cornell.edu.

Although the Clinic supports the Rule Proposal insofar as it seeks to streamline existing rules, it is concerned with certain provisions in the Rule Proposal that could harm investors. Specifically, Proposed Rule 2040(c) and Proposed Supplementary Material .01 create overly broad and vaguely defined safe havens for nonregistered individuals that receive payments related to securities transactions.

I. Background of the Rule Proposal

Section 15(a) of the Securities Exchange Act of 1934 ("Section 15(a)") prohibits individuals who are not registered with the Securities Exchange Commission ("SEC") from effecting, or otherwise deriving profit from, securities transactions. Accordingly, the FINRA

Rulebook contains provisions that regulate transaction-related payments to nonregistered persons.[1]

On December 3, 2009, FINRA published Regulatory Notice 09-69 (the "First Proposal"), and requested comments on its proposal to consolidate rules governing transaction-related payments to nonmembers.[2] If adopted, the First Proposal would have replaced the existing framework of rules governing payments to nonmembers with Proposed FINRA Rule 2040, and would also have amended FINRA Rule 8311.

In response to the First Proposal, commentators expressed concern over repealing NASD 2420(c) without providing an equivalent rule in Proposed FINRA Rule 2040.[3] NASD 2420(c) allows payments by FINRA members to nonmember foreign finders provided that both the member and the foreign finder satisfy certain requirements. Commentators also expressed concern over the purported burden of determining whether Section 15(a) requires a nonmember that receives payments from a member to register with FINRA.[4]

On September 10, 2014, FINRA submitted a second Proposed Rule Change—the Rule Proposal at issue—to the SEC that is an edited version of the First Proposal. In response to the comment letters' concerns, this Rule Proposal added, *inter alia*, (1) Proposed FINRA Rule 2040(c) and (2) Supplementary Material .01. While Rule 2040(c) addresses payments to nonregistered foreign finders, Supplementary Material .01 intends to provide guidance in determining whether Section 15(a) requires a nonmember receiving payments from a member to register with FINRA.

II. The Clinic Supports Efforts to Streamline Existing Rules, But Not at the Expense of Investor Security

The Clinic supports efforts to streamline the existing framework of rules governing payments to nonmembers. Indeed, a simplified rulebook is in the best interest of investors and broker-dealers alike. Nonetheless, efforts to simplify the existing rules should not compromise investor security. The following recommendations seek to further these ends.

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[1] These include the following rules: NASD Rule 2410 (Net Prices to Persons Not in Investment Banking or Securities Business), NASD 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).

[2] http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120480.pdf.

[3] *See e.g.*, Comment Letter from Ethan W. Johnson, Partner at Morgan, Lewis & Bockius LLP, to Marcia E. Asquith, Office of the Corporate Secretary of the Financial Industry Regulatory Authority (Feb. 1, 2010) (attached to the Rule Proposal at Exhibit 2b(2)).

[4] *See, e.g.*, *id.*

a. Proposed Rule 2040(c)'s "Assurance" Standard Creates an Overly Broad Safe Haven For Members Making Payments to Foreign Finders

Proposed Rule 2040(c) provides that FINRA members may pay foreign finders transaction-related compensation for referrals provided that, *inter alia*, "the member has assured itself that the finder . . . is not required to register in the United States as a broker-dealer nor is subject to 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." This highly subjective standard creates overly expansive safe havens not only for broker-dealers, but also for foreign finders that may not be registered with regulatory agencies abroad.

As drafted, this requirement allows members to make payments to nonmember foreign finders that Section 15(a) may require to register, FINRA By-Laws may disqualify from registration, or may be in violation of foreign law by accepting such payment. The language providing that a member must "assure itself" that such conditions would not apply is the root of the problem. Indeed, the "assurance" standard is unacceptably subjective because it depends on a specific member's knowledge, resources, and discretion. For instance, institutional investment firms may be able to hire outside counsel to determine whether a given transaction would violate foreign law, whereas a smaller firm may perform its own research and (incorrectly) conclude that the same transaction does not violate foreign law.

An additional problem with this requirement is that a foreign finder may not be registered with foreign regulatory agencies, thereby creating an unregulated void within the United States in which dubious foreign broker-dealers may profit. Under the requirement, a nonmember foreign finder may, for example, refer investors to a member in exchange for referral fees based on misrepresentations of the member's financial product. Indeed, allowing referral fees under such a regime incentivizes fraudulent referral practices by foreign finders.[5]

The Clinic respectfully recommends a simple solution to these problems: eliminate the subjective "assurance" standard. Removing the language at issue—the member has "assured itself"—would create an objective, bright-line standard that would better ensure investor security and incentivize member compliance. Thus, the proposed requirement should read: "the finder who will receive the compensation is not required to register in the United States as a broker-dealer nor is subject to disqualification as defined in Article III, Section 4 of FINRA's By-Laws, and the compensation arrangement does not violate applicable foreign law."

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[5] *See, e.g.*, *U.S. S.E.C. v. Zahareas*, 100 F. Supp. 2d 1148, 1148-49 (D. Minn. 2000) (detailing facts of case where foreign finder subject to SEC bar had nonetheless agreed to receive a "foreign finders fee" of a percentage of total revenues generated by domestic IPO), *rev'd in part and vacated in part*, 272 F.3d 1102 (2001).

b. Supplementary Material .01 Creates an Overly Broad Safe Haven for Members Making Payments to Nonregistered Individuals

Supplementary Material .01 (the "Supplement"), an addition to Proposed FINRA Rule 2040, directs members making transaction-related payments to nonmembers to determine whether Section 15(a) requires the recipient of the payments to register with FINRA as a broker-dealer by "(1) reasonably relying on previously published releases, no-action letters or interpretations from the Commission or Commission staff that apply to their facts and circumstances; (2) seeking a no-action letter from the Commission staff; or (3) obtaining a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area." The Supplement, similar to Proposed Rule 2040(c), creates standards of compliance that are fraught with subjectivity, thereby endangering public investors.

Given the dearth of case law on consumer product disputes and the fact-specific nature of no-action letters, the "reasonable reliance" standard, in this context, depends almost entirely on the judgment of broker-dealers who have a financial incentive to interpret the listed materials broadly. Moreover, although the Supplement is intended to mitigate the burden of determining whether Section 15(a) requires registration, the uncertainty of a "reasonable reliance" standard invites a much costlier alternative: private dispute resolution, administrative hearings, or litigation.[6]

The third source upon which the Supplement directs members to base determinations—advice of counsel—contains inherently subjective and problematic language. Specifically, whether counsel is "reputable" or "knowledgeable in the area" depends on the market in which he or she practices and the member's discretion. Furthermore, the Supplement effectively creates an affirmative defense for otherwise prohibited payments; in the context of securities litigation, however, the general rule is that reliance on the advice of counsel is merely a factor to consider rather than a total defense.[7] Lastly, the Supplement is unclear as to whether "area" refers to geography or legal practice.

If FINRA chooses to retain the Supplement, the Clinic respectfully recommends deletion of the first and third sources listed in the Supplement—respectively, (1) reasonable reliance on applicable published releases, no-action letters or interpretations from the Commission or Commission staff; and (3) obtaining a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area. Instead, the Supplement should read in pertinent part as

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[6] Indeed, "the results of non-compliance, including the cost of penalties and the operational requirements that may be imposed through regulatory action, can be greater than the financial cost and operational impact of hiring qualified personnel and developing and maintaining compliance programs." Agnes Bundy Scanlan & Catherine Purdon, *Compliance Program Management for Financial Services Institutions*, 62 BUS. LAW. 735, 743 (Feb. 2007).

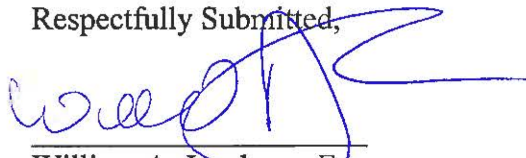
[7] *See Markowski v. S.E.C.*, 34 F.3d 99, 105 (2d Cir. 1994) (citing *SEC v. Savoy Industries, Inc.*, 665 F.2d 1310, 1314 n. 28 (D.C. Cir. 1981)).

follows: "Members that are uncertain as to whether an unregistered person may be required to be registered under Section 15(a) of the Exchange Act by reason of receiving payments from the member should seek no-action letters from the Commission staff." Although this bright-line rule would require expenditures for seeking no-action letters, it would likely be much less costly than dispute resolution that the Supplement, as currently drafted, would create. Moreover, the minimal burden that the recommended language may impose would incentivize registration, regulation, and oversight, thereby reducing investor risk.

III. Conclusion

The Clinic supports FINRA's efforts to streamline and simplify the current framework of rules governing payments to nonmembers; nevertheless, a more navigable Rulebook should not come at the expense of investor security. Proposed Rule 2040(c) and Proposed Supplementary Material .01, as drafted, create vague compliance standards that, if enacted, would endanger public investors. The recommended drafting above would cure these issues and should be adopted.

Respectfully Submitted,



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