

Insights

FINRA RE-AFFIRMS SETTLED PRINCIPLE THAT TRANSACTION-BASED COMPENSATION TYPICALLY CANNOT BE PAID TO UNREGISTERED PERSONS OR ENTITIES

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FINRA's final adjudicative body, the National Adjudicatory Counsel ("NAC") recently issued a decision,¹ affirming a Hearing Panel decision, sanctioning Silver Leaf Partners, LLC ("Silver Leaf") for making improper payments to unregistered persons and entities. The NAC imposed a \$100,000 fine and the requirement to retain an independent consultant. The Silver Leaf decision is a reminder to FINRA Members of the potential perils of making payments to unregistered persons or entities, directly or indirectly, based on the compensation of a securities transaction. Firms should review their policies and procedures to ensure that such payments are not made, or, at a minimum, are made with the utmost scrutiny and supervision.²

The Silver Leaf NAC decision arose out of a multi-million dollar FINRA arbitration award, relating to Silver Leaf's involvement in stock loan and block trading transactions. In FINRA Enforcement's complaint, it alleged, among other things, that Silver Leaf paid transaction-based compensation to an "unregistered finder" associated with the stock loan and block trading transactions as well as nonmember entities affiliated with its registered persons. It further alleged that these payments resulted from Silver Leaf's failure to supervise its business.

The NAC found that, between January 2012 and April 2015, Silver Leaf engaged in and facilitated stock loan and block trading transactions with the assistance of a registered party, Jay Chapler ("Chapler"). Chapler was tasked with introducing companies interested in engaging in stock loan and block trading transactions, and thereafter, Silver Leaf facilitated the transactions. As part of this "introductory" process, Chapler enlisted an unregistered finder ("SH")—a wealthy U.S. citizen residing in Florida who did business abroad. The NAC found that Silver Leaf shared certain compensation with SH. The decision identifies numerous email exchanges in which Silver Leaf indicated, through an entity representative, knowledge and approval of the payment-sharing structure with SH.

Separately, the NAC found that Silver Leaf paid certain transaction-based compensation to entities affiliated with registered persons, rather than paying the registered persons directly. The Securities Exchange Commission (“SEC”) flagged this issue in an examination in 2012. Notwithstanding the SEC’s exam finding, Silver Leaf continued paying the unregistered entities directly. The NAC Decision indicates that Silver Leaf paid transaction-based compensation to seven nonmember entities totaling \$2.6 million.

NASD Rule 2420 “prohibit[ed] any FINRA member from paying transaction-based compensation to any ‘nonmember broker or dealer.’” Importantly, NASD Notice to Members 05-18 makes clear that “[a] member may not evade the rule through indirect payments.” The NAC found two separate bases upon which Silver Leaf violated NASD Rule 2420 and FINRA Rule 2010.

First, Silver Leaf violated industry rules in paying transaction-based compensation to SH in connection with the block trade transactions. According to the Decision, Silver Leaf was paid a percentage of the fair market value of the transaction at close of the transaction, *i.e.*, transaction-based compensation. Silver Leaf then agreed to split those earnings amongst itself, its registered broker, and SH. The NAC found that SH functionally acted as a nonmember broker, in that he “was regularly involved in the soliciting securities transactions for Silver Leaf for which he received transaction-based compensation.” Thus, regardless of the procedural mechanism by which SH was paid—from Chapler directly—Silver Leaf “knew about, approved, and facilitated the payments to SH,” violating NASD Rule 2420 and FINRA Rule 2010.

Second, Silver Leaf paid transaction-based compensation to entities affiliated with its registered persons, rather than paying the registered persons directly. The NAC, in referencing previously published SEC guidance, noted that the law does not permit unregistered entities to receive commission income on behalf of registered representatives. As it pertains to the payments at issue here, the SEC had specifically warned Silver Leaf that it did not find its position—that such payments are permissible because the entities are wholly owned by the firm’s registered persons—persuasive. Additionally, there is no exception for single-member entities owned by one registered person, and Silver Leaf did not even establish that such a limit was applicable to the nonmember entities it paid.

Accordingly, the NAC held that Silver Leaf’s payments to SH and the nonmember entities directly violated NASD Rule 2420 and FINRA Rule 2010.³ The NAC imposed a \$50,000 fine for the Rule 2420 violations, and a separate \$50,000 fine for the related supervisory failures. Silver Leaf was also ordered to (1) retain an independent consultant to conduct a comprehensive review of its policies, systems, and procedures; (2) implement any recommendations made by said independent consultant; and (3) provide FINRA a written Implementation Report regarding same.

Firms should give a careful review of the NAC Silver Leaf decision. In particular, those FINRA Members that enter into business relationships with “finders” or third parties that locate business opportunities, in which compensation is based on a formula or the success of the third party, should

carefully scrutinize Silver Leaf's analysis. While FINRA Rule 2040 has replaced NASD Rule 2420, significant limitations continue to exist regarding making payments to unregistered third parties, when the payments are predicated on securities transactions or related activities.

1. https://www.finra.org/sites/default/files/2020-07/NAC_2014042606902_Silver-Leaf_062920.pdf

2. The Silver Leaf decision was based on the prior governing Rule, NASD Rule 2420. FINRA Rule 2040 has since supplanted NASD Rule 2420. However, given certain commonalities of these respective Rules, attention should be given to the principles from Silver Leaf that would apply to any enforcement proceeding brought under FINRA Rule 2040.

3. Additionally, in its appeal, Silver Leaf challenged FINRA's jurisdiction over the payment to SH and the nonmember entities. It alleged that the payments were not subject to the U.S. regulations and rules because the transactions involved foreign business. FINRA rejected this argument, as its jurisdiction extends to member conduct inside and outside the U.S.

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