Financial Industry Regulatory Authority

December 23, 2014

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

**Re: File No. SR-FINRA-2014-037 – Response to Comments**

Dear Mr. Fields:

This letter responds to comments submitted to the Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing,[1] a proposed rule change to adopt FINRA Rule 2040 (Payments to Unregistered Persons) regarding payments by members to unregistered persons, and Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act).

The proposed rule change also would streamline provisions of 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) and Incorporated NYSE Rule Interpretation 345(a)(i)/02 (Compensation Paid for Advisory Solicitations), which would be deleted from the current FINRA rulebook. In addition, the proposed rule change would adopt the requirements of NASD Rule 1060(b) (Persons Exempt from Registration) and Incorporated NYSE Rule Interpretation 345(a)(i)/03 (Compensation to Non-Registered Foreign Persons Acting as Finders), as FINRA Rule 2040(c) (Nonregistered Foreign Finders) in the consolidated FINRA rulebook without material change. The proposed rule change also would amend FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar), add new Supplementary Material .01 (Remuneration Accrued Prior to Effective Date of Sanction or Disqualification), and adopt the requirements of NASD IM-2420-1(a) (Non-members of the Association), as FINRA Rule 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation).

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1 See Securities Exchange Act Release No. 73210 (September 25, 2014), 79 FR 59322 (October 1, 2014) (Notice of Filing; File No. SR-FINRA-2014-037) (the "Proposing Release").



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The Commission received seven comment letters in response to the Proposing Release.[2] The comments received by the Commission on the consolidated rule proposal and FINRA's responses to the comments are discussed in detail below.

**A. General Support**

SIFMA, NASAA, Cornell and ABA generally supported FINRA's efforts to consolidate and streamline rules relating to payments to unregistered persons. SIFMA stated that FINRA has thoughtfully developed and proposed revisions to its rules that reflect a cohesive vision of the applicable regulatory framework related to payments of commissions or fees derived from a securities transaction to unregistered persons. In addition, SIFMA appreciated FINRA's efforts to incorporate comments, including input provided by member firms, regarding the proposed rule change, as previously issued in Regulatory Notice 09-69,[3] by specifically adding Supplementary Material .01 and retaining NASD Rule 1060(b) that provide greater clarity and reduce the compliance burden for members seeking to comply with the requirements of the proposed rule change. Cornell stated that a simplified rulebook is in the best interest of investors and broker-dealers alike.

Two commenters, IMS and Cornell, expressed concern that the proposed rule change does not go far enough. IMS objected to the proposal because it believes that FINRA has not fully addressed industry concerns relating to the implementation of the proposed rule and has left unresolved issues in two of the three subsections of the

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2 Letters from Catherine T. Dixon, Chair, Federal Regulation of Securities Committee, Business Law Section, American Bar Association, dated November 5, 2014 ("ABA"); Howard Spindel, Senior Managing Director, and Cassondra E. Joseph, Managing Director, Integrated Management Solutions USA LLC, dated October 22, 2014 ("IMS"); Paul J. Tolley, Senior Vice President, Chief Compliance Officer, Commonwealth Financial Network, dated October 22, 2014 ("Commonwealth"); William Beatty, President, North American Securities Administrators Association, Washington Securities Commissioner, dated October 22, 2104 ("NASAA"); Kevin Zambrowicz, Associate General Counsel & Managing Director, SIFMA, dated October 22, 2014 ("SIFMA"); Peter J. Chepucavage, Esq., GC, Plexus Consulting Group, dated October 21, 2014 ("Plexus"); and William A. Jacobson, Clinical Professor of Law, Cornell Law School, and Director, Cornell Securities Law Clinic, Ithaca, New York, dated October 17, 2014 ("Cornell").

3 See Regulatory Notice 09-69 (FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Payments to Unregistered Persons).

proposed rule.[4] Plexus believed that the proposed rule provides the SEC with an opportunity to provide clarity in the area of finders and, moreover, argued that allowing FINRA to adopt the SEC's standard is not efficient.[5]

FINRA believes the proposed rule change provides a concise framework for firms to address issues regarding payments to unregistered persons, including to nonregistered foreign finders. Moreover, while FINRA acknowledges the need for more comprehensive guidance in the area of foreign finders, FINRA believes it is beyond the scope of this proposed rule change to provide detailed guidance on each type of activity that is permissible between U.S. broker-dealers and foreign persons and the conditions that may apply under the federal securities laws. FINRA believes such rulemaking or guidance more appropriately falls under the mandate of the SEC, and will coordinate with SEC staff on providing additional guidance, as appropriate.

**B. Proposed FINRA Rule 2040(a) – General**

1. Focus on Receipt of Transaction-Based Compensation

SIFMA stated that it supports proposed Rule 2040(a) but seeks clarity on proposed Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act), which is discussed in detail below. NASAA expressed concern that, without a clear regulatory framework in place, the receipt of transaction-based compensation will lead to abusive practices. As such, NASAA believed that registration should be required for individuals that receive transaction-based compensation because "such registration is integral to the regulation of firms and individuals…and exceptions to this principle should be rare, and when implemented they should be highly prescriptive."[6]

Commonwealth disagreed with FINRA's focus on the "receipt of transaction-based compensation" as the main factor for determining whether registration as a broker-dealer is required. Commonwealth specifically cited recent case law such as *SEC v. Kramer* and *SEC v. Bravata* that point to other factors.[7] Commonwealth stated that

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4 See IMS (referring generally to what the commenter views as "unresolved issues" in proposed Rule 2040(a) and (c), as further discussed herein).

5 See Plexus.

6 See NASAA.

7 See *SEC v. Kramer*, 778 F. Supp. 2nd 1320 (M.D. Fla. 2011). See also *SEC v. John J. Bravata, et al.*, Civil Action No. 09-cv-12950 (E.D. Mich.) (Lawson, J.). Commonwealth argued that both cases conclude that the SEC's reliance on past

FINRA should consider all of the relevant factors before FINRA and the SEC adopt any new rule by which a firm can determine whether a person must register in accordance with Section 15(a) of the Exchange Act. Commonwealth urged FINRA to either withdraw the proposed rule change or make substantial modifications to it to address these concerns.

FINRA disagrees that the proposed rule focuses only on the receipt of transaction-based compensation as the determinative factor for who is required to register as a broker-dealer under the Exchange Act. While the proposed rule change does specifically include "receipt of any such payments," as a factor, the proposed text also expressly includes "and the activities related thereto." FINRA recognizes that SEC guidance in this area provides that certain activities may be deemed (alone or in combination) to confer "broker" status,[8] and the receipt of transaction-based compensation coupled with these activities may trigger the requirement to register as a broker-dealer under the Exchange Act. FINRA believes the proposed rule change is consistent with current SEC rules and guidance.

### C. Proposed FINRA Rule 2040(b) – Retiring Representatives

SIFMA, ABA and IMS supported FINRA's proposed creation of a concise regulatory framework regarding the payment of continuing commissions to retiring registered representatives by member firms and noted that the proposed rule effectively consolidates existing guidance. IMS stated "that FINRA adequately balanced theory and practical implementation in this subsection of the Proposed Rule and [it] applaud[s] what FINRA has done in this regard."

In contrast, NASAA stated that the proposal should be more explicit on the restrictions surrounding continuing compensation that can be paid to retired representatives. It noted that FINRA makes reference to and asserts a similarity between its current proposal and the prior SEC no-action letter issued to SIFMA on the topic, but NASAA believed the SEC guidance contains a more detailed discussion of the topic. While the proposed rule does not expressly list each condition set forth in prior SEC no-action letters, FINRA believes that the proposed rule change incorporates the prior guidance issued by the SEC staff by expressly requiring that any proposed arrangement with a retiring representative must comply with federal securities laws and SEA rules and regulations.

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no-action letters is inconsistent and not legally binding, and the Commission's proposed single-factor "transaction-based compensation" test for broker activity is an inaccurate statement of the law.

8 See Paul Anka, SEC No-Action Letter (available July 24, 1991). See also Muni Auction Inc., SEC No-Action Letter (available March 13, 2000) and Bond Globe, Inc., SEC No-Action Letter (available February 6, 2001).

**D. Proposed FINRA Rule 2040(c) – Non Registered Foreign Finders**

1. Support for Retaining NASD Rule 1060(b)

In Regulatory Notice 09-69, FINRA had initially proposed to delete NASD Rule 1060(b) because it believed the activity should be governed by the general requirements of proposed FINRA Rule 2040(a). However, based on the comments received in response to Regulatory Notice 09-69, FINRA is proposing to transfer NASD Rule 1060(b) unchanged into the consolidated FINRA rulebook. SIFMA largely supported the proposed rule change, but seeks clarification of certain language. IMS, Plexus and Commonwealth expressed concern that FINRA missed the opportunity to provide much needed clarity in the area of foreign finders and the compensation they can be paid. Cornell stated that proposed Rule 2040(c) and Supplementary Material .01 "create overly broad and vaguely defined safe havens for nonregistered individuals that receive payments related to securities transactions."[9]

2. Clarification That Foreign Finder Under Rule 2040(c) is not a "Person Associated with a Member"

ABA urged FINRA to clarify that a foreign finder is not a "person associated with a member," as that term is defined under the FINRA By-Laws.[10] ABA expressed concern that by relocating this provision, which is currently contained in NASD Rule 1060(b) to new FINRA Rule 2040, FINRA may not have fully incorporated existing guidance and may have "changed the character of the provision from a registration 'safe harbor' to a prescriptive rule that sets forth the only permissible basis on which transaction-based compensation may be paid to a foreign finder."[11]

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9 See Cornell.

10 See FINRA By-Laws, Article I (Definitions), subsection (rr) defines a "person associated with a member" or "associated person of a member" to mean: (1) a natural person who is registered or has applied for registration under the Rules of the Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the Corporation under these By-Laws or the Rules of the Corporation; and (3) for purposes of Rule 8210, any other person listed in Schedule A of Form BD of a member.

11 See ABA.

3. Proposed Changes to Rule Text

Cornell recommended that proposed Rule 2040(c)(1) be amended to eliminate the use of a subjective "assurance" standard by revising the language to 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." Cornell stated that the "assurance" standard is unacceptably subjective because it depends on a specific member's knowledge, resources, and discretion and 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.

ABA suggested that proposed Rule 2040(c)(2) and (3) be amended to permit members to focus on the residency, instead of the citizenship, of customers as this provides a "brighter and more enforceable line for all concerned and that the Commission has recognized residency as a better policy guide for the proper application of the broker-dealer registration requirements, except in very limited circumstances."[12] ABA believed that the requirements in the proposed rule change that finders not be U.S. citizens and customers be foreign nationals (not U.S. citizens) impose an undue burden.

IMS stated that the conditions a firm must satisfy to rely on proposed Rule 2040(c) (e.g., determining whether the finder is not required to register as a U.S. broker-dealer and not subject to a disqualification under FINRA's By-Laws, the compensation arrangement does not violate applicable foreign law, etc.) will increase compliance costs for firms, particularly when outside counsel has to be retained. In addition, IMS noted that the additional disclosure requirements and recordkeeping requirements would be costly for firms, especially for small firms.[13]

4. Scope of Foreign Finders Proposal Is Not Comprehensive

Two commenters, SIFMA and ABA, expressed concern that the scope of the proposed rule change appears to be too restrictive. Both commenters stated that as a result of language in the Proposing Release that proposed Rule 2040(c) permits compensation when the foreign finder's sole involvement is the initial referral to the member, any activities beyond the initial referral of non-U.S. customers and payment of transaction-

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12 Id.

13 See IMS.

based compensation for any such activities "would not be within the permissible scope of the foreign finders exception as set forth in proposed FINRA Rule 2040(c)."[14]

SIFMA stated that the Existing Nonregistered Foreign Finder Rules include NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03 as a safe harbor, not as an exclusive means of compliance with the Existing Nonregistered Foreign Finder Rules, and requested that the proposed rule language be clarified with the use of the phrase "unless otherwise permitted by the federal securities laws or FINRA rules," because there may be other permissible activities, beyond the initial referral, that would be within the permissible scope of the foreign finders exception. ABA recommended that FINRA clarify the proposed rule text to permit the payment of compensation to foreign finders so long as the activities of the foreign finder are otherwise permitted. ABA argued also that the inclusion of the word "sole" in the Proposing Release is unnecessarily restrictive and anti-competitive.

In addition, SIFMA requested additional guidance to assist in the implementation and operation of proposed Rule 2040(c). Specifically, SIFMA noted that proposed Rule 2040(c)(4) requires that "customers receive a descriptive document, similar to that required by Rule 206(4)– 3(b) of the Investment Advisers Act, that discloses what compensation is being paid to finders." SIFMA stated that investment advisers must disclose the additional amount that will be charged to the investment advisory fee (normally expressed as a percent of assets under management) and the differential attributable to the finder arrangement and, in general, the nature of fees between an investment adviser and its clients differ from the nature of fees between a broker-dealer and its customers. Therefore, SIFMA believed that it would be useful to have examples of how the condition would operate.

Plexus believed that the proposed rule provides the SEC with an opportunity to provide clarity in the area of finders and, moreover, argued that allowing FINRA to adopt the SEC's standard is not efficient.[15] Plexus expressed concern about the current SEC guidance, in particular the Paul Anka SEC no-action letter, which it argued narrowed the issue to whether a transaction fee is paid. It further stated that the industry believes it is safe to pay fixed fees to employees or finder/consultants and urged the SEC to provide clarity on the Anka letter and the transaction fee test.[16]

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14 See SIFMA.

15 See Plexus.

16 See Plexus. See also supra note 8.

5. FINRA Response

FINRA appreciates that the commenters acknowledged that FINRA is proposing to transfer NASD Rule 1060(b) unchanged to the consolidated rulebook in response to earlier comments on Regulatory Notice 09-69. The proposed rule change does not seek to address all circumstances under which payments may be made by U.S. broker dealers to foreign finders. In addition, the proposed rule carries over a narrow safe harbor that permits a firm to pay on-going compensation to a foreign finder under the conditions set forth in the provision. FINRA recognizes that the proposed rule change does not address all open issues with respect to the payment of transaction-based compensation to foreign finders, but believes that this type of comprehensive rulemaking or guidance is outside the scope of this proposal. To the extent that additional interpretive issues remain, FINRA will work with SEC staff on issuing related guidance, as appropriate.

FINRA declines to amend the proposed rule text or provide examples as suggested by the commenters as it is not proposing to make any substantive changes to the provision. FINRA does not intend to change the meaning or scope of the proposed provision or its related guidance by relocating the provision from the Series 1000 rules of the NASD rulebook to the Series 2000 rules of the FINRA rulebook. Similar to NASD Rule 1060(b) and NYSE Rule Interpretation 345(a)(i)/03, proposed Rule 2040(c) is not intended to be the only means by which a member may pay compensation to a foreign finder. Members may rely on other applicable federal securities laws and regulations where the activities of a foreign finder go beyond the scope permitted by the proposed rule (e.g., the initial referral of a customer to the member).

In addition, as stated in the Proposing Release, based solely on its activities in compliance with proposed FINRA Rule 2040(c), the foreign finder would not be considered an associated person of the member. Further, FINRA believes the word "solely" is critical and that any activities by the foreign finder beyond the initial referral of the customer would no longer allow a firm to rely on the "safe harbor" established by the proposed rule and may require registration under Section 15(a) of the Exchange Act or result in association with the member under the FINRA By-Laws. Therefore, the inclusion of this restriction is not new and has always been understood to be part of the provision.

**D. Proposed FINRA Rule Supplementary Material .01 (Reasonable Support for Determination of Compliance with Section 15(a) of the Exchange Act)**

1. Requests to Clarify Scope and Terms

Several commenters had concern with the scope and requirements of proposed Supplementary Material .01.[17] Specifically, ABA, SIFMA, Cornell and IMS expressed concern with the third prong of the proposed rule that allows a firm to obtain a "legal opinion" from independent and reputable U.S. licensed counsel. The commenters stated that seeking SEC no-action letters or opinions of "outside" "reputable" and "knowledgeable" counsel will be burdensome and costly, especially for small firms. IMS argued that, among other burdens, the proposal would mean that in-house counsel is automatically disqualified from rendering such an opinion, even if that counsel is prepared and qualified, by reputation and knowledge, to issue an objective opinion. ABA urged FINRA to provide greater flexibility in the range of measures that a member firm may rely on to "reasonably support" its determination and suggested that proposed Rule 2040(a)(3) be amended to provide that a member firm support its determination based on "advice of knowledgeable outside counsel" and make clear that the enumerated bases for determining that the necessary "reasonable support" exists are not exclusive.

Cornell stated that determining whether counsel is "reputable" or "knowledgeable in the area" depends on the market in which he or she practices and the member's discretion and requested clarification as to whether "area" refers to geography or legal practice. IMS stated that the concepts of "reputable" and "knowledgeable" are subjective and the costs of implementing "these mandates are likely prohibitive and disproportionate to any economic benefit the firm might receive."[18] SIFMA requested further guidance to illustrate the standard "reasonable under the circumstances" as well as guidance on the expected frequency of the periodic review.

2. Other Comments

Several commenters believed that FINRA should provide greater clarity on when and under what circumstances payments to unregistered foreign finders are permitted.[19] IMS objected to the proposed rule arguing that, instead of providing clarity, FINRA has imposed five additional conditions by proposing Supplementary Material .01. IMS further argued that FINRA did not address the impact of the proposed rule change on several

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17 See ABA, SIFMA, IMS and Cornell.

18 See IMS.

19 See IMS, Commonwealth and Plexus.

activities that may be exempt from broker-dealer registration through SEC or FINRA guidance.[20]

NASAA stated that the addition of this Supplementary Material .01 mitigates some of the concerns previously raised by them in response to Regulatory Notice 09-69, but they remain concerned with the complex issues surrounding the compensation of unregistered persons that they stated is largely unaddressed by the current proposal.

Cornell stated that Supplementary Material .01's "reasonable reliance" standard depends almost entirely on the judgment of broker-dealers who have a financial incentive to interpret materials broadly. Further, Cornell stated that although the Supplementary Material 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.

3. FINRA Response

FINRA is proposing to adopt Supplementary Material .01 because it recognizes the potential costs and burdens of obtaining a firm-specific, no-action letter from the SEC. The proposed supplementary material is intended to clarify that firms may rely on other means to demonstrate compliance and provides firms with the flexibility to rely on other options that may be less costly and time consuming.

FINRA does not intend proposed Supplementary Material .01 to be an exhaustive list by which firms can make a reasonable determination. A legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area is not the only means available to firms. Among other things, firms may continue to rely on the advice of in-house counsel or foreign counsel under prong 1 that permits a firm 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."

FINRA declines to define how frequently a firm must review its determination under the proposed rule because the review must be reasonable based on the nature and scope of the activity in question and therefore requires a factual review. FINRA believes, however, that an annual review for on-going payments would generally be reasonable, absent evidence of activities by the recipient of the payments that raise red flags.

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20 See IMS. In its letter, IMS expressly referenced crowding (SEC Release Nos. 33-9470; 34-70741), the SEC Six Lawyer no-action letter (SEC No-Action Letter, January 31, 2014; revised February 4, 2014); and FINRA's proposed rules for limited corporate finance brokers (Regulatory Notice 14-09).

E. **Proposed FINRA Rule 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation)**

No comments were received on this proposed rule.

F. **Proposed Amendments to FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, Bar or Other Disqualification)**

No comments were received on this proposed rule.

FINRA believes that the foregoing, along with the discussion in the Proposing Release, fully responds to the issues raised by the commenters. If you have any questions, please contact me at 202-728-6903.

Sincerely,

Kosha K. Dalal