

# Regulatory Notice

## 10-01

## Membership Application Proceedings

### Proposed Consolidated FINRA Rules Governing FINRA's Membership Application Proceedings

**Comment Period Expires: March 5, 2010**

#### Executive Summary

As part of the process of developing a new, consolidated rulebook (the Consolidated FINRA Rulebook),<sup>1</sup> FINRA is requesting comment on proposals relating to FINRA's membership rules. These rules, which were adopted in August 1997, provide a means for FINRA, through its Membership Application Process (MAP), to know and assess the proposed business activities of its potential and current member firms. The proposed amendments revise certain provisions of the existing membership rules to streamline the standards of review for new and continuing membership applications, clarify certain administrative aspects of the MAP process, update or eliminate outdated terminology and require certain additional information (including certain affiliate information) about the applicant and incorporate certain provisions from the Incorporated NYSE membership rules.

The text of the proposed rules is set forth in Attachment A on our Web site at [www.finra.org/notices/10-01](http://www.finra.org/notices/10-01).

Questions regarding this *Notice* should be directed to:

- Steve Kasprzak, Associate Director & Principal Counsel, Sales Practice Policy, Member Regulation, at (646) 315-8505; or
- Ann-Marie Mason, Counsel, Sales Practice Policy, Member Regulation, at (202) 728-8231.

**January 2010**

#### Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

#### Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Systems

#### Key Topics

- Affiliate Information
- Continuance in Membership Application
- Membership Agreement Change
- Membership Application Process
- Membership Rules
- New Member Application
- Safe Harbor for Business Expansions

#### Referenced Rules & Notices

- FINRA By-Laws, Art. I(h)
- Information Notice 3/12/08
- NASD IM 1011-1
- NASD Rule 1010 Series
- NASD Rule 1011
- NASD Rule 1012
- NASD Rule 1013
- NASD Rule 1014
- NASD Rule 1015
- NASD Rule 1016
- NASD Rule 1017
- NASD Rule 1019
- NYSE Rule 311
- NYSE Rule 312
- NYSE Rule 313
- NYSE Rule 321
- NYSE Rule Interpretation 401/03
- NYSE Rule Interpretation 401/04
- NYSE Rule 416
- SEA Rule 15c3-3



Financial Industry Regulatory Authority

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 5, 2010.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, N.W.  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should only use one method to comment on the proposal.

**Important Notes:** The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.<sup>2</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>3</sup>

## Background and Discussion

### A. Background

#### 1. FINRA Membership Rules

Exchange Act Section 15A(b)(8) requires that a national securities association, such as FINRA, establish rules providing a fair procedure for the denial of membership in such association. FINRA's current membership rules (NASD Rule 1010 Series (Membership Proceedings)) were adopted in August 1997, and they provide a means for FINRA, through its Membership Application Process (MAP), to know and assess the proposed business activities of its potential and current member firms. The MAP process is a fluid, probing exercise that seeks to evaluate all relevant facts and circumstances regarding each applicant. In particular, the MAP process seeks to identify potential weaknesses in an applicant's supervisory, operational and financial controls. The MAP process's ultimate goal is to ensure that each applicant is capable of conducting its business in compliance with applicable rules and regulations, and that its business practices are consistent with just and equitable principles of trade as required by FINRA rules.

NASD Rule 1011 (Definitions) sets forth the defined terms applicable to the MAP process, and NASD Rule 1012 (General Provisions) sets forth the requirements for submitting MAP applications and supporting documentation. There are three types of MAP applications. One category is new member applications (NMAs) that are filed pursuant to NASD Rule 1013 (New Member Application and Interview).<sup>4</sup> The other two categories are applications for approval of changes in ownership, control or material changes in business operations (Continuance in Membership Applications or CMAs) and applications for removal or modification of restrictions on a firm's membership (Membership Agreement Changes or MACs) that are filed pursuant to NASD Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations). NASD IM-1011-1 (Safe Harbor for Business Expansions) provides parameters for certain changes in a member firm's business profile (such as the addition of associated persons, registered and unregistered offices and markets made) that would not trigger a CMA filing.

All applications are evaluated to determine whether the applicant meets the 14 standards or criteria (*e.g.*, completeness and accuracy of the application and supporting documentation, the acquisition of all requisite licenses and registrations, a sufficient level of net capital, the establishment of all necessary contractual agreements and business relationships, an adequate supervisory system) set forth in NASD Rule 1014 (Department Decision).

NASD Rule 1014 (with respect to an NMA) and NASD Rule 1017 (with respect to a CMA or MAC) require FINRA staff to determine whether to grant or deny the application. NASD Rule 1015 (Review by National Adjudicatory Council) permits an applicant to submit a request for review by the National Adjudicatory Council of an adverse decision rendered on a NMA, CMA or MAC. NASD Rule 1016 (Discretionary Review by FINRA Board) also permits a Governor of the FINRA Board to call for a discretionary review of a membership proceeding. Finally, a person aggrieved by final action of FINRA under the NASD Rule 1010 Series may apply for review by the SEC pursuant to NASD Rule 1019 (Application to Commission for Review).

## **2. NYSE Membership Rules**

While tailored for broker-dealers operating on a national securities exchange, the current NYSE membership rules also seek to capture information from member organization applicants and set approval criteria for applications. For instance, NYSE Rule 311 (Formation and Approval of Member Organizations) requires an applicant member organization to submit, among other things, shareholder lists, principal executive officer lists and a written authorization by each natural person agreeing to a background investigation. NYSE Rule 311 also requests general corporate information (*e.g.*, date of proposed formation, names of officers) and requires that certain persons (*e.g.*, directors, control persons, principal executives, general partners) within a member organization be appropriately designated and approved. Further, NYSE Rule 313 (Submission of Partnership Articles – Submission of Corporate Documents) requires member organizations to submit to the NYSE for approval certain documents that establish a partnership's or corporation's existence.

NYSE Rule 312 (Changes Within Member Organizations) sets forth the requirements for changes within member organizations. While NYSE Rule 312 does not expressly require notice or approvals of changes in business, NYSE Rule 312(b)(4) requires written notice of a member corporation's failure to comply with all of the approval conditions set forth in NYSE Rule 311. Additionally, NYSE Rule 312(g) requires prior written approval for certain changes to a member corporation's capital structure, while NYSE Rule 312(d) provides that whenever a person approved by the NYSE as a member or approved person ceases to be approved, the member corporation must reduce the amount of that person's outstanding voting stock in the member corporation, such that the person can no longer exercise controlling influence over the management or policies of the corporation. NYSE Rule 312(f) provides that member organizations may not recommend their own publicly held securities or those of certain affiliates and that members may effect transactions in such securities only on an unsolicited basis.<sup>5</sup> NYSE Rule 313 (Submission of Partnership Articles – Submission of Corporate Documents) delineates certain corporate or partnership documents that each member organization must submit to enter into and continue in NYSE membership. Finally, NYSE Rule 321 requires prior written approval before a member organization forms or acquires a subsidiary that is engaged in a securities or kindred business.

Other NYSE rules also require member organizations to provide the NYSE with additional information or notice of changes in business operations. Specifically, NYSE Rule Interpretation 401/03 (Conversions, Acquisitions and Changes in Business Activities) requires a member organization to provide NYSE with notice of important organization or operational changes (*e.g.*, mergers, acquisitions, new product lines). Also, NYSE Rule Interpretation 401/04 (Early Reporting of Developing Problems) makes clear that the NYSE expects notification from a member organization upon its discovery of any existing or impending condition(s) which it reasonably believes could lead to capital, liquidity or operational problems or impairment of record-keeping, clearance or control functions.<sup>6</sup> Finally, NYSE Rule 416(a) and (c) (Questionnaires and Reports) and its Supplementary Material paragraph .10 require member organizations to submit, in the format, manner and time frame prescribed by the NYSE, any information the NYSE deems essential for the protection of investors and the public interest, including financial and operational reports for affiliated organizations.

### 3. Proposal

FINRA proposes to transfer the NASD membership rules, with substantive changes, into the Consolidated FINRA Rulebook. Among other things, the proposed amendments will revise certain provisions of the existing membership rules to streamline the standards of review for new and continuing membership applications, clarify certain administrative aspects of the MAP process, update or eliminate outdated terminology, require certain additional information about the applicant and incorporate certain provisions from the NYSE membership rules. The proposed amendments also will require applicants to provide information regarding their affiliates, which will, in turn, enhance FINRA's ability to assess applicants, as well as significant changes in the business activities and control relationships of member firms and their affiliates. The proposed rule changes are detailed further below.

## **B. Proposed FINRA Rule 1111 (Definitions)**

FINRA proposes adopting NASD Rule 1011 (Definitions) as FINRA Rule 1111 (Definitions) with the following substantive changes.

### **1. Definition of “Affiliate”**

The proposed rule change defines, for the first time, the term “affiliate” to mean (1) a person that directly or indirectly controls an applicant (excluding a natural person who controls an applicant solely in his or her role as a director, general partner or officer (or occupies a similar status or performs a similar function)); or (2) an entity that is controlled by, or is under common control with, an applicant.

### **2. Definition of “Control”**

Proposed FINRA Rule 1111 defines, for the first time, the term “control” to mean the power to direct or cause the direction of the management or policies of a person whether through ownership of securities, by contract or otherwise. Pursuant to the proposed definition, control over a person is presumed if another person, directly or indirectly (1) has the right to vote 25 percent or more of the voting securities; (2) is entitled to receive 25 percent or more of the net profits; or (3) is a director, general partner or officer (or occupies a similar status or performs similar functions) of the other person. The proposed definition also clarifies that any person that does not meet the conditions above shall be presumed not to control such other person. Additionally, the proposed definition clarifies that any presumption may be rebutted by evidence, but will continue until a determination to the contrary has been made by FINRA.

FINRA is proposing this new definition rather than continuing to rely on the current FINRA By-Laws definition of “controlling”<sup>7</sup> as it is more consistent with the control standards that are in proposed FINRA Rule 1160 (Continuing Membership Application for Approval of Change in Ownership, Control, or Business Operations).

### **3. Definition of “Material Change in Business Operations”**

As discussed further below in the context of proposed FINRA Rule 1160, the proposed rule change relocates the definition of the term “material change in business operations” to proposed FINRA Rule 1160, as that term establishes the standards for when a member firm has a material change in business operations that requires the filing of a CMA.

#### 4. Definition of “Sales Practice Event”

Proposed FINRA Rule 1111 amends the NASD Rule 1011 definition of “sales practice event” to include “statutory disqualification” as defined in Exchange Act Section 3(a)(39) as one of the events that must be reported to FINRA via the Central Registration Depository (CRD®) or other mechanism, thereby expanding the definition to include certain misconduct by an applicant or associated person, such as having been convicted of misdemeanor tax evasion, that it does not currently capture.

#### 5. Other Proposed Amendments

The proposed rule change also makes the following minor amendments to the current definitions being transferred to proposed FINRA Rule 1111:

- amending the definition of “Applicant” to clarify that, in the context of proposed FINRA Rule 1160, an applicant may also be referred to as a “member”;
- amending the definition of “Associated Person” to add an LLC managing member to the examples of persons with supervisory responsibilities who would be associated persons and to clarify that an associated person includes any employee of the applicant, except any person whose functions are solely clerical or ministerial;
- adding the term “Executive Vice President(s)” to the definition of “Interested FINRA Staff”; and
- adding the term “LLC managing member” to the definition of the term “principal place of business” to reflect the existence of limited liability corporations.

### C. Proposed FINRA Rule 1112 (General Procedures)

The proposed rule change adopts NASD Rule 1012 (General Provisions) as proposed FINRA Rule 1112 (General Procedures), subject to certain clarifying amendments. First, the proposed rule clarifies that an applicant for membership must file its application in accordance with proposed FINRA Rule 1112 and submit in a timely manner its application fee pursuant to Schedule A of FINRA's By-Laws. The proposed rule also clarifies that a CMA or MAC applicant must file its application in accordance with proposed FINRA Rule 1112 and in the manner prescribed in Rule 1160.

Proposed FINRA Rule 1112 clarifies that filing an application and supporting documentation via electronic delivery encompasses delivery by facsimile, email or a dedicated electronic filing system. Additionally, proposed FINRA Rule 1112 clarifies that, for purposes of the membership rule series, service by FINRA or a filing by an applicant via electronic delivery will be deemed complete on the date recorded by FINRA's electronic systems for such communications.

Proposed FINRA Rule 1112 also reduces from 60 days to 30 days the time for an applicant to respond to an initial written request by FINRA for information or documentation before the application is deemed to have lapsed (absent a showing of good cause). The response time frame for subsequent written requests remains at 30 days. The proposed rule also includes a new provision providing that, absent a showing of good cause, an application will lapse if an applicant fails to schedule, within 30 days of filing its Form NMA, all of the qualification examinations of those associated persons that are necessary for the applicant to conduct its intended business and ensure that such associated persons successfully complete their required qualification examinations within 120 days of filing the Form NMA. Another new provision similarly provides that, absent a showing of good cause, an application will lapse if an applicant fails to schedule, within 30 days of filing its CMA, all of the qualification examinations of those associated persons that are necessary for the applicant to commence its proposed change in ownership, control or business operations and ensure that such associated persons successfully complete their required qualification examinations within 120 days of filing the CMA.

The proposed rule change also eliminates the current NASD Rule 1012 requirement that an applicant submit a new fee if it resubmits, subsequent to a lapse, a CMA or MAC application as FINRA does not currently charge a fee for filing those applications. Proposed supplementary material clarifies that an applicant is required throughout the application process to correct, amend or modify, by submitting supplementary amendments and/or any documentation, any application filed with FINRA that is or becomes inaccurate or misleading.



#### **D. Proposed FINRA Rule 1121 (New Member Application, Interview, and Department Decision)**

The proposed rule change adopts NASD Rule 1013 (New Member Application and Interview) as proposed FINRA Rule 1121 (New Member Application, Interview, and Department Decision), subject to the amendments discussed below.

##### **1. New Affiliate Information**

As previously noted, NASD Rule 1013 outlines the filing requirements for new member applicants. To meet these requirements, applicants submit certain information regarding their associated persons, business models, finances and supervisory structures. In addition to this required information, proposed FINRA Rule 1121 requires an applicant for membership to provide certain additional information about itself. Specifically, the proposed rule requires an applicant to provide:

- its establishing constituent documents, including any corporate resolution, charter, by-laws, partnership agreement, operating agreement, certificate of LLC and any analogous documents;
- an organizational chart identifying the associated person (by name and CRD number) responsible for supervising each office, division and business line;
- its anti-money laundering procedures, including the associated person responsible for implementation; and
- the independent audit firm (which, pursuant to SEC requirements, must be registered with the Public Company Accounting Oversight Board) the applicant will use for audits, the anticipated annual audit schedule and, if applicable, a copy of the applicant's most recent audit report.

FINRA believes that this additional information will assist the staff in performing more comprehensive new member application reviews.

Additionally, proposed FINRA Rule 1121 requires an applicant for FINRA membership to provide information regarding its affiliate relationships, including an organizational chart that identifies the applicant and all of its affiliates, provides a brief summary of each affiliate's principal activity and identifies the legal relationship between the applicant and each affiliate. Proposed FINRA Rule 1121 also requires an applicant to provide a detailed and comprehensive summary of the business relationship between the applicant and any affiliate:

- whose financial information is consolidated with that of the applicant;
- whose liabilities or obligations have been, directly or indirectly, guaranteed by the applicant;
- that is the source of flow-through capital to the applicant in accordance with Appendix C of SEA Rule 15c3-1;
- upon which the applicant or its customers rely for operational support or services that are used in connection with the applicant's securities, investment banking or investment advisory business;
- that has the authority or the ability to withdraw, or cause the withdrawal of, capital from the applicant;
- that has a mutually dependent financial relationship with the applicant, including any expense-sharing agreements;
- that has a financial or marketing relationship with the applicant; or
- that provides any third-party products and/or services as part of any operation or function of the applicant required to be supervised by the applicant pursuant to FINRA rules.

The proposed rule also requires the applicant, at FINRA's discretion, to provide evidence of, and information regarding, any business relationship disclosed pursuant to the items listed above from the books and records of the applicant and/or the books and records of any affiliate that is a party to such business relationship.

In addition, proposed FINRA Rule 1121 clarifies that an applicant must disclose any plans to enter into contractual commitments including underwriting agreements or other activities, such as investment advisory business, whether or not exempt from SEC registration under Section 203A of the Investment Advisers Act.

FINRA is proposing to require this additional affiliate information from new membership applicants as FINRA previously has found during the NMA review process that some applicants and their affiliates have such close, and sometimes interwoven, business relationships that a more thorough review is needed to ensure that adequate investor protection safeguards are in place. In short, these amendments seek to ensure FINRA's access to all of the relevant aspects of an applicant's business that are within the scope of FINRA's statutory authority.

Further, self-regulatory organizations (SROs) previously have required member firms to provide affiliate information. For instance, NYSE Rule 304(e) (Allied Members and Approved Persons)<sup>8</sup> requires persons that control a member organization, or that are engaged in a securities or kindred business and are controlled by or under common control with a member organization (namely, affiliates), become approved persons, thus subjecting them to the jurisdiction of the NYSE. Such entities are often not otherwise subject to the NYSE's regulatory authority. Unlike NYSE Rule 304, proposed FINRA Rule 1121 does not require affiliates of a firm to consent to FINRA's jurisdiction.

Finally, proposed supplementary material, consistent with the current NYSE requirements, prohibits an applicant from identifying any division that is not a separate legal entity by words such as "Company," "Corporation" or "Incorporation."

## **2. Procedural Amendments Relating to New Membership Applications**

The proposed rule change transfers to proposed FINRA Rule 1121 the NMA application procedural guidelines that are currently positioned in NASD Rule 1014 (Department Decision) as FINRA believes that these guidelines fit more logically into the NMA application rule.

Proposed FINRA Rule 1121 also increases from \$350 to \$500 the amount of the application fee FINRA will retain as a processing fee if the staff determines within 30 days after the application's filing that the application is not substantially complete. Proposed FINRA Rule 1121 also permits a one-time opportunity for an applicant to refile its membership application within 30 days of service of written notice that the application is not substantially complete by submitting only a new Form NMA and the application fee, rather than being required to submit the entire application. After the 30-day period, an applicant will need to submit a new application (the Form NMA and other documents such as the Form BD and CRD entitlement forms) and fee.

Proposed FINRA Rule 1121 also requires for the first time that an applicant file its Form NMA no later than 180 days after the submission of its Form BD or FINRA will deem the application to be abandoned and refund the application fee, less a \$250 processing fee. FINRA is proposing this new provision to address the problem of applicants who wait six months or more after filing their Form BD and entitlement forms to file their Form NMA, thereby causing administrative back log while their membership applications remain "in limbo" with both the SEC and FINRA.

Currently, unless FINRA directs otherwise for good cause shown, a membership interview shall be scheduled within 90 days after the filing of an application or within 60 days after the filing of all additional information requested by FINRA, whichever is later. To streamline the application process, proposed FINRA Rule 1121 reduces the latter time frame to 30 days.

Finally, the proposed rule change transfers, with the changes described below, NASD IM-1013-1 (Membership Waive-in Process for Certain New York Stock Exchange Member Organizations) and NASD IM-1013-2 (Membership Waive-in Process for Certain NYSE Alternext US LLC Member Organizations) as supplementary material. The two IMs permitted certain NYSE and NYSE Amex member organizations to be eligible for a streamlined application process for FINRA membership. The proposed rule change deletes the descriptions of such application processes, while retaining those provisions that specify the rules applicable to such members. More specifically, the proposed supplementary material clarifies that such waive-in members are subject to the consolidated FINRA rules, including the obligation to file a CMA if the member seeks to expand its business operations to include any activities other than the permitted floor activities, as well as the remaining Incorporated NYSE Rules. The supplementary material continues to specify that such members also are subject to the remaining NASD rules to the extent they expand their business operations beyond the permitted floor activities. FINRA intends to eliminate this new supplementary material as unnecessary once all of the Incorporated NYSE Rules and NASD Rules have been eliminated from the Transitional Rulebook.

#### **E. Proposed FINRA Rule 1130 (Basis for Department Decision)**

The proposed rule change adopts the majority of NASD Rule 1014 (Department Decision) as proposed FINRA Rule 1130 (Basis for Department Decision), subject to the amendments outlined below.

First, proposed FINRA Rule 1130 requires all NMAs, CMAs and MAC applications to address all of the application evaluation standards outlined in the rule, but permits a CMA or MAC applicant to provide a written explanation regarding why the applicant believes a particular standard(s) is not applicable based on the nature and scope of the application.

Second, the proposed rule change adds a new application evaluation standard that requires an applicant to fully disclose and document all of its funding sources and permit FINRA to determine that such sources are not objectionable.

Third, proposed FINRA Rule 1130 clarifies as a standard that the applicant is required to have adequate financial and operational controls to comply with its net capital requirements. Additionally, the proposed rule expands the circumstances when FINRA staff may impose a higher minimum net capital on an applicant to include situations where an applicant is entering into contractual commitments regarding any investment advisory business.

Fourth, proposed FINRA Rule 1130 permits FINRA staff to consider certain information regarding an applicant's affiliates (*e.g.*, any pending or settled state, federal or self-regulatory action or investigation against the affiliate) in determining whether an applicant meets the standard requiring it to be capable of complying with the federal securities laws and regulations and FINRA rules.

Fifth, as noted above, the proposed rule changes transfers the NMA application procedural guidelines that are currently positioned in NASD Rule 1014 (Department Decision) into proposed FINRA Rule 1121.

Finally, the proposed rule change streamlines and consolidates the standards such that their total number is reduced from 14 to 11.

#### **F. Proposed FINRA Rule 1140 (Review by National Adjudicatory Council)**

As noted above, NASD Rule 1015 (Review by National Adjudicatory Council) permits an applicant to submit a request for review by the National Adjudicatory Council of an adverse decision. The proposed rule change adopts NASD Rule 1015 as proposed FINRA Rule 1140 (Review by National Adjudicatory Council) with no substantive changes.

#### **G. Proposed FINRA Rule 1150 (Discretionary Review by FINRA Board)**

As stated above, NASD Rule 1016 (Discretionary Review by FINRA Board) permits a Governor of the FINRA Board to call for a discretionary review of a membership proceeding. The proposed rule change adopts NASD Rule 1016 as proposed FINRA Rule 1150 (Discretionary Review by FINRA Board) with no substantive changes.

#### **H. Proposed FINRA Rule 1160 (Continuing Membership Application for Approval of Change in Ownership, Control, or Business Operations)**

The proposed rule change adopts NASD Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations), the membership rule requiring a member to file an application for approval of certain changes to its ownership, control or business operations, as proposed FINRA Rule 1160 (Continuing Membership Application for Approval of Change in Ownership, Control, or Business Operations), subject to the following amendments.

### **1. Procedural Amendments Relating to Continuing Membership Applications**

The proposed rule change makes a number of procedural amendments to the current NASD Rule 1017 requirements. Specifically, proposed FINRA Rule 1160 clarifies that an application that does not address all of the decision standards in proposed FINRA Rule 1130 will be deemed substantially incomplete. However, as stated above, proposed FINRA Rule 1130 permits a CMA or MAC applicant that does not believe a certain standard applies to provide a written explanation of such belief.

The proposed rule also amends the current NASD Rule 1017 provision permitting FINRA to impose interim restrictions on a member that effects a change in ownership or control pending final FINRA action on the application to clarify that an applicant may only effect such change 30 days after submitting a complete application. A new provision provides that any interim restrictions remain in effect for the applicant and all successors to the applicant's ownership or control unless removed by final action of FINRA or stayed by the NAC, FINRA Board or the SEC.

Proposed FINRA Rule 1160 also includes a new provision clarifying that the staff will serve a request for additional information or documents within 30 days after the filing of a complete application and that the applicant must provide the requested information within 30 days of the request. The proposed provision also reserves the right of FINRA staff to request additional information or documents at any time during the application process. Also, to reduce redundancy, a new provision permits FINRA staff the discretion to permit the filing of a single application by one party where the circumstances of a particular transaction or event would generally require the filing of a CMA by two or more member firms.

Proposed FINRA Rule 1160 increases from 30 days to 45 days the time frame for the Department of Member Regulation (Department) to issue a written decision on a CMA after the conclusion of the final CMA interview or a CMA applicant's final filing of additional information or documents, whichever is later. Proposed FINRA Rule 1160 also retains the requirement that the Department's decision shall state whether the application is granted or denied in whole or in part and include a rationale for the decision referencing the applicable decision standards in proposed FINRA Rule 1130. Additionally, the proposed rule clarifies that the decision shall also state whether the CMA is subject to one or more restrictions reasonably designed to address a specific financial, operational, supervisory, disciplinary, investor protection or other regulatory concern based on the decision standards in proposed FINRA Rule 1130.

## 2. Amendments to Business Operation Changes Requiring an Application

Proposed FINRA Rule 1160 expands the criteria under which a CMA filing is triggered under NASD Rule 1017 by requiring a CMA when a change “directly or indirectly” in the equity ownership, partnership capital “or other ownership interest” in a member results in one person directly or indirectly owning, controlling “or holding a presently exercisable option” to own or control 25 percent or more of the equity, partnership capital “or other ownership interest” in the member. However, proposed FINRA Rule 1160 permits FINRA staff to waive a CMA when the direct or indirect change in ownership or control does not result in any practical change in the member firm’s business activities, management, supervision, assets, liabilities or ultimate ownership or control.

Also, the staff is proposing to clarify the current requirement that a member firm file an application if there is a direct or indirect acquisition of 25 percent or more of its assets or any asset, business or line of operation that generates revenues comprising 25 percent or more of its earnings to include all “purchases or transfers.” Additionally, the proposed rule expands that requirement to include any divestitures (including sales or transfers) that meet those percentages. This proposed change is designed to address those instances where a member firm’s transfer of assets is intended, or would have the effect of, rendering the member firm “judgment proof” if the firm was the subject of a significant arbitration award or litigation penalty. However, proposed FINRA Rule 1160 permits FINRA to waive the filing requirement if the member firm is ceasing operations and filing a Form BDW, and neither the member firm nor its registered persons is subject to any claim that could be adversely affected by the proposed transaction.

Additionally, the filing requirements of Rule 1160 apply not only to FINRA member firms that engage in certain mergers and direct or indirect acquisitions with other FINRA member firms, but also to FINRA member firms that engage in such transactions with broker-dealers that are *not* member firms of FINRA. FINRA believes that all such transactions engaged in by FINRA member firms should be subject to FINRA’s review and approval, regardless whether the counterparty is a FINRA member firm.

Currently, NASD Rule 1017 excludes from its filing requirements certain transactions where (1) in the case of mergers, both member firms are also NYSE members or the surviving entity will continue to be an NYSE member; (2) in the case of acquisitions, the acquiring member firm is an NYSE member; and (3) in the case of direct or indirect acquisitions of 25 percent or more of the member firm’s assets or any asset, business or line of operation that generates revenues comprising 25 percent or more of the member’s earnings, both the seller and the acquirer are NYSE members. At the time these exclusions were incorporated into the rule, their primary purpose was to avoid subjecting applicants to duplicative review processes (by FINRA (then NASD) and NYSE Regulation). However, since NYSE Regulation no longer independently conducts regulatory reviews of such transactions, the proposed rule change deletes these exclusions so that all such transactions are subject to FINRA’s review and approval.

As noted earlier, the proposed amendments reposition the definition of “material change in business operations” from NASD Rule 1011 to proposed FINRA Rule 1160. The proposed rule change also amends the definition to include instances where a change in business operations would result in the settling or clearing of transactions for the applicant’s own business, the settling or clearing of transactions for other broker-dealers or the carrying of customer accounts for the first time. The definition also essentially incorporates NASD Rule 3140’s requirement that a firm obtain FINRA approval before making a business change that would alter its SEA Rule 15c3-3(k) exemptive status by defining any change in a firm’s SEA Rule 15c3-3(k) exemptive status as a material change in business, thereby requiring a CMA filing that must be approved before making such change. Finally, the proposed rule clarifies that the definition’s list of material changes in business operations is illustrative only and is not meant to be an exhaustive listing of what is deemed to be material.

### **3. Amendments to the Filing and Content of Applications**

Proposed FINRA Rule 1160 requires a member firm to file its application “in the manner prescribed by FINRA” rather than retain NASD Rule 1017’s current requirement that a member firm’s application be filed at the district office in the district in which the member firm’s principal place of business is located. This proposed change reflects new operational procedures that are being developed for application submissions.

Proposed FINRA Rule 1160 also retains NASD Rule 1017’s requirement that a CMA or MAC application describe in detail the proposed change(s) in ownership, control or business operations and include a business plan, pro forma financials and written supervisory procedures reflecting the change. However, to ensure better accuracy of CMA and MAC application materials, proposed FINRA Rule 1160 also requires that CMAs and MAC applications identify and update any member firm application information (*e.g.*, organizational charts, constituent documents) required pursuant to proposed FINRA Rule 1121(a) that has been rendered inaccurate or incomplete as a result of any applicable event(s) triggering the application. The proposed rule clarifies that, to the extent a member firm has not previously submitted member firm application information required pursuant to Rule 1121(a) to the Department that is relevant to, or implicated by, the event(s) triggering the application, the member firm would have to include such information in its CMA or MAC application. Additionally, the proposed rule requires a CMA or MAC application to include a schedule and timeline for any systems changes and associated system testing.



In addition, if the application requests approval of a change in ownership or control, proposed FINRA Rule 1160 requires that the application include the names of the new owners or controlling parties, their percentage of ownership or control, the ultimate sources of their funding for the purchase and recapitalization of the member, copies of any agreements relating to the change in ownership or control and an indication of whether, if at all, the procedures and operations of the member firm will be impacted by the change.

#### **4. Safe Harbor Amendments**

As noted above, the proposed rule change relocates the contents of NASD IM-1011-1 (Safe Harbor for Business Expansion) as proposed supplementary material to proposed FINRA Rule 1160 as these provisions pertain specifically to the CMA process. The proposed rule change, however, makes one significant amendment to the relocated provisions. Specifically, the proposed supplementary material prohibits the safe harbor from being available to any member that seeks to acquire either an office (registered or unregistered) or associated persons involved in sales from a member firm where either that firm or its associated persons to be acquired have a “disciplinary history,” as defined in the supplementary material.

#### **I. Proposed FINRA Rule 1170 (Notice of Certain Member Changes and Continuous Access to Affiliate Information)**

NASD Rule 1017 currently requires a member firm to file a CMA when there is a 25 percent or more change in its equity ownership or partnership capital. While FINRA has found that the 25 percent threshold is sufficient to meet some regulatory concerns, FINRA is also aware that knowledge of certain transactions and/or patterns of transactions (whether or not coordinated) that occur below the 25 percent threshold is useful in maintaining effective oversight of member firms by identifying potential regulatory issues. For example, a 20 percent change of ownership of a broker-dealer purchased at a price reflecting 100 percent of the broker-dealer’s value can be a transaction structured to circumvent filing a CMA. Further, when a member firm’s senior management does not remain at the firm beyond the asset transaction transition period this may also indicate a potential regulatory issue. Additionally, in instances where a business expansion occurs (especially where the expansion requires a substantial infusion of capital or requires additional licenses or other regulatory or agency approval), FINRA has discovered that these expansions are often material events in the sense that they may have an impact on a firm’s supervisory and compliance infrastructure and/or finances. While current practices allow FINRA staff to review these changes on an ad hoc basis, they are not codified and present the risk that similar transactions may be given disparate treatment among the various districts.

Accordingly, proposed new FINRA Rule 1170 (Notice of Certain Member Changes and Continuous Access to Affiliate Information) requires a member firm to provide timely, prior written notice of certain significant changes in its business 30 days prior to the event's occurrence (or as soon as possible if circumstances make it impracticable to meet the 30-day time period), notwithstanding that such changes may not trigger a CMA filing. These events include:

1. direct or indirect acquisitions or divestitures of 10 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues comprising 10 percent or more in the aggregate of the member's revenues;
2. direct or indirect acquisitions or divestitures of 10 percent or more of the member's shares, partnership interests or other ownership interests by any one person or by a control group;
3. the addition, removal or subsequent modification of a business relationship between the member and an affiliate requiring disclosure under proposed FINRA Rule 1121;
4. a change or loss of the member's key personnel (such as its CEO, CFO, COO, CCO or any individual with similar status or functions);
5. a change in the member's service bureau, clearance activities (other than those that would require a CMA pursuant to proposed FINRA Rule 1160) or method of bookkeeping or recordkeeping, or utilizing an outside service provider;
6. the expansion of business: (a) requiring an infusion of capital that is 25 percent or more of the member firm's net capital as calculated from the ending date of the member's previous FOCUS filing period, or (b) requiring additional licenses, registrations, memberships or approvals as required by a self-regulatory organization or other regulatory agency;
7. the expansion of business adding products or services that would be new in terms of the type of investments, transactions or risks from those business products or services offered by the member firm since the time of the last approval of a membership application;
8. increasing the number of sales personnel, office locations or markets made beyond the scope of the safe harbor provisions of proposed FINRA Rule 1160;
9. the listing of the member firm (on an identified or anonymous basis) on any facility or medium that is designed to solicit offers or inquiry with respect to the possible purchase of the member in whole or in part, or the transfer of some or all of the member's assets; or
10. the discovery of any existing or impending condition(s) that the member firm reasonably believes could lead to capital, liquidity or operational problems, or the impairment of recordkeeping, clearance or control functions.

Upon notice of items (5) through (8) or item (10), proposed FINRA Rule 1170 permits FINRA staff to determine whether such event would substantively affect the business or resources of the member and, in the public interest, require the member to submit a CMA.

Proposed FINRA Rule 1170 also clarifies that the disclosure of an event under the rule in no way obviates a member's obligation to make a CMA filing should the member determine, or have a reasonable basis to believe, that the event requires such a filing.

Additionally, proposed FINRA Rule 1170 requires a member firm to submit promptly any affiliate information that the member firm or applicant would otherwise be required to provide under FINRA's membership rules. This provision essentially incorporates NYSE Rule 416 and its related supplementary material, which requires NYSE member organizations to provide financial and operational reports for affiliated organizations if requested. As noted above, a member firm's affiliate information has previously been helpful in identifying potential regulatory issues.

#### **J. Proposed FINRA Rule 1180 (Application to the SEC for Review)**

As noted above, NASD Rule 1019 (Application to Commission for Review) permits a person aggrieved by final action of FINRA under the NASD Rule 1010 Series to apply for review by the SEC. The proposed rule change adopts NASD Rule 1019 as proposed FINRA Rule 1180 (Application to the SEC for Review) without substantive changes.

#### **K. Proposed Eliminated Requirements**

Finally, the proposed rule change deletes NYSE Rules 311, 312, 313, 321 and related supplementary materials and rule interpretations, NYSE Rule 416(a) and (c) and related supplementary material and NYSE Rule Interpretation 401/03 as either redundant or obsolete.

## Endnotes

- 1 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those member firms of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See SEA Section 19 and rules thereunder.
- 4 NASD IM-1013-1 (Membership Waive-In Process for Certain New York Stock Exchange Member Organizations) and NASD IM-1013-2 (Membership Waive-In Process for Certain NYSE Alternext US LLC Member Organizations) set forth a membership waive-in process for certain NYSE and NYSE Alternext US LLC (n/k/a NYSE Amex LLC) member organizations that, pursuant to certain conditions, were automatically eligible to become FINRA members. As discussed in further detail herein, FINRA is proposing to amend these provisions to reflect the expiration of the waive-in period.
- 5 FINRA recently eliminated NYSE Rule 312(f) from FINRA's rulebook in connection with the adoption of FINRA Rules 2262 (Disclosure of Control Relationship with Issuer) and 2269 (Disclosure of Participation or Interest in Primary or Secondary Distribution). See Exchange Act Release No. 60659 (September 11, 2009), 74 FR 48117 (September 21, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-044); see also *Regulatory Notice 09-60* (October 2009) (SEC Approves New Consolidated FINRA Rules) (announcing, among other things, the December 14, 2009, effective date of FINRA Rules 2262 and 2269).
- 6 FINRA is not addressing NYSE Rule Interpretation 401/04 in this proposed rule change but will consider it as part of its ongoing review and consolidation of FINRA's financial and operational rules.
- 7 See FINRA By-Laws, Art. I(h): "'controlling' shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise. A person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary. Notwithstanding the foregoing, a presumption of control shall not apply where such person holds voting stock, in good faith, as an agent, bank, broker, nominee, custodian or trustee for one or more owners who do not individually or as a group have control of such entity."
- 8 NYSE Rule 304(e) was not incorporated into the FINRA rulebook.

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