

Payments to Unregistered Persons – The Next Round

The role of the Financial Industry Regulatory Authority (FINRA) in dealing with payments to unlicensed persons for securities-related and capital-raising activities has grown significantly. On Dec. 30, 2014, the U.S. Securities and Exchange Commission (the SEC) approved FINRA Rule 2040 governing when and how registered broker-dealers can provide compensation to unregistered persons. Not only does the approval enhance the authority of FINRA's activities in this area, it informally codifies some of the existing guidance and clarifies some of the existing ambiguities.

For many years both FINRA, and its predecessor the National Association of Securities Dealers (NASD), had a more limited role in enforcing the registration requirements of Section 15(a)(1) of the Securities Exchange Act of 1934 (the Exchange Act). Section 15 requires persons who are effecting or causing others to effect securities transactions for compensation as a business to be registered as broker-dealers. Under the Exchange Act and with limited exceptions, an unlicensed person is not permitted to receive compensation for such activities. While the primary enforcement of this requirement rested with the SEC, FINRA (and other self-regulatory organizations) assisted in enforcing these requirements by adopting rules that limited the ability of a member firm to make such payments. However, FINRA has refrained from issuing its own guidance as to whether a person is covered by Section 15(a)'s registration requirements.

Many areas covered by Rule 2040 simply incorporate non-controversial and existing policies from prior rules. The concern of this *Alert* is two gray areas that have posed concerns for issuers of securities, registered firms, and lawyers advising clients in the industry. These two areas relate to "finders" and "foreign persons."

"Finders" are unlicensed persons who seek to receive compensation from parties to a securities transaction, such as a private or public offering, for such activities as negotiating transactions, introducing licensed broker-dealers, or bringing investment capital to the table. The proposed Rule 2040 and related interpretive material meshes with Section 15 to provide guidance from FINRA to member firms that will help to identify whether a person seeking such compensation should be registered. The approval notes that "FINRA will expect members to determine that [the proposed activities of the unlicensed party] would not require the recipients of the payments to register..." The firm would be required to reasonably support its determination. A member firm that does not fulfill this affirmative obligation would be deemed to directly violate a FINRA rule rather than face a more ambiguous and indirect claim that it "unknowingly" paid someone who should have been licensed.

The second area of clarification involves foreign finders. Although the new rule incorporates former Section 1060(b) of the NASD rules, it spells out the conditions a member firm and a foreign finder must satisfy before a member firm may compensate the foreign finder:

- > The member firm must confirm that the foreign finder is not required to register in the U.S. and is not a disqualified person;
- > The individual is a foreign national or entity;
- > The customers are foreign nationals;
- > The customers receive disclosure concerning the compensation arrangement;
- > The customers acknowledge that disclosure in writing;
- > Records of such payments are maintained in the books of the member firm;
- > Confirms specifically disclose that there is a finder's fee being paid.

The release reaffirms that the only permissible role for a foreign finder will be to provide an introduction, and confirms that the foreign finder would have to be registered if it assumed a more extensive role. If it engages in activities beyond the initial referral then that may require registration.

The expanded role of FINRA in this area is reflected in its addition to the FINRA Rule Book of Supplementary Material providing interpretive guidance on these issues. Many of the points covered incorporate existing policies and guidance from the SEC. One area that drew some comments during the proposal process related to foreign finders, expressing concern that this imposed additional costs on and sensitive decisions regarding the criteria by member firms. The FINRA response focused on several approaches to these issues, including obtaining no-action letters from the SEC or opinions from outside, reputable, and knowledgeable counsel.

Clearly, approval of Rule 2040 by the SEC signals its interest in dealing with the continuing concerns about unlicensed persons fulfilling any but the most limited functions, and the increased impact in that area of the internationalization of capital-raising functions flowing across borders.

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