**Office of Chief Counsel**
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subject: Section 162(f) "Agency or Instrumentality" and FINRA

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the Financial Industry Regulatory Authority (FINRA) is a “corporation or other entity serving as an agency or instrumentality” of the government of the United States for purposes of section 1.162-21(a)(3) of the Income Tax Regulations.

CONCLUSION

FINRA is a corporation serving as an agency or instrumentality of the government of the United States for purposes of section 1.162-21(a)(3) when it is performing its federally-mandated duties under the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., of conducting enforcement and disciplinary proceedings relating to compliance with federal securities laws, regulations, and FINRA rules promulgated pursuant to that statutory and regulatory authority.

LAW AND ANALYSIS

Section 162(f)

Section 162(f) of the Code provides that no deduction shall be allowed under section 162(a) for any fine or similar penalty paid to a government for the violation of any law. Section 1.162-21(a) of the Income Tax Regulations provides that no deduction shall be allowed under section 162(a) for any fine or similar penalty paid to:

> (1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;
>
> (2) The government of a foreign country; or
>
> (3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.

The *Guardian Industries* Test

The terms "agency" and "instrumentality" as used in section 1.162-21(a)(3) are not defined in the statute or the regulations. Also, those terms are not defined in the legislative history of section 162(f). Guardian Indus. Corp. v. Commissioner, 143 T.C. 1, 12 (2014).

In Guardian Industries, after a thorough analysis of the meaning of the terms "agency" and "instrumentality" in various contexts, the court adopted a functional test for purposes of section 162(f). Initially, the court stated that the phrase "agency or instrumentality" does not have an unambiguous, plain meaning. 143 T.C. at 13, 16. The court described how "`[a]gency' and `instrumentality' are terms of considerable breadth, and they are susceptible of different meanings in different contexts." Id. Accordingly, the court stated that "an entity can be an `agency' or `instrumentality' of government for one purpose but not another." 143 T.C. at 13-14.

The court in Guardian Industries explained that its task was to determine the appropriate test to use in deciding whether an entity should be regarded as an "agency or instrumentality," given the context in which it operates and the legislative purpose underlying section 162(f). 143 T.C. at 17. Also, the court opined:

> In a variety of contexts, courts have stated that "[t]he authority to act with the sanction of government behind it determines whether or not a governmental agency exists." Lassiter v. Guy F. Atkinson Co., 176 F.2d 984, 991 (9th Cir. 1949). Whether an entity has "the authority to act with the sanction of government behind it" seems especially relevant in the context of section 162(f). The power to impose fines and penalties is an essential attribute of sovereignty. Thus, in determining whether an entity is "an agency or instrumentality" for purposes of section 162(f), it is important to ascertain not only whether the entity has been delegated power to impose fines, but also whether it has the authority of government behind it when it seeks to collect the fine or otherwise enforce its

> decision. The real sting from imposition of a fine or penalty follows from the ability to collect it.

143 T.C. at 18-19 (footnote omitted). The Tax Court held "that an entity should be regarded as an `agency or instrumentality' for purposes of section 162(f) if it has been delegated the right to exercise part of the sovereign power of a government or governments; if it performs an important governmental function; and if it has the authority to act with the sanction of government behind it." 143 T.C. at 19.

The Creation of FINRA

FINRA is a non-profit Delaware corporation that was formed in July 2007 when the National Association of Securities Dealers, Inc. ("NASD") consolidated with the regulatory arm of the New York Stock Exchange. Fiero v. Fin. Indus. Regulatory Auth., Inc., 660 F.3d 569, 571 n.1 (2d Cir. 2011), rev'g 606 F. Supp. 2d 500 (S.D.N.Y. 2009); see also https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-interpretations/2015/NYSE%2015-8.pdf (describing change effective January 1, 2016, concerning NYSE Regulation). "FINRA is a registered SRO under the 1934 Act, see 15 U.S.C. §§ 78c(a)(26), 78s(b), and has the authority to, inter alia, create and enforce rules for its members in order to provide `regulatory oversight of all securities firms that do business with the public,' Securities and Exchange Commission Release No. 34-56145, 72 Fed. Reg. 42169, 42170 (Aug. 1, 2007)." Wachovia Bank, N.A. v. VCG Special Opportunities Master Fund, Ltd., 661 F.3d 164, 172 (2d Cir. 2011), cert. denied, 132 S. Ct. 2439 (2012).

The Role of SROs

An "SRO" is a self-regulatory organization. A 2015 report from the United States Government Accountability Office describes the function and purpose of SROs as follows:

> The securities industry is generally regulated by a combination of direct Securities and Exchange Commission (SEC) regulation and industry self-regulation with SEC oversight. Congress adopted this oversight framework to prevent excessive government involvement in market operations, which could hinder competition and market innovation. Also, Congress concluded that self-regulation with federal oversight would be more efficient and less costly to taxpayers. Under this system, privately funded nongovernmental entities, commonly referred to as self-regulatory organizations (SRO), such as national securities exchanges and associations, perform much of the day-to-day oversight of the securities markets and broker-dealers under their jurisdiction. SROs are primarily responsible for establishing standards under which members conduct business; monitoring how that business is conducted; and bringing disciplinary actions against members for violating applicable federal statutes, SEC rules, and

> SRO rules. SEC oversees SROs to ensure that they carry out their regulatory responsibilities.

Securities Regulation, SEC Can Further Enhance Its Oversight Program of FINRA, p. 1 GAO-15-376 (April 2015) (footnote omitted), available at http://www.gao.gov/assets/670/669969.pdf. See also John Crawford, et al., Memorandum Concerning the Securities and Exchange Commission and the Commodity Futures Trading Commission (paper prepared for The Volcker Alliance), available at https://volckeralliance.org/sites/default/files/attachments/Background%20Paper%203_Memorandum%20Concerning%20The%20Securities%20and%20Exchange%20Commission%20and%20The%20Commodity%20Futures%20Trading%20Commission.pdf (cited by Commissioner Aguilar's (Hopefully) Helpful Tips for New SEC Commissioners, https://www.sec.gov/news/statement/helpful-tips-for-new-sec-commissioners.html (Nov. 30, 2015)); Kenneth Durr and Robert Colby, The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792–2010 (Securities and Exchange Commission Historical Society, 2010), available at http://www.sechistorical.org/museum/galleries/sro.

> FINRA's Restated Certificate of Incorporation

The third section of FINRA's restated certificate of incorporation provides that the business or purposes to be conducted or promoted shall include the following:

> …
>
> (3) To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors;
>
> …
>
> (5) To establish, and to register with the Securities and Exchange Commission as, a national securities association pursuant to Section 15A of the Securities Exchange Act of 1934, as amended, and thereby to provide a medium for effectuating the purposes of said Section; ….

FINRA's restated certificate of incorporation dated July 2, 2010, is available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4589. See also http://www.finra.org/about/what-we-do.

FINRA is the parent company of FINRA Regulation, Inc. FINRA has delegated certain authority to FINRA Regulation, Inc. See http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4595. However, actions taken pursuant to delegated authority remain subject to review,

ratification, or rejection by the FINRA Board in accordance with procedures established by that Board.

The Delegated Responsibilities and Functions

Section II.A.1 of the delegation provides that the following responsibilities and functions have been delegated to FINRA Regulation, Inc.:

…

b. To determine Association policy, including developing and adopting necessary or appropriate rule changes, relating to the business and sales practices of FINRA members and associated persons with respect to, but not limited to, (i) public and private sale or distribution of securities including underwriting arrangements and compensation, (ii) financial responsibility, (iii) qualifications for FINRA membership and association with FINRA members, (iv) clearance and settlement of securities transactions and other financial responsibility and operational matters affecting members in general and securities quoted or trade reported through a FINRA facility, (v) FINRA member advertising practices, (vi) administration, interpretation, and enforcement of FINRA rules, (vii) administration and enforcement of Municipal Securities Rulemaking Board ("MSRB") rules, the federal securities laws, and other laws, rules and regulations that the Association has the authority to administer or enforce, (viii) standards of proof for violations and sanctions imposed on FINRA members and associated persons in connection with disciplinary actions, and (ix) arbitration, mediation or other resolution of disputes among and between FINRA members, associated persons and customers.

c. To take necessary or appropriate action to assure compliance with Association policy, FINRA and MSRB rules, the federal securities laws, and other laws, rules and regulations that the Association has the authority to administer or enforce, through examination, surveillance, investigation, enforcement, disciplinary, and other programs.

…

e. To examine and investigate FINRA members and associated persons to determine if they have violated FINRA or MSRB rules, the federal securities laws, and other laws, rules, and regulations that the Association has the authority to administer, interpret, or enforce.

f. To administer Association enforcement and disciplinary programs, including investigation, adjudication of cases and the imposition of fines and other sanctions.

…

k. To place restrictions on the business activities of FINRA members consistent with the public interest, the protection of investors, and the federal securities laws.

…

r. To manage external relations on enforcement, regulatory, dispute resolution, and other policy issues with Congress, the Securities and Exchange Commission ("Commission"), state regulators, other self-regulatory organizations, business groups, and the public.

….

http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4596.

Case Law Descriptions of FINRA

The Second Circuit has described the role of FINRA as follows:

> FINRA is a "self-regulatory organization" ("SRO") as a national securities association registered with the SEC pursuant to the Maloney Act of 1938, 15 U.S.C. § 78o-3, et seq. See Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 201 (2d Cir. 1999). FINRA is the successor to the National Association of Securities Dealers ("NASD"). It "is responsible for conducting investigations and commencing disciplinary proceedings against [FINRA] member firms and their associated member representatives relating to compliance with the federal securities laws and regulations." D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 157 (2d Cir. 2002) (quoting Datek Sec. Corp. v. Nat'l Ass'n of Sec. Dealers, Inc., 875 F. Supp. 230, 232 (S.D.N.Y. 1995) (internal quotation marks omitted)). As a practical matter, all securities firms dealing with the public must be members of FINRA. See Sacks v. SEC, 648 F.3d 945, 948 (9th Cir. 2011) (citing 72 Fed. Reg. 42,169, 42,170 (Aug. 1, 2007); 15 U.S.C. §§ 78c(a)(26), 78s(b)) (noting that FINRA is "responsible for regulatory oversight of all securities firms that do business with the public"); see also note 1, supra. FINRA's disciplinary proceedings are governed by the FINRA Code of Procedure ("FINRA COP"). The FINRA COP has been approved by the SEC, as required by Section 19 of the Securities Exchange Act of 1934. 15 U.S.C. § 78s(b) (describing the required procedure for approval of proposed SRO rule changes).
>
> FINRA has the power to initiate a disciplinary proceeding against any FINRA member or associated person for violating any FINRA rule, SEC regulation, or statutory provision. Id. § 78s(h)(3). To issue a complaint, FINRA's Department of Enforcement or Department of Market Regulation must obtain authorization

> from the FINRA Regulation Board or FINRA Board. FINRA COP § 9211. After a complaint is filed, a hearing panel conducts a hearing and issues a decision. Id. § 9231. Final decisions of the hearing panel may be appealed to the FINRA National Adjudicatory Council ("NAC"), which can affirm, modify, or reverse the hearing panel's decision. Id. §§ 9311, 9349(a), 9268-9269. NAC decisions may then be appealed to the SEC, pursuant to 15 U.S.C. § 78s(d), and from the SEC to the United States Court of Appeals, pursuant to 15 U.S.C. § 78y. 15 U.S.C. §§ 78s(d), 78y(a); see also Mister Discount Stockbrokers v. SEC, 768 F.2d 875, 876 (7th Cir. 1985).

Fiero, 660 F.3d at 571-572 (footnotes omitted).

The D.C. Circuit described the role of FINRA's predecessor, the NASD, as follows:

> The National Association of Securities Dealers, Inc. ("NASD") is the only officially registered "national securities association" under § 15A of the Securities Exchange Act of 1934 ("Exchange Act" or the "Act"), 15 U.S.C. § 78o-3 (2000). Domestic Sec., Inc. v. SEC, 357 U.S. App. D.C. 118, 333 F.3d 239, 242 (D.C. Cir. 2003). By virtue of its statutory authority, NASD wears two institutional hats: it serves as a professional association, promoting the interests of its members … ; and it serves as a quasi-governmental agency, with express statutory authority to adjudicate actions against members who are accused of illegal securities practices and to sanction members found to have violated the Exchange Act or Securities and Exchange Commission ("SEC" or the "Commission") regulations issued pursuant thereto. 15 U.S.C. § 78o-3(b)(7). See Merrill Lynch v. Nat'l Ass'n of Sec. Dealers, Inc., 616 F.2d 1363, 1367 (5th Cir. 1980) ("As a registered securities association, [NASD] has been 'delegated governmental power . . . to enforce . . . the legal requirements laid down in the Exchange Act.'") (citation omitted).

NASD v. SEC, 431 F.3d 803, 804 (D.C. Cir. 2005); see also Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th Cir. 2005) (SRO rules approved by the SEC preempt conflicting state law).

FINRA is an Agency or Instrumentality Under the *Guardian Industries* Test

FINRA's restated certificate of incorporation, the delegation to FINRA Regulation, Inc., and the applicable federal securities laws and regulations all clearly show FINRA's role as an SRO conducting federally-mandated enforcement and disciplinary proceedings relating to the federal securities laws and regulations. FINRA enforces compliance with the Securities Exchange Act, SEC regulations, and FINRA's own rules. FINRA does so by bringing disciplinary proceedings to adjudicate violations, which are subject to review by the SEC. Saad v. SEC, 718 F.3d 904, 907 (D.C. Cir. 2013). "[W]here FINRA enforces statutory or administrative rules, or enforces its own rules promulgated pursuant to statutory or administrative authority, it is exercising the powers granted to it

under the Exchange Act. Indeed, FINRA's powers in that regard are subject to divestment by the SEC under Section 19(g)(2) of that Act." Fiero, 660 F.3d at 575-576. The court in Fiero held that Congress did not empower FINRA to bring judicial actions to enforce its own fines; however, as the court noted, the SEC asserts the authority to issue an order affirming sanctions, including fines, imposed by FINRA, and to bring an action in a federal district court to enforce that order. See id. at 575 n.7.

The SEC reviews sanctions imposed by FINRA to determine whether they impose any burden on competition not necessary or appropriate, or are excessive or oppressive. Saad, 718 F.3d at 910. The court reviews the SEC's conclusions regarding sanctions to determine whether those conclusions are arbitrary, capricious, or an abuse of discretion. Id.; Siegel v. SEC, 592 F.3d 147,155 (D.C. Cir. 2010), cert. denied, 560 U.S. 926 (2010). Although the SEC has express statutory authority to seek judicial enforcement of penalties and to seek monetary penalties for violations of the federal securities laws, the SEC is prohibited from bringing an action against any person for violation of, or to command compliance with, the rules of a SRO unless it appears that (1) such SRO is unable or unwilling to take appropriate action against such person in the public interest and for the protection of investors, or (2) such action is otherwise necessary or appropriate in the public interest or for the protection of investors. Fiero, 660 F.3d at 574-575.

If a fine is imposed on a taxpayer for violation of the securities laws and regulations, the deductibility of the fine should not depend on whether the same type of bad conduct is being punished by the SRO or directly by the SEC. Otherwise, there would be inconsistent treatment of similarly situated taxpayers. Furthermore, deductibility of the fine should not depend on whether the taxpayer pays a fine to the SRO without contesting it or whether the taxpayer eventually pays the fine after exhausting all levels of review.

FINRA has been delegated the right to exercise part of the sovereign power of a government, it performs an important governmental function, and it has the authority to act with the sanction of government behind it. Moreover, FINRA has absolute immunity with respect to actions taken in furtherance of its regulatory duties. Lobaito v. Fin. Indus. Regulatory Auth., Inc., 599 Fed. Appx. 400 (2d Cir. 2015), cert. denied, 193 L. Ed. 2d 445 (2015); Santos-Buch v. Fin. Indus. Regulatory Auth., Inc., 591 Fed. Appx. 32 (2d Cir. 2015), cert. denied, 136 S. Ct. 43 (2015). Therefore, under the Guardian Industries test, FINRA is a corporation serving as an agency or instrumentality of the government of the United States for purposes of section 1.162-21(a)(3) when it is performing its federally-mandated duties under the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., of conducting enforcement and disciplinary proceedings relating to compliance with federal securities laws, regulations, and FINRA rules promulgated pursuant to that statutory and regulatory authority. We note that section 162(f) would not apply to a fine paid to FINRA solely for a violation of a "house-keeping" rule that is a matter of private contract between FINRA in its capacity as a professional association and its members.

The *Rothner* Opinion Does Not Affect Our Conclusion

A concession made by IRS counsel in Rothner v. Commissioner, T.C. Memo. 1996-442, does not affect our conclusion. In that case, the sole issue to be decided was whether the taxpayer could deduct, as an ordinary and necessary business expense, a $75,000 fine paid during 1989 to the Chicago Mercantile Exchange (CME) in settlement of a disciplinary proceeding brought against him by the CME. The CME maintained a written set of rules and regulations specifying the rights and obligations of membership in the CME and governing trading through its facilities. As a condition of membership in the CME, a member had to agree to abide by its rules. The taxpayer pre-arranged Eurodollar futures trades with the purpose of evading the CME's limits on execution of customer orders with other members of the same brokerage association. The court held that the taxpayer's payment of the CME fine was an ordinary and necessary business expense under section 162(a).

In the Rothner opinion, the court stated, "Respondent also concedes that section 162(f), which disallows the deduction of `any fine or similar penalty paid to a government for the violation of any law', does not apply to petitioner's payment of the CME fine. Accordingly, no question as to the allowability of the deduction on public policy grounds is involved." The reason for the Service's concession is not apparent. It could have resulted from a substantive interpretation of the law applied to the facts. The court specifically stated, "Except as otherwise provided by Federal law, the rights and obligations of CME members arise pursuant to contract law, rather than statute, government regulation, or tort." Therefore, the basis for the CME fine may have been solely under a contract theory.[1] The Service's concession could also have resulted from a decision that the evidence before the court was inadequate to support an argument under section 162(f). Cf. CCDM 31.1.1.1.3(3). We have not researched the then applicable law and the facts developed at the trial to make our own determination at this time. Regardless of the reason for the concession, it does not establish Service position. CCDM 31.1.1.1.1. Furthermore, it has no precedential value because it contains no analysis.

Taxpayer Arguments Considered and Rejected

We understand that some taxpayers have argued that SROs, such as NASD and FINRA, cannot be an "instrumentality" of the government for purposes of section 162(f) because the dictionary definition of "instrumentality" excludes self-regulatory

[1] Compare Bernstein v. Lind-Waldock & Co., 738 F.2d 179 (7th Cir. 1984); Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14 Stan. J.L. Bus. & Fin. 151, 196 (2008) ("initially, the regulatory powers of the NYSE were not governmental but rather a matter of private contract between the NYSE and its members").

organizations, such as NASD and FINRA. However, as explained by the court in Guardian Industries, the phrase "agency or instrumentality" does not have an unambiguous, plain meaning, and those terms are susceptible of different meanings in different contexts. 143 T.C. at 13, 16. The court specifically rejected a dictionary definition for purposes of section 162(f). 143 T.C. at 12-14, 17.

Some taxpayers have cited various non-tax cases in their argument that SROs cannot be an "instrumentality" of the government for purposes of section 162(f). A number of these cases address Fifth Amendment protections and reject an "agency or instrumentality" theory. However, the courts have not been unanimous in this view. See Crimmins v. American Stock Exchange, Inc., 346 F. Supp. 1256, 1259 (S.D.N.Y. 1972); see also United States v. Solomon, 509 F.2d 863 (2d Cir. 1975). Moreover, it is well-established that NASD had, and FINRA has, absolute immunity with respect to actions taken in furtherance of regulatory duties. See, e.g., Sparta Surgical Corp. v. NASD, 159 F.3d 1209 (9th Cir. 1998); Cent. Registration Depository v. FINRA, 459 Fed. Appx. 662 (9th Cir. 2011). Most importantly, as stated in Guardian Industries, "an entity can be an `agency' or `instrumentality' of government for one purpose but not another." 143 T.C. at 13-14. Fiero and similar cases, discussed above, describe how FINRA can act as an "agency or instrumentality" of the federal government.

Some taxpayers argue that SROs cannot be an "instrumentality" of the government for purposes of section 162(f) because the SROs themselves state that they are not part of the government.[2] The taxpayers claim that those facts and any potential testimony from officers of an SRO support their argument. This does not undermine our conclusion, because an entity can be an agency or instrumentality of government for one purpose but not another. Thus, testimony of an officer of an SRO is unnecessary, just as it was unneeded in the Guardian Industries case. The section 162(f) issue can be resolved in a motion for summary judgment because the material facts concerning FINRA will not be in dispute, and the interpretation of the applicable federal securities laws and regulations is a question of law, which has already been addressed by numerous courts.

Some taxpayers argue that there is no case law squarely on point establishing the principle that fines paid to NASD or FINRA fall within the meaning of section 162(f), and cite to Rothner. As explained above, however, Rothner is inapposite. Although there is no case law squarely on point, the Guardian Industries test has been established as binding precedent in the Tax Court, and in non-tax cases the quasi-governmental role of SROs for securities law purposes is well-established, as discussed above.

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[2] See, for example, the basic facts on FINRA's website (http://www.finra.org/about) ("FINRA is not part of the government. We're an independent, not-for-profit organization authorized by Congress to protect America's investors by making sure the securities industry operates fairly and honestly.")

Finally, we understand that some people are interpreting certain parts of a 1998 Non-docketed Service Advice Review (NSAR) memorandum, 1998 IRS NSAR 5131, 1998 WL 1993057 (March 25, 1998), involving FINRA's predecessor the NASD, as an expression of the national office's current assessment of litigation hazards. The NSAR considered the application of section 162(f) to a fine paid to the NASD for excessive mark-up violations with respect to an initial public stock offering and reached the same conclusion we reach in this memorandum, that section 162(f) applies. However, the NSAR stated that "there are considerable litigating hazards with respect to the `agency or instrumentality' theory." The taxpayer arguments in the NSAR are the same arguments that we have considered and rejected above as having no merit. Therefore, we no longer think "there are considerable litigating hazards." Also, as you know, the NSAR has no precedential effect. See I.R.C. § 6110(k)(3), formerly § 6110(j)(3).

Please coordinate any litigation on this section 162(f) issue with our office. Please call Robert Basso at (202) 317-7011 if you have any questions.