Morgan, Lewis & Bockius LLP
5300 Wachovia Financial Center
200 South Biscayne Boulevard
Miami, FL 33131-2339
Tel: 305.415.3000
Fax: 305.415.3001
www.morganlewis.com

Morgan Lewis
COUNSELORS AT LAW

Ethan W. Johnson
Partner
305.415.3394
ejohnson@MorganLewis.com

February 1, 2010

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 2006-1506

Re: **Comment on Proposed Consolidated FINRA Rule 2040 Governing Payments to Unregistered Persons (Regulatory Notice 09-69)**

Dear Ms. Asquith:

We are pleased to have the opportunity to submit our comments to the proposed Consolidated FINRA Rule 2040 which is intended to streamline, *inter alia,* existing NASD Rules 1060(b) and 2420 and NYSE Rule Interpretation 345(a)(i)/03 (referred to herein as the "NYSE Foreign Finder Interpretation") and related interpretations (the "Proposal"). We are writing on behalf of a number of our U.S. broker-dealer and clearing firm clients, including Pershing LLC, that will be impacted by the Proposal if it is adopted. We are submitting this letter pursuant to the request for comments published in Regulatory Notice 09-69.

We support FINRA's effort to develop clear and concise rules regarding payments to unregistered persons. However, we do not believe that the Proposal, which seeks to eliminate those aspects of NASD Rules 2420(c) and 1060(b) and the NYSE Foreign Finder Interpretation that address payments to persons and businesses residing outside of the United States, and, instead, require member firms to rely solely on guidance from the Securities and Exchange Commission (the "SEC") or its staff, promotes clarity. We are apprehensive, particularly, that the proposed elimination of the guidelines established by existing NASD and NYSE rules and interpretations may reduce the competitiveness of FINRA members outside of the United States.

Our view is based on our concern that current SEC rules and staff interpretations, as well as case law, in this area are sparse and fact-specific and do not give adequate guidance on the

question of when a non-U.S. person is required to register with the SEC as a broker-dealer as a result of its relationship with a member firm resident in the United States. This is true particularly in the context where the only point of contact of the non-U.S. person to the U.S. securities markets is the referral of other non-U.S. persons to the FINRA member or obtaining execution, clearing, settlement or custody services for non-U.S. customers.[i] If the Proposal is adopted as proposed many of our clients that provide execution, clearing, settlement, custody and other brokerage services to hundreds of non-U.S. financial firms, or have referral arrangements with foreign persons, may be forced to restructure their business models substantially or worse still, eliminate these activities entirely.[ii]

In addition to our concern that existing SEC staff guidance regarding broker-dealer status in the context of foreign referrals too often relies on a case-by-case analysis and is not helpful, we believe the existing framework under NASD Rules 1060 and the NYSE Foreign Finder Interpretation provides adequate protections to referred clients in the form of additional disclosures mandated by the existing rules. These protections would be eliminated under the Proposal since the sole question would then be whether the referring foreign person is required to register as a broker-dealer in the United States by virtue of the receipt of referral payments. Similarly, the withdrawal of Rule 2420 would eliminate the protections afforded to the U.S. markets that are contained in Rule 2420(c), such as the requirement that the member firm and foreign firm enter into an agreement restricting sales into the U.S.

We would, instead, urge FINRA either to retain Rules 1060(b) and 2420(c) and the NYSE Foreign Finder Interpretation in their current form (subject to one recommended change discussed below) or to work closely with the SEC to develop comprehensive guidance that will assure FINRA members that they may perform clearing, settlement, custody and execution services for foreign financial institutions and make referral payments to, or share compensation with, such financial institutions and other persons even though the institutions and other persons are not registered as brokers or dealers with the SEC.

Analysis

NASD Rule 1060(b) and NYSE Interpretation 345(a)(i)/03. Existing NASD Rule 1060(b) and the NYSE Foreign Finder Interpretation (a published interpretation of NYSE Rule 345) provide that FINRA and NYSE member firms may pay transaction-related compensation to non-registered foreign persons based upon the business of customers they direct to the member firm if certain conditions are met.

Both NASD Rule 1060(b) and the NYSE Foreign Finder Interpretation are virtually identical. The only difference is the requirement in the NASD rule that the foreign finder not be subject to a statutory disqualification (as defined in the FINRA by-laws). This would include such things as certain criminal convictions, as well as bars, expulsions, current suspensions and injunctions.

NASD Rule 2420. This rule generally prohibits payment of fees and commissions to non-member brokers or dealers. Paragraph (c) of the rule states that paragraphs (a) and (b) of the rule do not apply to payments to foreign brokers or dealers not eligible for membership as long as the member making the payments secures from such foreign broker or dealer an agreement that in making any sales to purchasers within the United States of securities acquired as a result of such transactions, the foreign broker or dealer will conform to the provisions of paragraphs (a) and (b) of the rule to the same extent as if it were a member. While this rule does not expressly address the relationship between U.S. clearing firms and their non-U.S. correspondents, it is frequently cited as confirmation that the FINRA rules permit member firms to enter into a variety of clearing and sub-clearing agreements and other brokerage arrangements with foreign non-member firms and to share fees or pay other forms of compensation without requiring the foreign firms or their personnel to register with the SEC.[iii]

Recommendation

The existing rules were developed in order to allow member firms to compete more effectively overseas where the payment of referral fees and the sharing of compensation between financial institutions is a common form of business development or practice. This goal should be preserved. The rules present low risk to the securities markets and investors because generally the sole involvement of the referring foreign person is to make a referral to the member firm or to obtain execution, clearing or settlement services from such member and they do not permit broader contact with U.S persons. Moreover, after a successful referral the foreign referring person typically does not remain involved in the relationship between the member firm and the foreign persons referred to the firm.[iv] Further, as noted above, significant additional protections are afforded under the foreign referral rule by requiring the referring party to disclose important details to the referred customers such as the fact that transaction-related compensation is being paid to the foreign referring person. As a result, we believe that FINRA should not withdraw the rules and should continue to provide guidance for foreign referral payments or other financial compensation arrangements as long as the conditions of the rules are satisfied.

We would also note that under most introducing arrangements each foreign financial institution specifically agrees to introduce only accounts that are held by non-U.S. persons domiciled outside the U.S. and represents to the member firm that: (i) it is a foreign entity domiciled outside the jurisdiction of the U.S.; (ii) it is not registered, nor is it required to register, with the SEC as a broker or dealer; (iii) it is not subject to a disqualification, as this term is defined in Article III, Section 4 of the By-Laws of the NASD; (iv) to the best of its knowledge, the compensation arrangement does not violate the law of any applicable foreign jurisdiction; and (v) every introduced account shall be either a non-U.S. national or non-U.S. organized entity domiciled outside the U.S.

Consequently, we do not believe that the arrangements whereby the member firm pays referral fees to, or shares fees and commissions with, non-member foreign persons, including foreign financial institutions, in consideration of their introduction of customers or transactions of their foreign customers pose any material risk that unlicensed firms will be providing brokerage services to U.S. persons. Moreover, in light of the absence of any promotional efforts by the foreign referring firm on behalf of the business conducted by the member firm as a result of the referral, we believe that the foreign referring firm does not have the type of "salesman's stake" that normally is addressed in connection with U.S. broker-dealer registration.

With respect to existing Rule 2420(c), we recommend that it be retained in its current form. We do recommend, however, one small change in the text of the rule. The current rule states that the provisions of paragraphs (a) and (b) of Rule 2420 do not apply to "any nonmember broker or dealer in a foreign country who is not eligible for membership in a national securities association" (emphasis added). We recommend that the exemption in paragraph (c) be based on the person not being required to be a registered broker-dealer in the United States and member of a national securities association rather than using the existing "eligible" standard. In advising our clients over the years we have found it difficult to determine when a foreign firm would not be eligible for such membership. Also, we would submit that eligibility is not a relevant determinant of whether a foreign firm should register before it may enter into clearing or other arrangements with member firms. Further, this change would make the standard applied in Rule 2420(c) consistent with the standard found in Rule 1060(b).

Lastly, we have the following comments on the proposed rule, assuming for this purpose that the existing rules will not be retained in their current forms: (i) eliminate "or offer to pay" from the introductory clause in section (a) of the proposed rule since determining whether and when an offer to pay has been made would add a level of subjectivity that would undercut the effort to bring clarity to this area; (ii) eliminate "appropriately" from the beginning of subsection (a)(2) as the requirement in the subsection will need to be satisfied even it the person is "inappropriately" registered, if that is even possible; and (iii) narrow the scope of the pre-conditions in section (a)(2) to just those of verifying that the person is registered and not subject to any statutory disqualifications – the burden of checking all the laws, rules and regulation cited in the proposed rule will be a strong disincentive against a member firm ever making such payments.

Conclusion

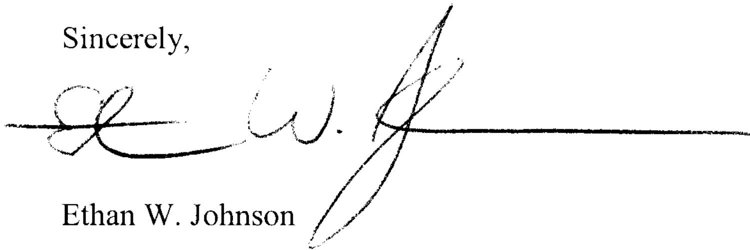
As discussed above, the existing rules with respect to foreign referrals and dealing with non-member firms are helpful and provide adequate protection to foreign customers that are referred to FINRA members and ensure that foreign non-member firms conform to FINRA standards when dealing with U.S. customers and markets. In addition, existing guidance from the SEC with respect to registration of foreign financial institutions is insufficient to

serve as the sole basis for determining whether compensation may be paid to foreign persons by FINRA members. Accordingly, we respectfully urge FINRA to retain the provisions of existing Rules 1060(b) and 2420 and the NYSE Foreign Finder Interpretation (subject to our recommended change) or work with the SEC to develop more comprehensive guidance in this area.

However, if FINRA determines to proceed with its proposal in its present form, we strongly urge FINRA to establish an extensive phase-in period and to grandfather existing arrangements between members and foreign financial institutions and permit them to continue operating as though the existing rules were still in force.

We and our clients appreciate the opportunity to comment on the Proposal. If you any have questions about this matter and our comments, please feel free to call me at 305-415-3394.

Sincerely,



Ethan W. Johnson

cc: Mark D. Fitterman

i The primary sources of SEC guidance are: (i) Part III B of the Adopting Release for Rule 15a-6 (34-27017); (ii) Part III of 1970 SEC Release 33-5068 dealing with the applicability of U.S. securities laws to offer and sale of mutual funds outside of the U.S.; (iii) Vickers Da Costa/Citicorp, SEC No-Action Letter (pub. avail. August 13, 1986); (iv) National Westminster Bank plc, SEC No-Action Letter (pub. avail. July 7, 1988); (v) Security Pacific Corporation, SEC No-Action Letter (pub. avail. April 1, 1988); and (vi) Dinosaur Securities LLC, SEC No-Action Letter (pub. avail. June 23, 2006). *See e.g.*, the Dinosaur Securities letter in which the SEC Staff indicated that it would not provide no-action relief on the question of whether a foreign person receiving compensation for referring customers must register as a broker-dealer with the SEC. We would note that the SEC has approved the NASD rules and NYSE interpretations discussed herein, which evidences that these existing rules reflect the SEC's current views.

ii We note that proposed FINRA Rule 4311(a)(2) expressly permits U.S. clearing firms to enter into clearing agreements with persons other than U.S.-registered brokers or dealers. The adoption of Rule 4311 as contemplated will be very helpful in closing some of the gaps identified above in this letter. At a minimum the interaction between and among proposed Rules 4311 and 2040 and existing Rules 1060(b) and 2420 should be studied carefully to maximize integration and clarity.

iii *See also* NYSE Rule 382(a) which expressly addresses agreements between NYSE member firms and foreign non-member organizations.

[iv] The referring party often will have a continuing relationship with the referred party and may even act as an advisor to the referred party but would not have any official capacity in the relationship between the parties.