

HOW TO IMPLEMENT PAYMENTS TO UNREGISTERED PERSONS RULE



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Broker/dealers are frequently asked to make payments to finders, service providers and other intermediaries in connection with securities transactions or services. Effective Aug. 24, 2015, new **Financial Industry Regulatory Authority** rules will prohibit member firms from making certain types of payments to persons other than registered B/Ds—unless the member determines that the recipient of the payment would not be required to register as a B/D on account of receiving the payment.

Firms will need to have “reasonable support” for determining that the recipient can receive the payment without B/D registration, and will have to maintain records of that determination.

PREVIOUS RULES

FINRA and its predecessors have long had rules prohibiting the sharing of certain fees, commissions and discounts pertaining to securities transactions with non-members, subject to a host of formal exceptions and interpretations.

These rules were originally intended to encourage membership in FINRA by restricting members’ dealing with non-members. But as FINRA membership became mandatory for almost all B/Ds, the rules were interpreted as prohibiting the sharing of securities-related commissions or fees with persons that may be acting as unregistered B/Ds.

Over time, FINRA issued letters that permitted members to make certain payments so long as a member procured a no-action letter from **Securities and Exchange Commission** staff indicating that the recipient could receive such payments without becoming subject to the B/D registration requirements under the Securities Exchange Act of 1934.

New FINRA Rule 2040 modernizes and replaces former **NASD** Rule 2420 and related interpretive material, as well as **New York Stock Exchange** interpretations of NYSE rules 353 and 345(a). Rule 2040 codifies, in spirit, the FINRA staff’s interpretations of the former rules, while somewhat liberalizing the requirements by eliminating the obligation to obtain a specific SEC no-action letter.

But at the same time, the new rule places on the member firm wishing to make a payment the burden of determining that the recipient would not be required to register as a B/D, “reasonably supporting” such a determination, maintaining a record of it and, for continuing payments, reviewing this determination periodically.

Rule 2040 will also prohibit the sharing of securities-related compensation with appropri-

ately registered associated persons, unless the payment complies with all applicable federal securities laws, as well as SEC and FINRA rules. In addition, Rule 2040 preserves a pre-existing rule permitting members to engage (and make payments to) unregistered foreign finders and retiring registered representatives of the firm, each subject to various specific conditions.

A separate companion amendment to FINRA Rule 8311 clarifies existing standards concerning payments to associated persons whose registrations are suspended or revoked or who are subject to particular disqualifications.

DETERMINING PAYMENT COMPLIANCE WITH B/D REGISTRATION REQUIREMENT

Reasonable Support For Determination

Key to complying with Rule 2040 will be having “reasonable support” for the firm’s determination that a payment to an unregistered person does not trigger the B/D registration requirements under the Exchange Act. Supplementary Material .01 to Rule 2040 permits members to derive support for their determination by:

- Reasonably relying on previously published releases, no-action letters or interpretations from the SEC or SEC staff that apply to their facts and circumstances;
- Seeking a no-action letter from the SEC staff; or
- Obtaining a legal opinion from independent, reputable U.S.-licensed counsel knowledgeable in the area.

FINRA made clear in a regulatory notice pertaining to the new rule that these methods of making a reasonable determination are not exclusive, and that members may, for example, rely on in-house counsel or even foreign counsel.

Who Must Register As A B/D?

Although, on the surface, the reasonably supported determination requirement would seem to be fairly flexible, there are not, in fact, many situations in which the SEC or its staff have clearly indicated that these types of payments are permissible.

Interestingly, the Exchange Act itself does not refer to compensation as an element of broker or dealer status. In general, a broker is a person who engages in the business of effecting transactions in securities for the account of others, and a dealer is a person who engages in the business of buying and selling securities for its own account. Unless an exemption is available, brokers and dealers are required to register with the SEC if they use any means of interstate commerce with

respect to effecting or soliciting transactions in securities, other than government securities.

The SEC and the courts have come to evaluate whether someone is a broker or a dealer based on the “facts and circumstances” of their activities, taking into account a variety of factors and the context of those activities. The SEC staff’s position is that receiving commissions or other compensation that is based on the size or completion of securities transactions—so-called “transaction-based compensation”—is typically a hallmark of broker or dealer status.

In the SEC staff’s view, the recipient of transaction-based compensation generally bears a heavy burden to demonstrate that it is *not* subject to B/D registration, though the courts have not always been as willing to accept that receiving such compensation, without the presence of other factors, triggers the registration requirement.

There are, however, a number of areas in which the SEC, FINRA and their respective staffs have permitted such compensation to be received by unregistered persons, subject to various conditions, including:

- Certain foreign B/Ds;
- Certain foreign finders;
- Certain merger and acquisition advisers;
- Payments of ordinary dividends to the shareholders of the B/D;
- Payments to an affiliate to permit the affiliate to act as a “paymaster” for employees of the affiliated group; and
- Payments to research providers out of soft dollar commissions.

However, the SEC precedents supporting such payments often do not lend themselves to extension or generalization outside of their particular context because the rules and guidance on each of these are very fact-specific.

Where Is Guidance Available?

SEC guidance in this area is often difficult to access because it is spread across decades of staff no-action letters (and denials of no-action relief), proposing and adopting rule releases, enforcement proceedings and other more obscure locations. In-house counsel and compliance personnel seeking key sources may find it useful to consult the following resources, all of which may be accessed via the SEC website:

- Guide to Broker/Dealer Registration;
- Exchange Act Rule 15a-6 and the related adopting release, which address the cross-border application of the B/D registration requirements;
- Exchange Act Release *Continued on page 14*

REGULATOR	REGION	TOPIC	DETAILS	DEADLINE
Financial Industry Regulatory Authority	North America	Algorithmic trading strategies	FINRA is requesting comment on a proposal to require registration of persons involved in the development of algorithmic trading strategies.	Comments due May 18.
Nasdaq	North America	Market center	Filed with the SEC a proposal to change Rule 4611 and adopt new Rule 4615 related to Nasdaq market center participant registration and sponsored access.	Comments due May 19.
CBOE	North America	Financial reports	Filed with the SEC a proposal to amend rules regarding the submission of financial reports.	Comments due May 20.
European Securities and Markets Authority	Europe	Structured finance instruments	ESMA is consulting on disclosure requirements for structured finance instruments.	Comments due May 20.
Nasdaq	North America	Closing process	Filed with the SEC a proposal to postpone implementation of rules 4751(h) and 4754(b) related to the closing process.	Comments due May 20.
NYSE	North America	Midday auction	Filed with the SEC a notice designating a longer period for action on a proposal to adopt new Rule 124 to conduct a midday auction, and amending Rule 104 to codify the obligation of designated market makers to facilitate the midday auction.	The new deadline is May 24.
CFTC	North America	Residual interest deadline for FCMs	The CFTC is amending regulation to remove Dec. 31, 2018 as the automatic termination date for the phased-in compliance schedule for futures commission merchants.	Becomes effective May 26.

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34-46745 (Oct. 30, 2002), which proposed certain exemptions for banks from the B/D registration requirements; and

- Selected no-action letters concerning B/D registration requirements

WHAT SHOULD COMPLIANCE POLICIES AND PROCEDURES CONTAIN?

Basic Prohibition

The firm's policies regarding payments to unregistered persons should prohibit commission sharing or other payments relating to securities transactions to unregistered persons absent approval from designated control persons—such as the general counsel or chief compliance officer—and supervisor approval.

Examples of these may include payments to:

- Finders and unregistered intermediaries;
- Vendors, including transaction-processing technology providers;
- The firm's affiliates and their unregistered employees; and
- Corporate officers or shareholders of customers.

Controls

Persons within the firm who review forms or drafts of agreements (such as in-house counsel and documentation teams) and who approve or process payments should be required to look for, and to escalate as necessary, any contract clauses or payment requests that appear to be potentially inappropriate. As above discussed above, transactions that potentially involve securities-related

payments to unregistered should not be permitted to proceed absent control person approval.

Signoff And Continuing Payments

Designated control persons should document their determination that a proposed payment may be made along with the basis for that determination—such as an opinion of external counsel or an internal memorandum analyzing the relevant facts and circumstances and referencing applicable SEC guidance or other authority.

In cases of payments to or other arrangements with unregistered foreign finders, retiring registered representatives of the firm and persons whose registrations are suspended or revoked or who are subject to particular disqualifications, the reviewing legal or compliance designee should pay particular attention that the conditions under each of Rule 2040 and Rule 8311 applicable to these situations are considered and observed.

In the case of continuing payments, FINRA requires that approvals be revisited periodically. In its regulatory notice, the staff indicated that, absent red flags, an annual review would generally be considered reasonable.

Recordkeeping

The firm's policies and procedures should provide that a record of these determinations (and any supervisory approvals) be maintained and accessible in response to an examiner's inquiry. As a practical matter, it would be useful to develop a system by which the record of the approval and determination are associated with

in the firm's records with the relevant contract and payments.

Training

While not expressly required under Rule 2040, this is an area that would be an appropriate subject for training within the firm, particularly for personnel involved in reviewing new business relationships, contracting and payments. CCOs may also consider covering the topic in their annual compliance interview for 2015.

ONUS TO ACT

While the substance of Rule 2040 is slightly more flexible than its predecessors, the new reasonably supported determination standard and related documentation requirements effectively place on member firms—and particularly legal and compliance professionals—the onus of establishing:

- New processes to identify potentially prohibited payments;
- Controls to prevent such payments until a proper determination has been made by an authorized person;
- Protocols for making the required determinations (such as seeking advice from internal or external counsel); and
- Appropriate records and a "tickler" system to trigger the periodic review of determinations for continuing payments.

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