

UNITED STATES OF AMERICA
BEFORE THE NATIONAL CREDIT UNION ADMINISTRATION

In the Matter of

XXXX

Docket No. BD - 03-16

Creditor Claim
XX Federal Credit Union

**Decision and Order on Appeal
Decision**

This matter comes before the National Credit Union Administration Board (Board) pursuant to §709.8 of NCUA Regulations (12 C.F.R. §709.8), as an appeal of the decision by the Agent for the Liquidating Agent (ALA) for XX Federal Credit Union (FCU) to disallow a claim by XXXX requesting payment of certain commission income associated with the sale of non-deposit investments.

Background and Initial Determination

FCU, with assets of approximately \$109 million, had become insolvent and was closed for liquidation on April 30, 2015. During its operation, FCU was engaged in a program involving the sale of non-deposit investment products, and the issues in this case involve the payment of and entitlement to commission income in connection with those sales.

FCU had entered into networking agreements, beginning in 2003, with three different securities firms, at different times, through whom the sales were administered.¹ Each securities firm was registered with the Securities and Exchange Commission as a broker-dealer, and XXXX asserts that he was a registered sales representative of each of them. XXXX, who was Vice President for Investment Services at FCU, served as a dual employee of FCU and the respective broker-dealer. As such, he was the retail salesperson through whom the sales were consummated. The broker-dealer paid commissions on the sales made at the FCU main office location, with contractually specified amounts of the commission paid to XXXX and to FCU, respectively. FCU's share of the commission was based on the fact that the sales were consummated at its office location.

¹ FCU had contracts with DFC Investor Services from October 2003 to August 2007; with IMFG Securities from August 2007 to March 2008; and with LPL Financial LLC from March 2008 through the date of FCU's liquidation in 2015. The ALA was only able to obtain documentation pertaining to the latest of these three relationships.

The issue in this case involves sales on FCU's premises that were made by XXXX to individuals who were not members of FCU. XXXX asserted that FCU had no legitimate claim to commission income derived from nonmember sales and that this income should have been paid to him. The ALA, finding no basis on which XXXX could legitimately establish his entitlement to this income, rejected the claim, and XXXX sought administrative review of that determination by the Board.

Discussion and Analysis.

XXXX argues that FCU received commission income to which it was not entitled in connection with sales of non-deposit investments to individuals who were not members of FCU. According to XXXX, he, and not FCU, was entitled to retain this commission income.² XXXX relies on two different source materials as support for this position. First, he notes that an NCUA examiner, in his report of examination effective as of December 31, 2014, included in his Document of Resolution (DOR) a criticism of FCU's sales program, including a specific criticism that some commissions were related to sales made to non-members. Second, appellant asserts that applicable rules administered by the Financial Institution Regulatory Authority (FINRA) and the SEC prohibit FCU from receiving and retaining such income. Each of these arguments is addressed below.

Examiner criticism. In the write-up comprising the examiner's DOR, the examiner criticized FCU for several shortcomings in its non-deposit investment sales program. The examiner noted, for example, a lack of clear distinction between activities of the credit union and activities of XXXX, whose business card identified him as representing "FCU Wealth Advisors," a business entity that did not exist. In addition, the FCU investment tab on its website linked with a page from the broker-dealer website without a clear disclosure or disclaimer that the user is leaving the FCU website. The examiner also questioned whether applicable rules governing conflict of interest had been violated due to the receipt by XXXX, who was a senior official of FCU, of commission income in connection with the credit union's exercise of an incidental power.

For present purposes, the pertinent criticism is that the networking arrangement adopted by FCU resulted in sales to both members and non-members of FCU. The examiner characterized this as impermissible, due to the fact that FCU did not use a CUSO as the vehicle through which sales were made. Instead, sales were made directly from the FCU premises by XXXX, who fulfilled the role of a dual employee on behalf of FCU and the broker-dealer. The examiner directed FCU to discontinue all investment services until it had obtained a legal opinion addressing whether its configuration as structured was permissible.

The file materials indicate that FCU did retain outside counsel to review the arrangement. The firm concluded that, as a senior executive, XXXX should not have received any compensation as part of an arrangement in which FCU was engaging in an incidental power.³ The firm went on to express doubt that FCU could have successfully sued XXXX to require him to return

² XXXX has estimated the value of his claim at \$512,000. Based on its assessment of the merits of XXXX's claim, the Board has not focused on or verified the accuracy of this number.

³ See 12 C.F.R. §721.7

commissions he had already received. The firm did not address the issue of whether FCU was entitled to retain commission income pertaining to sales made to nonmembers.

Although the examiner did not cite to it specifically, an opinion from the Office of General Counsel does exist that characterizes the receipt of commission income by an FCU for sales of non-deposit investment products to nonmembers as impermissible.⁴ As implied by the examiner, arrangements that involve the use of a CUSO as the vehicle through which sales to nonmembers are made may be permissible, whether directly by a CUSO that is also a registered broker-dealer or indirectly through a contractual arrangement between the CUSO and a broker-dealer. As long as such arrangements result in the sale of investment products “primarily” to members of the credit union(s) that own or have contracts with the CUSO, the arrangements are permissible.⁵ In this case, however, FCU did not rely on the services of a CUSO, but instead contracted directly with the broker-dealer. As such, FCU was not entitled to receive commission income attributable to sales made to individuals who were not its members.

This conclusion does not, however, provide support to XXXX’s claim that he is entitled to these commissions. In the first place, the contract he signed with FCU creating the dual employee relationship expressly contemplates that sales covered by the contract may be made to both members and nonmembers of FCU. XXXX signed that agreement and should not now be heard to complain that he objects to the arrangement. After all, he did earn and receive commission income with respect to all retail sales he consummated, whether to members or nonmembers. Furthermore, as FCU’s Vice President for Investment Services, it was to some degree incumbent upon XXXX to assure that the contractual arrangements to which FCU was a party were compliant with applicable regulatory requirements.

In the second place, vis-à-vis the broker-dealer, there was no distinction between FCU’s members and nonmembers. Sales to individuals with whom XXXX dealt while on FCU’s premises were subject to compensation payable by the broker-dealer, and XXXX does not dispute that he received all to which he was contractually entitled. Whether or not FCU was entitled to overriding commissions from the broker-dealer for sales to nonmembers is an issue of regulatory concern, not contractual, and certainly not contractual with respect to XXXX. He struck his bargain with the broker-dealer for his compensation, and he received it. Whether, as a regulatory matter, FCU was entitled to commission income for nonmember sales is of no concern to him.

Alleged violation of securities laws. In his claim letter and his appeal letter, XXXX asserts that FCU was prohibited by securities laws and rules from receiving commission income on sales to nonmembers. There is no merit to this assertion, which is based on an apparent misreading of the applicable rules. It is correct, as appellant notes, that the securities rules generally prohibit the sharing of commission income from the sale of investment products between a broker-dealer that is a member of FINRA and a nonmember.⁶ There is, however, a recognized exception to the

⁴ See OGC Op. 03-0736 (Jan. 19, 2005) (“an FCU has no authority to provide investment services to nonmembers” and “could not derive income from” sales made by a dual employee to nonmembers).

⁵ 12 C.F.R. §712.3(b)

⁶ See FINRA Rule 2040, governing the payment of transaction based compensation by member firms to unregistered persons.

general rule that expressly allows for compensation to be paid by a broker-dealer to a financial institution for sales consummated on its premises.

The exception is based on a no-action letter issued in 1993 to the Chubb Securities Corporation by the SEC's Division of Market Regulation that sets out specific criteria by which a networking arrangement may be established between a registered broker-dealer and a financial institution. The arrangement entails the use of a dual employee, an individual who is both a registered representative of the broker-dealer and also an employee of the financial institution. The so-called "Chubb Letter," which by its terms applies to credit unions, sets out guidelines for conducting the sale of investment products on the premises of the depository institutions. The Chubb Letter specifically contemplates that sales will be made to customers of the depository institution and to other people (referred to in the Letter as "the general public"), and that the depository institution may receive compensation in the form of commissions for such sales. The Chubb Letter makes no reference to or distinction concerning the membership status of the individuals to whom the investment products are sold.⁷ Furthermore, the Chubb Letter makes clear that the broker-dealer is the entity with exclusive responsibility for both the supervision of the dual employee concerning his securities activities and for his compensation. To the extent XXXX has a complaint relative to his compensation, he should pursue it against the broker-dealer for whom he served as representative, not FCU.

XXXX appears to have misread the Chubb Letter. Appellant asserts that the exception contemplated by the Chubb Letter is only available to credit unions that have established a CUSO, where the CUSO is the entity with the contract with the broker-dealer. Absent the involvement of a CUSO, according to XXXX, a credit union may not receive anything more than a reimbursement of its direct expenses associated with the networking arrangement. There are at least two problems with this position:

- a CUSO is not required for an FCU to enter a networking arrangement with a broker-dealer. NCUA amended its incidental powers rule in 2001 to specifically provide that FCUs may earn income from finder activities such as third party brokerage arrangements.⁸ As specifically documented in NCUA Letter to FCUs 10-FCU-03, there are three permissible ways for an FCU to structure a networking arrangement with a broker-dealer. Only one of these entails use of a CUSO. As described in 10-FCU-03, the second way is through the use of a shared employee arrangement with a broker-dealer. This is precisely the model followed by FCU in this case.
- XXXX signed a contract with FCU in which he specifically acknowledged the dual employee arrangement under which he would be serving. The contract makes explicit reference to the Chubb Letter and clearly specifies the roles of the parties. It is clear that no CUSO is involved. It is also clear that sales are contemplated to both members and non-members of FCU. XXXX should not now be allowed to renounce the agreement he

⁷ Applicability of the Chubb Letter to commercial banks and thrifts ceased with the enactment of the Gramm-Leach-Bliley Act in 1999; however, it remains applicable to credit unions.

⁸ 66 Fed. Reg. 40845, 40852 (Aug. 6, 2001)

signed in an effort to undermine the contractual right of FCU to receive commission income on sales he consummated on FCU's premises.

Conclusion

XXXX has failed to establish any right or entitlement to commission income paid by pertinent broker-dealers to FCU representing its compensation for sales of non-deposit investments consummated on FCU's premises to individuals who were not its members.

Order

For the reasons set forth above, it is ORDERED as follows:

The decision of the ALA for FCU denying XXXX's claim for commission income paid to FCU in connection with sales of non-deposit investment products to nonmembers is affirmed and the appeal of XXXX is denied.

The Board's decision constitutes a final agency determination, which is reviewable in accordance with the provisions of Chapter 7, Title 5, United States Code.⁹ Such action must be filed within 60 days of the date of this final determination.

So **Ordered** this 20th day of December, 2016, by the National Credit Union Administration Board.

_____/S/_____
Gerard Poliquin
Secretary of the Board

⁹ It should be noted that the regulation describing judicial review of Board decisions on creditor claims (12 C.F.R. §709.8(c)(1)(iv)(B)) erroneously refers to review by the U.S. Court of Appeals, instead of the federal District Court. Venue is correctly described in the regulation.