

Notices

Regulatory Notices

- 13-29** FINRA Requests Comment on a Revised Proposal Regarding the Consolidated FINRA Rules Governing FINRA's Membership Application Proceedings; **Comment Period Expires: November 4, 2013**
- 13-30** SEC Approves Amendments to Customer Arbitration Code to Simplify Panel Selection in Cases With Three Arbitrators; **Effective Date: September 30, 2013**
- 13-31** FINRA Highlights Examination Approaches, Common Findings and Effective Practices for Complying With its Suitability Rule

Election Notices

- 09/04/13** Upcoming Election to Fill FINRA District Committee Vacancies; **Nomination Deadline: October 4, 2013**
- 09/04/13** FINRA Small Firm Advisory Board Election; **Nomination Deadline: October 4, 2013**

Information Notice

- 09/20/13** New S901 Regulatory Element Continuing Education Program

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Membership Application Proceedings

FINRA Requests Comment on a Revised Proposal Regarding the Consolidated FINRA Rules Governing FINRA's Membership Application Proceedings

Comment Period Expires: November 4, 2013

Executive Summary

FINRA seeks comment on a revised proposal to transfer the NASD Rule 1010 Series (Membership Proceedings), with substantive changes, into the Consolidated FINRA Rulebook as the FINRA Rule 1100 Series (Member Application). The revised proposal includes changes in response to comments on the prior proposal set forth in [Regulatory Notice 10-01](#). The proposal also includes additional rule provisions to address regulatory issues identified by FINRA staff and codify existing membership-related interpretations and practices.

The text of the proposed rules is set forth in Attachment A on our website at www.finra.org/notices/13-29.

Questions concerning this *Notice* should be directed to:

- ▶ Joseph Sheirer, Director and Counsel II, Membership Application Program, at (212) 858-5132; or
- ▶ Patricia Albrecht, Associate General Counsel, Office of General Counsel, at (202) 728-8026.

September 2013

Notice Type

- ▶ Request for Comment
- ▶ Consolidated Rulebook

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Systems

Key Topics

- ▶ Continuing Membership Application
- ▶ Membership Agreement
- ▶ Membership Application Process
- ▶ Membership Rules
- ▶ New Member Application
- ▶ Safe Harbor for Business Expansions

Referenced Rules & Notices

- ▶ FINRA By-Laws Art. I(rr) and Art. IV, Sect. 4(c)
- ▶ FINRA Rules 2111, 4120 and 4370
- ▶ NASD IM-1011-1, 1013-1 and 1013-2
- ▶ NASD Rule 1010 Series
- ▶ NASD Rules 1011, 1012, 1013, 1014, 1015, 1016, 1017, 1019 and 1090
- ▶ Notices to Members 97-19 and 98-38
- ▶ NYSE Rules 311, 312, 313, 321, 401 and 416
- ▶ NYSE Rule Interpretations 311(f) and (g), and 401/03 and /04
- ▶ Regulatory Notices 08-66, 09-42 and 10-01
- ▶ SEA Rules 15c3-1, 15c3-3, 17a-11 and 17f-2
- ▶ SEA Section 3(a)(39)



Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by **November 4, 2013**.

Comments must be submitted through one of 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, NW
Washington, DC 20006-1506

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

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).²

Background & Discussion

FINRA's current membership rules, the NASD Rule 1010 Series, provide a means for FINRA, through its Membership Application Program (MAP), to assess the proposed business activities of potential and current member firms with the ultimate goal of ensuring 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.

In January 2010, FINRA published *Regulatory Notice 10-01*, seeking comment on a proposal to transfer the NASD Rule 1010 Series, with substantive changes, into the Consolidated FINRA Rulebook as the FINRA Rule 1100 Series. Among other things, the proposed amendments revised the existing membership rules to streamline the standards of review for new member applications (NMAs) and continuing membership applications (CMAs), clarified administrative aspects of the membership process, updated or eliminated outdated terminology, required additional information (including affiliate information) about the applicant and incorporated provisions from the Incorporated NYSE membership rules. *Regulatory Notice 10-01* also proposed eliminating much of the Incorporated NYSE membership rule requirements as redundant or obsolete. FINRA received nine comment letters in response to *Regulatory Notice 10-01*, and has revised the proposal as further detailed below. FINRA invites comment on all aspects of the proposal and specifically requests comment on the economic impact of the proposed rules.

A. Proposed FINRA Rule 1111 (Definitions)

NASD Rule 1011 (Definitions) sets forth the defined terms applicable to the MAP process. The proposal adopts NASD Rule 1011 as proposed FINRA Rule 1111 (Definitions) with the following changes.

1. Proposed FINRA Rule 1111(a) (“Affiliate”)

Proposed FINRA Rule 1111(a) 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, limited liability company (LLC) managing member or officer exercising executive responsibility (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. This proposed definition is substantially similar to the definition of “Affiliate” previously proposed in *Regulatory Notice 10-01*, but includes a reference to “LLC managing member” to reflect that LLCs are an increasingly common organizational structure and that an LLC managing member performs a role similar to a general partner of a partnership.

One commenter noted that the proposed definition differs from the Form BD’s definition of “control affiliate”³ by excluding certain natural persons; however, FINRA does not believe that the proposed consolidated membership rule provisions applying to an applicant’s affiliates must extend to natural persons that control an applicant solely due to their status as a director, general partner, LLC managing member or officer (or similar status or function).

2. Proposed FINRA Rule 1111(c) (“Associated Person”)

Proposed FINRA Rule 1111(c) transfers NASD Rule 1011’s definition of “Associated Person” but amends the definition to expressly include an LLC member as an associated person and provide a de minimis exception from the definition. Specifically, the proposed rule defines “Associated Person” to mean: (1) a natural person registered under FINRA rules; (2) a sole proprietor, or any partner, LLC member, officer, director, or branch manager of the applicant, or any person occupying a similar status or performing similar functions; (3) any employee of the applicant, except any person whose functions are solely clerical or ministerial; (4) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the applicant; (5) any person directly or indirectly controlling the applicant whether or not such person is registered or exempt from registration under the FINRA By-Laws or FINRA rules; (6) any person engaged in investment banking or securities business controlled directly or indirectly by the applicant whether such person is registered or exempt from registration under the FINRA By-Laws or FINRA rules; or (7) any person who will be or is anticipated to be a person described in (1) through (6) above.⁴

In addition, the term “Associated Person” would not include any person with a de minimis ownership interest (*i.e.*, less than 10 percent) in an LLC, partnership or other type of legal business organization, unless that person is entitled under the business organization’s constituent documents to 10 percent or more of the business organization’s profits or distributions or otherwise has control of the applicant. This proposed de minimis ownership exclusion provides greater clarity regarding the associated person status of owners with small ownership interests in the applicant that do not otherwise control the applicant by virtue of an entitlement to significant portions of an applicant’s profits or distributions or otherwise have the power, directly or indirectly, to control the applicant.

As proposed in *Regulatory Notice 10-01*, the definition referred to “LLC managing member.” In response to questions regarding whether the definition also would include non-managing LLC members, FINRA has replaced “LLC managing member” with “LLC member” to clarify that all LLC members would be considered associated persons, subject to the de minimis exception noted above. This approach is consistent with the inclusion of all partners in the definition of associated person.

3. Proposed FINRA Rule 1111(d) (“control”)

Proposed FINRA Rule 1111(d) defines, for the first time, the term “control” to mean the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract or otherwise. Any person is presumed to control another person if such person: (1) is a director, general partner, LLC managing member or officer exercising executive responsibility (or having similar status or functions); (2) directly or indirectly has the right to vote 25 percent or more of a class of voting security or has the power to sell or direct the sale of 25 percent or more of a class of voting securities; or (3) in the case of a partnership or LLC, has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital.

This definition differs from the definition proposed in *Regulatory Notice 10-01*⁵ and responds to commenters’ requests for clarity and suggestion that FINRA, for regulatory consistency, adopt Form BD’s definition of “control.” The proposed definition tracks the Form BD’s “control” definition but replaces the references to “company” with “person,” which is defined in FINRA Rule 0160 to include “any natural person, partnership, corporation, association, or other legal entity.” In addition, the proposed definition includes references to “LLC” and “LLC managing member” to reflect that LLCs are an increasingly common organizational structure.

4. NASD Rule 1011(k) (“material change in business operations”)

As discussed further below in the context of proposed FINRA Rule 1160, the proposal relocates with changes NASD Rule 1011(k)’s 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.

5. Proposed FINRA Rule 1111(n) (“sales practice event”)

NASD Rule 1011(n) defines the term “sales practice event,” which is used in the context of specific provisions within NASD Rules 1013 (requiring an NMA applicant to provide written acknowledgment of any heightened supervisory procedures or special educational programs expected to be required for any associated person whose record reflects disciplinary actions or sales practice events) and 1014 (standards of admission that include as a factor consideration of whether any of an applicant’s associated persons have records reflecting disciplinary actions or sales practice events). Proposed FINRA Rule 1111(n) transfers NASD Rule 1011(n)’s definition but amends it to include “statutory disqualification” as defined in Section 3(a)(39) of the Securities Exchange Act of 1934 (SEA).

Specifically, the proposed rule defines “sales practice event” to mean “any customer complaint, arbitration, ‘statutory disqualification’ as defined in [SEA Section 3(a)(39)], or civil litigation that has been reported to the Central Registration Depository, that currently is required to be reported to the Central Registration Depository, or otherwise has been reported to FINRA.” As previously noted in *Regulatory Notice 10-01*, the proposed change would effectively expand 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.

6. Other Proposed FINRA Rule 1111 Definitions

The proposal also makes minor amendments to the following 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” (see proposed FINRA Rule 1111(b));
- ▶ adding the term “Executive Vice President(s)” to the definition of “Interested FINRA Staff” (see proposed FINRA Rule 1111(l)); and
- ▶ adding the term “LLC managing members” to the definition of the term “principal place of business” to reflect the existence of limited liability companies (see proposed FINRA Rule 1111(m)).

The proposal transfers, with no substantive changes, the definitions of the terms “Department,” “Director,” “district,” “district office,” “FINRA Board,” “FINRA Regulation Board,” “Governor” and “Subcommittee” (see proposed FINRA Rule 1111(e) through (k) and (o), respectively).

B. Proposed FINRA Rule 1112 (General Procedures)

NASD Rule 1012 (General Provisions) sets forth the requirements for submitting MAP applications and supporting documentation. The proposal adopts NASD Rule 1012 as FINRA Rule 1112 (General Procedures) with the following changes.

1. Proposed FINRA Rule 1112(a) (Filing by Applicant or Service by FINRA)

Proposed FINRA Rule 1112(a) retains NASD Rule 1012(a)'s provisions requiring that NMA and CMA applicants file their respective applications in accordance with proposed FINRA Rule 1112 and submit in a timely manner the requisite application fees pursuant to Schedule A to the FINRA By-Laws.

(a) Methods for Filing Application and Delivering Communications

The proposed rule also retains *Regulatory Notice 10-01*'s proposed provision allowing an applicant to file an application or any document or information requested by FINRA by first-class mail, overnight courier, hand delivery or electronic delivery (facsimile, email or a dedicated electronic filing system). In response to a commenter's suggestion that FINRA's responses be delivered electronically rather than by regular mail, FINRA has revised proposed FINRA Rule 1112(a) to provide FINRA with the same delivery methods for its communications as are afforded to applicants. Thus, the proposed change will allow FINRA to serve a notice or decision electronically.

(b) Alternate Method for Determining Date of FINRA Service or Filing by Applicant

Proposed FINRA Rule 1112(a) also retains NASD Rule 1012(a)'s provisions setting forth the manner in which service by FINRA or filing by an applicant shall be deemed complete. As proposed in *Regulatory Notice 10-01*, FINRA Rule 1112 provided that service or filing by electronic delivery shall be deemed complete on the date "recorded by FINRA's electronic systems for such communications." In response to commenters' concerns that the proposed rule does not provide methods for determining the date of completion in the event that there are failures or interruptions in FINRA's electronic systems, FINRA has revised this provision to include "or by other means of verification prescribed by FINRA."

2. Proposed FINRA Rule 1112(b) (Lapse of Application)

Proposed FINRA Rule 1112(b) retains NASD Rule 1012(b)'s provision providing that, absent a showing of good cause, an NMA or CMA will lapse if an applicant fails to respond fully within 60 days or 30 days, respectively, after service of an initial written request for information or documents. The proposed rule also retains the provision requiring a lapsed applicant that again wishes to seek membership or approval of a change in ownership, control or business operations to file a new NMA or CMA, including the timely submission of the requisite application fee pursuant to Schedule A to the FINRA By-Laws.

(a) Time Period for Applicant to Respond to Request for Information

As proposed in *Regulatory Notice 10-01*, under FINRA Rule 1112(b) an NMA would have lapsed if an applicant failed to respond within 30 days after service of an initial written request for information or documents. In response to commenters' concerns that the 30-day period would not provide new member applicants sufficient time to respond, FINRA is retaining NASD Rule 1012's current 60-day time frame. Consistent with NASD Rule 1012, and as proposed in *Regulatory Notice 10-01*, FINRA Rule 1112 continues to provide 30 days for NMA applicants to respond after service of any subsequent written request for information or documents and for CMA applicants to respond after service of any initial or subsequent written request.

(b) Failure to Schedule or Pass Required Examinations

As proposed in *Regulatory Notice 10-01*, FINRA Rule 1121 provided, for the first time, that an NMA or CMA would lapse, absent a showing of good cause, if an applicant failed to schedule the required examinations for its associated persons within 30 days after filing an NMA or CMA and ensure that such associated persons successfully complete their required qualification examinations within 120 days of filing the NMA or CMA. As revised, the proposal deletes these provisions in response to commenters' concerns regarding an applicant's ability to comply with the proposed requirements with respect to all of its associated persons, including applicants' associated persons who have not yet informed their existing employers of their departure.

The proposed deletion, however, does not affect current (and proposed) FINRA membership rule provisions that an NMA or CMA will lapse or be denied if an applicant fails to respond fully to requests for evidence of qualification or is unable to demonstrate compliance with the standards in NASD Rule 1014 (Department Decision) (and proposed FINRA Rule 1130 (Basis for Department Decision)). NASD Rule 1014 (and proposed FINRA Rule 1130) requires, among other things, that an applicant and its associated persons have all licenses and registrations required by state and federal authorities and self-regulatory organizations (SROs).

3. Proposed FINRA Rule 1112(c) through (e): Ex Parte Communications, Recusals or Disqualifications and Computation of Time

Proposed FINRA Rule 1112(c) through (e) adopts NASD Rule 1012(c) through (e) without significant changes. These provisions address: (1) the prohibitions against ex parte communications that become effective when FINRA staff knows that an applicant intends to file a written request for review by the National Adjudicatory Council (NAC) under proposed FINRA Rule 1140; (2) the recusal or disqualification of a FINRA Board of Governors (FINRA Board) or NAC member that has a conflict of interest or bias in a matter governed by the proposed FINRA Rule 1100 Series; and (3) the meaning and computation method for the term "day," as it is used in the proposed FINRA Rule 1100 Series.

4. Proposed FINRA Rule 1112.01 (Applications to be Kept Current)

Proposed FINRA Rule 1112.01 provides that each applicant is under a duty throughout the application process to promptly correct, amend or modify any NMA or CMA filed with FINRA pursuant to the proposed FINRA membership rules that is or becomes inaccurate or misleading, by submitting supplementary amendments and documentation.

C. Proposed FINRA Rule 1121 (New Member Application, Interview, and Department Decision)

NASD Rule 1013 (New Member Application and Interview) sets forth the content and interview requirements for NMAs. The proposal adopts NASD Rule 1013 as FINRA Rule 1121 (New Member Application, Interview, and Department Decision) subject to the following changes.

1. Proposed FINRA Rules 1121(a)(1) (Filing Requirements) and (a)(2) (Uniform Registration Forms)

Proposed FINRA Rule 1121(a)(1) adopts NASD Rule 1013(a)(1)'s provisions requiring a new member applicant to file its application with the Department of Member Regulation (Department) in the manner prescribed by FINRA and detailing the required information an applicant must include in its application, such as the Form NMA, Form BD, fingerprint card for each associated person who will be subject to SEA Rule 17f-2, new member assessment report and specific information regarding an applicants' associated persons, business models, finances, recordkeeping system, continuing education training plan and supervisory structures. Proposed FINRA Rule 1121(a)(2) adopts without substantive changes the requirement that the applicant submit its uniform registration forms (*e.g.*, Form U4, Form U5, amendments to Forms BD or U4).

As further discussed below, proposed FINRA Rule 1121(a)(1) also includes provisions requiring additional information to be included in an NMA.

(a) *Constituent Documents*

Proposed FINRA Rule 1121(a)(1) retains without any changes the provision originally proposed in *Regulatory Notice 10-01* requiring that an applicant provide its constituent documents, as applicable, including corporate resolutions, charters, by-laws, partnership agreements, operating agreements, certificates of LLC and any analogous documents.

(b) *Organizational Chart and Proposed FINRA Rule 1121.01 (Division of Member Firms)*

Proposed FINRA Rule 1121(a)(1) retains NASD Rule 1013(a)(1)'s requirement that the applicant provide an organizational chart. The proposal deletes the provision proposed in *Regulatory Notice 10-01* requiring that the organizational chart identify the associated persons (by name and CRD number) to be responsible for the supervision

and management of each applicant office, division and business line. FINRA, however, may request this information from an applicant if it becomes necessary to have such information to render a decision on an NMA. In addition, proposed FINRA Rule 1121.01, consistent with current NYSE requirements, prohibits an applicant from identifying in its organizational chart any divisions that are not separate legal entities by words such as “Company,” Corporation” or Incorporation.”⁶

(c) Investment Advisory-Related Contractual Information

Proposed FINRA Rule 1121(a)(1) adopts, without change, NASD Rule 1013(a)(1)’s requirement that an applicant provide “any plan to enter into contractual commitments, such as underwritings or other securities-related activities.” The proposal deletes from the provision language previously proposed in *Regulatory Notice 10-01* referencing “underwriting agreements or other activities, such as investment advisory business” because such activities are already captured by the existing rule text.

(d) Affiliate Organizational Chart

As proposed in *Regulatory Notice 10-01*, FINRA Rule 1121(a)(1) would have required an applicant to provide an affiliate organizational chart: (1) identifying the applicant and all of its affiliates; (2) providing a brief summary of each affiliate’s principal activity; and (3) identifying the legal relationship between the applicant and each affiliate. In response to commenters’ concerns, FINRA has narrowed the provision to require that a new member applicant provide an affiliate organizational chart identifying the applicant and any affiliate that controls the applicant, is controlled by the applicant or has one of the below enumerated business relationships for which the applicant must provide a detailed summary.

(e) Summary of Affiliate Business Relationship

Proposed FINRA Rule 1121(a)(1) requires an applicant to provide a detailed and comprehensive summary of the business relationship between the applicant and any affiliate:

- (1) with which the applicant consolidates financial statements for purposes of SEA Rule 15c3-1 (revised from the originally proposed criteria specifying affiliates whose financial information is consolidated with that of the applicant);
- (2) whose liabilities or obligations have been directly or indirectly guaranteed by the applicant;
- (3) that is the source of flow-through capital to the applicant in accordance with Appendix C of SEA Rule 15c3-1; or
- (4) that has the authority or the ability to withdraw or cause the withdrawal of capital from the applicant.

Proposed FINRA Rule 1121 previously enumerated other types of affiliate business relationships for which an applicant would have been required to provide a detailed summary⁷ and required that evidence of such business relationship be provided, at FINRA's discretion, from the books and records of the applicant or any affiliate that is a party to such business relationship.

Commenters said that the proposed reporting requirements were too broad and unduly burdensome, with commenters suggesting that FINRA limit the reporting requirements to only those affiliates materially affecting the applicant (*e.g.*, providing operational support to the applicant, offering investment products and services, having a material impact on the applicant's financial, supervisory or compliance obligations). Commenters also raised concerns regarding the provision requiring that evidence of the business relationships be provided from the books and records of the applicant or the affiliate.

In response to commenters' concerns, the proposal limits the list of affiliate business relationships to those business relationships that could impact an applicant's financial condition. In addition, proposed FINRA Rule 1121(a)(1) clarifies that the applicant shall provide the necessary information and evidence for the disclosed business relationships. In this regard, the revised affiliate business relationship criteria are limited to those relationships that can be evidenced by the applicant.

Commenters also requested guidance regarding the content of a "detailed and comprehensive summary." With respect to the content of the "detailed and comprehensive summary" describing the business relationship between the applicant and the relevant affiliates, an applicant would be expected to identify: (1) the specific nature of the business relationship between the parties; (2) whether such relationships are governed by contract or other agreement; (3) the relationship's anticipated impact to the applicant; and (4) whether the affiliate has the ability to enter into transactions that impact the financial or operational condition or obligations of the applicant and, if so, a description of how the applicant would be impacted.

(f) Anti-Money Laundering Procedures and Independent Audit Firm Identification

Proposed FINRA Rule 1121(a)(1) retains without any changes the provision proposed in *Regulatory Notice 10-01* requiring that an applicant for membership provide a copy of its anti-money laundering procedures, including the name of the associated persons responsible for implementation.

FINRA is deleting a provision proposed in *Regulatory Notice 10-01* that would have required that a new member applicant identify the independent audit firm (which, pursuant to SEC requirements, must be registered with the Public Company Accounting Oversight Board) to be engaged by the applicant, and provide the anticipated audit schedule and, if applicable, a copy of the applicant's most recent audit report. Because registered broker-dealers must file annually with the SEC specified financial statements certified by a public accounting firm, FINRA will have access to this information once the applicant is registered with the SEC.

2. Proposed FINRA Rule 1121(a)(3) (Request for Additional Documents or Information)

Proposed FINRA Rule 1121(a)(3) adopts NASD Rule 1013's provision requiring the Department, within 30 days after the filing of an application, to serve an initial request for additional documents or information necessary to render a decision on the application and providing a new member applicant with 60 days to respond after service of the initial request and with 30 days to respond after service of any subsequent request. As proposed in *Regulatory Notice 10-01*, the proposed rule would have provided only 30 days for an applicant to respond to an initial request. Retaining the original 60-day time period is consistent with proposed FINRA Rule 1112(b)'s retention, in response to comments to *Regulatory Notice 10-01*, of NASD Rule 1012(b)'s original 60-day period for new member applicants to respond to an initial or subsequent request for information before an application lapses.

3. Proposed FINRA Rule 1121(a)(4) (Rejection of Application that is Not Substantially Complete) and Opportunity to Re-File NMA

Proposed FINRA Rule 1121(a)(4) adopts NASD Rule 1013(a)'s provision that the Department may reject an application and deem it not to have been filed if the Department determines that an NMA is not substantially complete within 30 days of the application's filing. FINRA shall refund the application fee, less a \$500 processing fee. If the applicant determines to continue to seek membership, the applicant must submit a new application and fee pursuant to Schedule A to the FINRA By-Laws.

FINRA is deleting a provision proposed in *Regulatory Notice 10-01* that would have provided a one-time opportunity for an applicant to re-file an NMA within 30 days of service of a written notice by the Department that the NMA is not substantially complete by submitting only a new Form NMA and the application fee, rather than the entire application and all supporting documents. The provision did not take into account the fact that FINRA's electronic filing processes require an applicant to submit all supporting documents when filing the Form NMA so that the electronic filing system may perform a completeness check prior to accepting the filing. If the filing is flagged as incomplete, the electronic filing system permits the applicant to correct any identified deficiencies, such as omitted information or documentation.

4. Proposed FINRA Rule 1121(a)(5) (Application Timing)

Proposed FINRA Rule 1121(a)(5) retains, without change, the provision proposed in *Regulatory Notice 10-01* requiring that an applicant file its Form NMA no later than 180 days after submission of its Form BD or FINRA will deem the application process to be abandoned and refund the application fee, less a \$250 processing fee. FINRA believes this provision will help eliminate the problem of membership applications remaining “in limbo” with both the SEC and FINRA because of applicants waiting six months or more after filing their Form BD and entitlement forms to file their Form NMA.

5. Proposed FINRA Rule 1121(b) (Membership Interview)

Proposed FINRA Rule 1121(b) adopts with changes NASD Rule 1013(b)'s provisions requiring the Department to conduct a membership interview with an applicant's representatives before the Department serves its decision on an NMA. The provisions include requirements that: (1) the Department serve an applicant with written notice specifying the date and time and required persons at least seven days before the membership interview; (2) the Department schedule the membership interview within 90 days after the filing of the NMA or within 30 days after the filing of all additional requested information or documents; (3) the membership interview be conducted in the FINRA district office where the applicant has or intends to have its principal place of business, unless otherwise agreed; (4) the applicant provide updated financial documents on or before the membership interview; (5) the Department review the application and proposed FINRA Rule 1130's standards with the applicant's representatives during the membership interview; and (6) the Department provide the applicant at the interview (or promptly serve on the applicant if received after the interview) with any information or documents obtained from sources other than the applicant on which the Department intends to base its decision.

The proposal revises proposed FINRA Rule 1121(b) in several respects. Specifically, the proposal revises the provision requiring the Department to review the application and proposed FINRA Rule 1130's standards with the applicant's representatives during the membership interview to clarify that the applicant's representatives are those identified by the applicant pursuant to proposed FINRA Rule 1121's membership interview provisions. In addition, the proposal clarifies that the Department may also review such standards from time to time with other representatives of the applicant or other persons as deemed necessary by the Department. Also, the proposed rule includes language clarifying that the Department may conduct more than one NMA interview. This change clarifies the Department's authority to require participation in additional interviews, based on the facts and circumstances of each NMA.

6. Proposed FINRA Rule 1121(c) through (h): Procedures Applicable to the Decision to Grant or Deny an NMA

The proposal transfers from NASD Rule 1014 (Department Decision) to proposed FINRA Rule 1121(c) through (h) the procedural provisions applicable to the Department's decision to grant or deny an NMA. These provisions address: (1) the Department's consideration of whether the applicant and its associated persons meet the standards in proposed FINRA Rule 1130; (2) the applicable time frame and required content of the Department's decision and the applicant's right to file a written request for review if the Department fails to serve a timely decision; (3) the applicant's requirement to file an executed membership agreement if the Department grants an application; (4) the Department's requirement to serve its decision and membership agreement on the applicant in accordance with proposed FINRA Rule 1112; (5) the effectiveness of a membership agreement restriction unless removed, modified or stayed by the NAC, FINRA Board or the SEC; and (6) the Department's decision constituting FINRA's final action unless the applicant files a written request for review.

The only proposed substantive change is to the provision specifying that if the Department fails to serve a decision on an NMA within the specified time period and the applicant files a written request with the FINRA Board for a decision, the FINRA Board may extend the time for issuing a decision by 90 days if the Department has shown good cause for the extension. Proposed FINRA Rule 1121 clarifies that the 90-day period begins from the FINRA Board's good cause determination.

7. Proposed FINRA Rule 1121.02 (Membership Waive-In)

Proposed FINRA Rule 1121.02 transfers 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), the provisions permitting certain NYSE and NYSE MKT (identified in NASD IM-1013-2 as NYSE Alternext) member organizations to be eligible for a streamlined application process for FINRA membership, with the following changes. First, the proposal deletes the descriptions of the application processes, while retaining the provisions specifying that the waive-in members are subject to the FINRA By-Laws and Schedules to By-Laws, including Schedule A, the consolidated FINRA rules and the NYSE rules incorporated by FINRA. In addition, the proposed supplementary material clarifies that a waive-in member must execute a membership agreement prior to expanding its business operations. If the business expansion would be considered a material change in business operations, as that term is defined in proposed FINRA Rule 1160, proposed FINRA Rule 1121.02 requires the waive-in member to submit a CMA and obtain approval prior to engaging in the expanded business activity. Upon approval of such business expansion, the firm shall be subject to all NASD rules in addition to the consolidated FINRA rules and the NYSE rules incorporated by FINRA.

D. Proposed FINRA Rule 1130 (Basis for Department Decision)

Proposed FINRA Rule 1130 adopts NASD Rule 1014 (Department Decision), which sets forth the standards or criteria the Department uses to evaluate whether to grant or deny an NMA or CMA (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). As further described below, the proposal streamlines and consolidates the standards to reduce their total number from 14 to 11 and makes other substantive changes.

1. Proposed FINRA Rule 1130: Preamble

Similar to NASD Rule 1013, proposed FINRA Rule 1130 provides that the Department shall determine whether an NMA or CMA applicant satisfies each of the evaluation standards after considering the applicant's NMA or CMA, any membership interviews, other information or documents provided by either the Department or the applicant and the public interest and protection of investors. Proposed FINRA Rule 1130 retains *Regulatory Notice 10-01's* proposed requirement that each NMA and CMA must address every evaluation standard outlined in the rule but permits an applicant to provide a written explanation regarding any standard that it believes is not applicable based on the nature and scope of its application. The final determination regarding the applicability of any standard will be made by the Department.

2. Proposed FINRA Rule 1130(a): Application is Complete and Consistent with Applicable Laws and FINRA Rules

Proposed FINRA Rule 1130(a) combines the standards in NASD Rule 1014(a)(1) and (14) to require that the Department determine whether the applicant has satisfied the standard that the applicant's NMA or CMA and all supporting documents are complete, accurate and consistent with the federal securities laws, the rules and regulations thereunder and FINRA rules.

3. Proposed FINRA Rule 1130(b): Applicable Licenses and Registrations

Proposed FINRA Rule 1130(b) adopts the standard in NASD Rule 1014(a)(2) that the Department determine whether the applicant and its associated persons have all licenses and registrations required by state and federal authorities and SROs and also includes the requirement that the applicant and its associated persons have paid all applicable fees.

4. Proposed FINRA Rule 1130(c): Direct and Indirect Funding Sources

Proposed FINRA Rule 1130 adds a new application evaluation standard requiring an applicant to fully disclose and establish through documentation satisfactory to FINRA all direct and indirect sources of its funding and providing that FINRA determine that such sources are otherwise consistent with the standards set forth in proposed FINRA Rule 1130.

In *Regulatory Notice 10-01*, the proposed provision required FINRA to determine that an applicant's funding sources were "not objectionable." However, FINRA has revised the provision in response to commenters' concerns that the "not objectionable" review standard was too vague. In addition, FINRA has revised the provision to incorporate the MAP Group's review practice of evaluating both "direct and indirect" sources of an applicant's funding to determine whether those sources are consistent with the applicant's ownership chain and whether they present any regulatory concerns. For instance, the MAP Group has identified questionable indirect funding sources such as undocumented loans from statutorily disqualified persons, proceeds from sales of securities of an issuer not identified as an applicant's owner and contributions from persons with other regulatory history that do not rise to the level of a statutory disqualification but nevertheless present regulatory concerns.

5. Proposed FINRA Rule 1130(d): Licensing, Regulatory or Disciplinary History of Applicant and its Affiliates

Proposed FINRA Rule 1130(d) carries over NASD Rule 1014(a)(3)'s requirement that the Department determine whether the applicant and its associated persons are capable of complying with the federal securities laws, rules and regulations and FINRA rules and the factors the Department must consider in making this determination. These factors include whether an applicant or its associated persons have a licensing, regulatory or disciplinary history and whether a state or federal authority or SRO has provided information indicating that the applicant or its associated persons otherwise poses a threat to public investors. The Department also must consider these factors for any applicant's affiliate that controls the applicant, is controlled by the applicant or has a business relationship requiring disclosure pursuant to proposed FINRA Rule 1121.

As proposed in *Regulatory Notice 10-01*, FINRA Rule 1121 would have required the Department to consider these factors for any affiliate of the applicant. However, in response to commenters' concerns, the proposal limits consideration to the types of affiliates outlined above. FINRA believes that the proposed requirement, as revised, is an important mechanism for evaluating the operations of each applicant.

The other factors carried over from NASD Rule 1014(a)(3) that the Department must consider are whether: (1) an applicant or its associated persons' record reflects a sales practice event, a pending arbitration or a pending private civil action; (2) an associated person was terminated for cause or permitted to resign after an investigation of a federal or state securities law (or rule or regulation thereunder), an SRO rule or industry standard of conduct; and (3) an associated person was the subject of remedial action (*e.g.*, special training, continuing education requirements, heightened supervision) by a state or federal authority or SRO. The proposal also relocates from NASD Rule 1014(a)(13) a provision requiring the Department to consider any information in FINRA's possession indicating that the applicant may seek to circumvent, evade or otherwise avoid compliance with the federal securities laws and regulations or FINRA rules.

6. Proposed FINRA Rule 1130(e) through (g): Contracts, Facilities and Systems

Proposed FINRA Rule 1130(e) through (g) are substantially similar to NASD Rule 1014(a) (4) through (6) and require that the Department consider whether the applicant has: (1) established all necessary contractual or other arrangements and business relationships (including adding a specific reference to “other brokers or dealers” to the listed entities (“banks, clearing corporations, service bureaus, or others”)); (2) sufficient facilities for its operations (or has adequate plans to obtain such facilities); and (3) communications and operational systems for the purpose of conducting business with customers and other members that are adequate and provide reasonably for business continuity pursuant to FINRA Rule 4370 (Business Continuity Plans and Emergency Contact Information).

7. Proposed FINRA Rule 1130(h): Financial and Operational Controls

Proposed FINRA Rule 1130(h) carries over NASD Rule 1014(a)(7)’s requirement that the Department determine whether the applicant is capable of maintaining a level of net capital in excess of the minimum required net capital adequate to support the applicant’s intended business operations on a continuing basis and that the Department may impose a reasonably determined higher net capital requirement after considering six enumerated factors. The factors include, among other things, any plan of the applicant to enter into contractual commitments, such as underwritings or other securities-related activities. The proposal in *Regulatory Notice 10-01* had amended this requirement to include underwriting agreements or other activities, such as investment advisory business. In response to commenters’ concerns, FINRA has revised the proposal to retain the current NASD Rule 1014 provision which references contractual commitments, such as underwritings and other securities-related activities. Proposed FINRA Rule 1130(h) also retains *Regulatory Notice 10-01*’s provision incorporating into the standard the requirement that the applicant’s financial and operational controls comply with SEA Rules 15c3-1 and 15c3-3.

Proposed FINRA Rule 1130 also retains NASD Rule 1014(a)(7)’s provision requiring the Department to consider the factor of any other activity that an applicant will engage in that reasonably could have a material impact on the applicant’s net capital within the first 12 months of business operations and extends that requirement to include the activity of the applicant or any affiliate that controls the applicant, is controlled by the applicant, or has a business relationship requiring disclosure pursuant to proposed FINRA Rule 1121. In *Regulatory Notice 10-01*, the proposed rule had extended the requirement to the activity of all of an applicant’s affiliates. In response to commenters’ concerns regarding the definition of “Affiliate,” FINRA has revised the provision to limit consideration to the activity of those affiliates outlined above.

In addition, proposed FINRA Rule 1130 retains NASD Rule 1014(a)(7)’s provision directing the Department to consider the amount of capital necessary for the applicant to meet expenses net of revenue for at least 12 months, based on reliable projections agreed to by the applicant and the Department.

Further, proposed FINRA Rule 1130(h) retains without substantive changes NASD Rule 1014(a)(7)'s provisions detailing the following remaining factors the Department must consider when deciding whether to impose a reasonably determined higher net capital requirement: (1) the amount of net capital sufficient to avoid the early warning level reporting requirements (such as SEA Rule 17a-11 (Notification Provisions for Brokers and Dealers) and FINRA Rule 4120 (Regulatory Notification and Business Curtailment), as applicable); (2) any planned market making activities and the number of markets to be made, the type and volatility of products and the anticipated maximum inventory positions; and (3) any plan to distribute or maintain securities products in proprietary positions and the risks, volatility, liquidity and speculative nature of the products.

8. Proposed FINRA Rule 1130(i): Supervisory System

Proposed FINRA Rule 1130(i) carries over NASD Rule 1014(a)(8)'s requirement that the Department determine whether the applicant has a supervisory system designed to prevent and detect, to the extent practicable, violations of the federal securities laws, the rules and regulations thereunder and FINRA rules, taking into consideration enumerated factors. One factor includes whether the applicant will recommend securities to customers. Consistent with new FINRA Rule 2111 (Suitability), FINRA has revised the proposal to extend this factor to include whether the applicant will recommend "investment strategies involving a security."

In addition, the proposal makes changes to the provision directing the Department to consider whether the applicant should be required to place associated persons on heightened supervision pursuant to *Notice to Members 97-19* (April 1997) to clarify that the applicant will impose appropriate remedial action, such as special training, continuing education or heightened supervision on any associated persons whose record reflects one or more disciplinary actions or sales practice events.

The proposal also retains without substantive changes the provisions outlining the other factors the Department must consider when evaluating the adequacy of the applicant's supervisory system. Those provisions require the Department to consider whether: (1) the number, location, experience and qualifications of an applicant's supervisory personnel are adequate; (2) the applicant has identified specific associated persons to supervise the applicant's functions and intended offices; (3) the applicant has identified functions for each associated person and adopted procedures to ensure appropriate state and FINRA registration of all persons whose functions are subject to such registration requirements; (4) each supervisory associated person has the relevant experience to perform the supervisory duties; (5) the applicant will solicit retail or institutional business; (6) a supervisor/principal's location or part-time status will affect the person's ability to be an effective supervisor; (7) a state or federal authority or SRO has previously imposed remedial action on an associated person; and (8) any identified condition that may have a material impact on the applicant's ability to detect or prevent violations of the federal securities laws or regulations and FINRA rules.

9. Proposed FINRA Rule 1130(j) and (k): Recordkeeping and Continuing Education

Proposed FINRA Rule 1130(j) and (k) transfer without substantive changes NASD Rules 1014(a)(11) and (a)(12), requiring the Department to consider, respectively, whether the applicant has an adequate recordkeeping system and training needs assessment and written continuing education training plan.

E. Proposed FINRA Rule 1140 (Review by National Adjudicatory Council)

NASD Rule 1015 (Review by National Adjudicatory Council) permits an applicant to submit to the NAC a request for review of an adverse decision. The proposal adopts NASD Rule 1015 as proposed FINRA Rule 1140, but increases the time for an applicant to file an appeal with the NAC from 25 days after service of the Department's decision to 30 days after service of the Department's decision and also increases from 10 days to 15 days the time for the Department to submit the record to the NAC. FINRA believes that increasing each period by five days will afford applicants and staff adequate time to prepare the substantial work and record required for appeals.

The proposed rule does not carry over NASD Rule 1015's provision requiring the Department to maintain a record in the "membership application docket" for each request relating to appeals to the NAC, as the Department does not maintain such a docket.

F. Proposed FINRA Rule 1150 (Discretionary Review by FINRA Board)

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 proposal adopts NASD Rule 1016 as proposed FINRA Rule 1150 with no substantive changes.

G. Proposed FINRA Rule 1160 (Application for Approval of Change in Ownership, Control, or Business Operations Pursuant to a Continuation of or Withdrawal from Membership) and Related Supplementary Material

Proposed FINRA Rule 1160 adopts with changes NASD Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations), the membership rule requiring a member to file a CMA for approval of specific changes to its ownership, control or business operations. Proposed FINRA Rule 1160.01 (Safe Harbor from Application in Limited Circumstances) relocates with changes the contents of NASD IM-1011-1 (Safe Harbor for Business Expansion) as supplementary material to proposed FINRA Rule 1160.

1. Proposed FINRA Rule 1160(a) (Events Requiring Application)

Proposed FINRA Rule 1160(a) transfers with changes NASD Rule 1017(a)'s provisions outlining the events requiring a member to file a CMA.

(a) Mergers and Acquisitions of Members

The proposal transfers NASD Rule 1017(a)'s criteria requiring a CMA where there is a merger or direct or indirect acquisition of a member with or by another broker-dealer, but eliminates the current exceptions for mergers where both parties are NYSE members and for acquisitions where the acquiring member is an NYSE member. Instead, the proposed rule would require a CMA for any merger or acquisition with or of another broker-dealer, whether or not such broker-dealer is a FINRA member.⁸

(b) Acquisition, Divestiture, Transfer, or Sale of Member's Assets, Business, or Line of Operation

Proposed FINRA Rule 1160(a) amends existing NASD Rule 1017(a)'s criteria requiring a CMA where there is a change involving a direct or indirect acquisition or transfer of 25 percent or more in the aggregate of the member's assets, business or line of operation that generates revenue composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis. The proposed rule clarifies that the change would include purchases, divestitures or sales meeting the outlined threshold. The proposed rule further clarifies that assets may include, for example, cash, securities, notes, real estate ownership interests, inventories and accounts receivable and that the reference to any asset, business or line of operation includes customer accounts. The proposed rule, however, would not require a CMA for acquisitions or divestitures performed in the ordinary course of business operations where the member proposes to exchange one type of asset for another (*e.g.*, turnover of proprietary inventory).

(c) Change in Ownership Interest

Proposed FINRA Rule 1160(a) transfers with changes NASD Rule 1017(a)'s criteria requiring a CMA for changes of 25 percent or more in a member's ownership. Specifically, the proposed rule requires a CMA for a change, directly or indirectly, in the equity ownership, partnership capital, LLC membership interest, or other ownership interest in the member that 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. This proposed change would not require a CMA for any ownership interest changes below 25 percent (*e.g.*, a 10 percent LLC member or limited partnership ownership interest change) absent any facts and circumstances that would trigger other criteria requiring a CMA, such as a change in control person.

(d) Change in Control Person

Proposed FINRA Rule 1160(a) explicitly requires, for the first time, a CMA for any change, directly or indirectly, of control persons of the member, other than the appointment or election of a natural person as an officer or director of the member in the normal course of business, regardless of whether such change occurred as a result of a direct or indirect change in the equity ownership, partnership capital, LLC membership interest or other ownership interest in the member. The proposed change codifies FINRA's existing interpretation of NASD Rule 1017 as requiring a CMA in such situations. As discussed further below, proposed FINRA Rule 1160 provides the opportunity for an applicant to request a CMA waiver where the change of control persons would not result in any day-to-day change in the applicant's business activities, management, supervision, assets or liabilities.

(e) Material Change in Business Operations

Proposed FINRA Rule 1160(a) transfers NASD Rule 1017(a)'s provision requiring a CMA for a "material change in business operations" and, as noted above, relocates into the proposed rule with changes NASD Rule 1011(k)'s definition of the term "material change in business operations," which defines the term as including, but not limited to: (1) removing or modifying a membership agreement restriction; (2) market making, underwriting or acting as a dealer for the first time; and (3) adding business activities that require a higher minimum net capital under SEA Rule 15c3-1 (Net Capital Requirements for Brokers or Dealers). As proposed in *Regulatory Notice 10-01*, FINRA Rule 1160(a) retained these categories but also included as a material change in business operations: (1) any change in exemptive status claimed under SEA Rule 15c3-3(k) (Customer Protection – Reserves and Custody of Securities); (2) settling or clearing transactions for the applicant's own business or for other broker-dealers for the first time; or (3) carrying accounts of customers for the first time.

The revised proposal retains all of the above categories as part of the definition of a "material change in business operations" and, consistent with current guidance, includes engaging for the first time in retail currency exchange activities or variable life settlements to retail customers.⁹ Thus, the proposal defines a "material change in business operations" as including, but not limited to: (1) removing or modifying a membership agreement restriction; (2) adding business activities that require a higher minimum net capital under SEA Rule 15c3-1; (3) any change in exemptive status claimed under SEA Rule 15c3-3(k); or (4) engaging, for the first time, in: (i) market making, (ii) underwriting, (iii) acting as a dealer, (iv) settling or clearing transactions for the applicant's own business, (v) settling or clearing transactions for other broker-dealers, (vi) carrying accounts of customers, (vii) retail foreign currency exchange activities, or (viii) variable life settlement sales to retail customers.

2. Proposed FINRA Rule 1160(b) (Filing and Content of Application) and Related Supplementary Material

Proposed FINRA Rule 1160 transfers with the following substantive changes NASD Rule 1017(b)'s provisions outlining a CMA's content and filing requirements.

(a) *Updated Information, Impact of Proposed Business Change and Consolidated CMA*

The proposal retains *Regulatory Notice 10-01*'s requirement that the CMA identify and update any required NMA information that would be inaccurate or incomplete as a result of the proposed business change, as well as including a schedule and timeline for any systems changes and associated system testing. The proposal also retains *Regulatory Notice 10-01*'s provision requiring, for the first time, that any CMA requesting approval of a change in ownership or control include details and supporting documentation regarding the ultimate sources of funding for the purchase, copies of any agreements relating to the change in ownership or control and whether the member's procedures and operations will be impacted by the change. In addition, proposed FINRA Rule 1160 would provide the Department discretion to require only one CMA in circumstances where a proposed business change would require two or more members to each file a CMA. In such circumstances, the Department may seek information and documentation from all members involved in the proposed business change.

(b) *CMA Waiver Request Process*

Proposed FINRA Rule 1160 provides that the Department may waive the CMA filing requirement for acquisitions or divestitures of the member's assets, businesses or lines of operation where the member is: (1) ceasing operation as a broker or dealer; (2) filing a Form BDW with the SEC; and (3) neither the member nor any of its associated persons is the subject of any claim (including, but not limited to, pending or settled arbitration or litigation actions) that could be disadvantaged by the proposed transaction. The proposed rule also provides that the Department may waive the CMA filing requirement for direct or indirect ownership or control changes where such changes do not result in any "day-to-day change in the business activities, management, supervision, assets, liabilities, or ultimate ownership or control of the member." As proposed in *Regulatory Notice 10-01*, the CMA waiver provisions originally provided that ownership or control changes qualifying for a CMA waiver would not result in any "practical change in the business activities, management, supervision, assets, liabilities, or ultimate ownership or control of the member."

Several commenters supported the waiver provisions but requested that FINRA clarify the standard that the ownership or control change would not result in any "practical change" to the member's operations and provide more detail regarding how to obtain a waiver. In addition, a commenter questioned the application of the waiver provision where the member is filing a Form BDW since, according to the commenter, a firm planning to file a Form BDW is not a candidate for a CMA, which is an application for a continuing membership.

In response, FINRA has revised the ownership or control change standard to replace the term “practical change” with “day-to-day change” and delete the requirement that the ownership or control change not result in any change in the member’s “ultimate ownership or control.” In addition, FINRA has revised proposed FINRA Rule 1160’s title to reference withdrawals to clarify that the proposed rule’s requirements would encompass some situations where a CMA applicant is also filing a Form BDW, consistent with FINRA’s current interpretation of NASD Rule 1017. For example, in instances where there is a direct or indirect acquisition or divestiture of 25 percent or more of a member’s assets, the CMA process is necessary to ensure that such asset transfers are performed in a manner that will not harm investors or market integrity. However, as noted above, FINRA considers a CMA waiver to be appropriate in those limited situations where the member is also ceasing operations as a broker or dealer (including filing a Form BDW with the SEC) and neither the member nor any of its associated persons is the subject of any claim that could be disadvantaged by the proposed transaction.

FINRA also has revised the proposal to add FINRA Rule 1160.01 (Waiver Requests) as supplementary material clarifying that the Department would generally grant a waiver where the member is only proposing a change in the: (1) member’s legal structure (*e.g.*, changing from a corporation to an LLC); (2) equity ownership, partnership capital, LLC membership interest or other ownership interest in an applicant held by a corporate legal structure that is due solely to a reorganization of ownership or control of the applicant within the corporate legal structure (*e.g.*, reorganizing only to add a holding company to the corporate legal structure’s ownership or control chain of the applicant); or (3) percentage of ownership interest, LLC membership interest or partnership capital of an applicant’s existing owners or partners resulting in an owner or partner owning or controlling 25 percent or more of the ownership interest or partnership and that owner or partner has no disclosure or disciplinary issues in the preceding five years. In addition, with respect to the process for requesting a waiver, proposed FINRA Rule 1160.01 clarifies that a member seeking a CMA waiver must submit a written request to the Department in the manner prescribed in proposed FINRA Rule 1112(a)(3).

3. Proposed FINRA Rule 1160(c) through (e): Interim Restrictions, Additional Information Requests and Not Substantially Complete Determination

Proposed FINRA Rules 1160(c) through (e) transfer with limited changes NASD Rules 1017(c) through (e). Proposed FINRA Rule 1160(c) details when a member may effect a change in ownership or control prior to a CMA’s approval or request the removal or modification of a membership agreement restriction. Proposed FINRA Rule 1160(d) generally provides that the Department may serve a request for additional information or documents within 30 days after the filing of a complete CMA. Proposed FINRA Rule 1160(e) details when the Department shall determine that a CMA is not substantially complete.

4. Proposed FINRA Rule 1160(f) (Continuing Membership Application Interview)

Proposed FINRA Rule 1160(f) carries over NASD Rule 1017(f) (Membership Interview), which permits the Department to require a continuing membership applicant to participate in an interview before the Department serves its decision on a CMA and includes language clarifying that the Department may conduct more than one CMA interview. This change clarifies the Department's authority to require participation in additional interviews, based on the facts and circumstances of each application. In addition, the proposed rule carries over with limited changes NASD Rule 1017(f)'s requirements that: (1) the Department serve an applicant with written notice specifying the date and time and required persons at least seven days before the CMA interview; (2) the membership interview be conducted in the FINRA district office where the applicant has or intends to have its principal place of business, unless otherwise agreed; (3) the Department review the CMA and proposed FINRA Rule 1130's standards with the applicant's representatives during the interview; and (4) the Department provide the applicant at the interview (or promptly serve on the applicant if received after the interview) with any information or documents obtained from sources other than the applicant on which the Department intends to base its decision.

5. Proposed FINRA Rule 1160(g) (Department Decision)

Proposed FINRA Rule 1160(g) transfers NASD Rule 1017(g) (Department Decision), which are the procedural provisions applicable to the Department's decision to grant or deny a CMA. The provisions include requirements that the Department must consider to determine whether the applicant and its associated persons meet the standards in proposed FINRA Rule 1130 and issue a written decision stating whether the CMA is granted or denied in whole or in part. Proposed FINRA Rule 1160 also includes language clarifying that the written decision shall include whether the CMA is subject to one or more restrictions reasonably designed to address a specific concern based on proposed FINRA Rule 1130's standards.

In addition, proposed FINRA Rule 1160(g) transfers NASD Rule 1017(g)'s requirement that the Department issue a decision within 30 days after the conclusion of the CMA interview (or last such interview, if more than one is required) or the applicant's final filing of additional information or documents, whichever is later. In *Regulatory Notice 10-01*, the proposed rule extended this time frame from 30 days to 45 days. However, in response to commenters' objections to the extension, FINRA has retained the existing 30-day period for the Department to issue a written decision.

The proposal transfers NASD Rule 1017(g)'s requirement that, if the Department fails to serve a decision on a CMA within the specified time period and the applicant files a written request with the FINRA Board for a decision, the FINRA Board may extend the time for issuing a decision by not more than 30 days if the Department shows good cause for the extension. Proposed FINRA Rule 1160 clarifies that the 30-day period begins from the date of the FINRA Board's good cause determination.

Proposed FINRA Rule 1160(g) transfers NASD Rule 1017(g)'s requirement that the Department may require an applicant to file an executed membership agreement if it approves a CMA and includes a new provision requiring those CMA applicants without an existing membership agreement that will continue to operate (*i.e.*, not file a Form BDW in connection with the application) to execute a membership agreement at the conclusion of the CMA review. FINRA has required all new members to enter into a membership agreement since August 1997. Prior to such time, members signed "restriction letters," when required. The proposed rule revision would eliminate the disparity in treatment of members based solely on the date on which they became a member. The required membership agreement for each member would be crafted to reflect all business activities conducted by the member, including those activities the member has previously engaged in and for which it has an adequate supervisory and operational structure. Implementing the requirement would result in a more clearly documented understanding between FINRA and its members regarding the scope of each member's business.

6. Proposed FINRA Rules 1160(h) (Service and Effectiveness of Decision) and (i) (Effectiveness of Restriction)

Proposed FINRA Rule 1160(h) transfers with only minor changes NASD Rule 1017(h), the provision detailing the manner in which the Department shall serve its decision on a CMA and the effectiveness of that decision pending any FINRA final action, unless otherwise directed by the NAC, the FINRA Board or the SEC. Proposed FINRA Rule 1160(i) is a new provision, previously proposed in *Regulatory Notice 10-01*, clarifying that a restriction on a CMA decision shall remain in effect and binds the applicant and all ownership or control successors unless removed or modified by a FINRA final action or stayed by the NAC, the FINRA Board or the SEC.

7. Proposed FINRA Rules 1160(j) (Request for Review; Final Action) and (k) (Removal or Modification of Restriction on Department's Initiative)

Proposed FINRA Rules 1160(j) and (k) transfer with no substantive changes the provisions in NASD Rules 1017(i) and (j) regarding an applicant's right to file a written request for review of the Department's CMA decision with the NAC and the Department's right to modify or remove a membership agreement restriction on its own initiative if the Department determines such action is appropriate.

8. Proposed FINRA Rule 1160(l) (Denial of Application for Approval of Change in Ownership, Control, or Business Operations)

Proposed FINRA Rule 1160(l) transfers with substantive changes NASD Rule 1017(k) (Lapse or Denial of Application for Approval of Change in Ownership), the provision requiring that if a CMA for a change in ownership lapses or is denied and all appeals are exhausted or waived, an applicant must, not more than 60 days after the lapse or exhaustion or waiver of appeal: (1) submit a new CMA and fee pursuant to Schedule A to the FINRA

By-Laws; (2) unwind the transaction; or (3) file a Form BDW. As revised, proposed FINRA Rule 1160(l) applies to a CMA for any change in ownership, control or business operations that is denied, rather than applying to a CMA for a change in ownership that is lapsed or denied. Furthermore, proposed FINRA Rule 1160(l) eliminates the option of submitting a new CMA and requisite fee and adds a provision requiring an applicant with a denied CMA to cease any activities that required the CMA while retaining the other existing options of unwinding the transaction or filing a Form BDW. Thus, proposed FINRA Rule 1160 would provide applicants of a denied CMA with 60 days after the exhaustion or waiver of appeal, to cease the activities requiring the CMA, unwind the transaction or file a Form BDW. In addition, proposed FINRA Rule 1160 retains the provision permitting the Department, for good cause shown by the applicant, to lengthen the 60-day period or to shorten the 60-day period for the protection of investors.

FINRA believes the revisions outlined above are critically important as it has encountered several instances where applicants have effected a change in ownership or control prior to the conclusion of a CMA proceeding but the staff later determines to deny the CMA. Such applicants have asserted that, under the current rules, they could submit a new CMA, and extend the time, without first having to cease their interim activities or unwind the transaction that prompted the original CMA.

9. Proposed FINRA Rule 1160.01 (Safe Harbor from Application in Limited Circumstances)

As noted above, proposed FINRA Rule 1160.01 adopts the contents of NASD IM-1011-1 (Safe Harbor for Business Expansion) as supplementary material to proposed FINRA Rule 1160. The safe harbor provides parameters for increases a member may make in the number of its sales personnel, office locations (registered and unregistered) or markets made within a one-year period that are presumed not to be considered a material change in business and thus do not require the filing of a CMA.

As proposed in *Regulatory Notice 10-01*, the safe harbor was not available to a member that has a membership agreement containing a specific restriction or to any member that has a disciplinary history (as defined in the safe harbor). Several commenters disagreed with the proposed exclusion from the safe harbor for any member with any kind of membership agreement restriction. In response, FINRA has revised the supplementary material to permit a member to rely upon the safe harbor for those types of business expansions from which it is not restricted. This proposed change modifies existing practice which has prohibited any expansion in the safe harbor areas if any one type of expansion was restricted.

G. Proposed FINRA Rule 1170 (Notice of Certain Member Changes)

Proposed FINRA Rule 1170 requires each member to provide the Department with timely prior written notice of any:

- ▶ direct or indirect acquisition (including purchases or transfers) or divestitures (including sales or transfers) of 10 percent or more in the aggregate of the member's assets (including, but not limited to, cash, securities, notes, real estate ownership interests, inventories and accounts receivable) or any asset, business or line of operation (including customer accounts) that generates revenues composing 10 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis; or
- ▶ change, directly or indirectly, in the equity ownership, partnership capital, LLC membership interest or other ownership interest in the member that results in one person directly or indirectly owning, controlling or holding a presently exercisable option to own or control, 10 percent or more of the equity, partnership capital, LLC membership interest or other ownership interest in the member.

For purposes of the proposed rule, "timely" means at least 30 days prior to the event except when 30 days is impracticable given the circumstances of the event, in which case the member must provide prior written notice as soon as practicable.

In *Regulatory Notice 10-01*, proposed FINRA Rule 1170 also required timely prior written notice of eight additional notification events (*e.g.*, a change or loss of a member's key personnel, a change in a member's service bureau, clearance activities or methods of bookkeeping).¹⁰ However, in response to commenters' concerns, including that certain event notification requirements would be duplicative of existing regulatory obligations (*e.g.*, CMA filing requirements or other SEC or FINRA reporting requirements), too vague to implement without further clarification or overly burdensome, proposed FINRA Rule 1170 retains only the two event notifications detailed above, but is revised to more closely track the provisions in proposed FINRA Rule 1160 on which they are based.¹¹ Proposed FINRA Rule 1170 also provided that, upon receiving notice of certain of the deleted notification events, the Department could determine that such event would substantively affect the member's business or resources and require the member to submit a CMA. Commenters requested further clarification of this provision. FINRA, however, has deleted this provision as unnecessary given the deletion of the corresponding events.

Although commenters questioned the rationale for the advance notification requirements, FINRA believes that knowledge of transactions or patterns of transactions (whether or not coordinated) in a member's assets or ownership interests that occur below the 25 percent threshold for requiring a CMA is useful in maintaining effective oversight of member firms in order to identify potential regulatory issues. Such issues may include a pattern of ownership interest changes in a member that could indicate potential violative conduct warranting additional oversight, as would similarly-sized transactions where the member is removing assets from the firm. The proposed rule, however, would not require advance notification for acquisitions or divestitures where the member exchanges one type of asset for another in the ordinary conduct of its business (*e.g.*, turnover of proprietary inventory).

In addition, as proposed in *Regulatory Notice 10-01*, FINRA Rule 1170 would have required a member to provide, upon request, any information concerning its affiliates that an applicant or member would otherwise be required to provide under FINRA's membership rules. In response to commenters' concerns, FINRA has determined to delete this provision.

H. Proposed FINRA Rule 1180 (Application to the SEC for Review)

Proposed FINRA Rule 1180 transfers without significant changes NASD Rule 1019 (Application to Commission for Review), providing that: (1) a person aggrieved by any final FINRA action pursuant to proposed FINRA Rules 1140 or 1150 may apply for review to the SEC pursuant to Exchange Act Section 19(d)(2); and (2) the filing of an application for review shall not stay the effectiveness of a decision constituting a final action of FINRA unless the SEC orders otherwise.

I. Proposed FINRA Rule 1190 (Foreign Members)

Proposed FINRA Rule 1190 adopts paragraphs (a), (b) and (c) of NASD Rule 1090 (Foreign Members), without substantive change. These provisions impose specific requirements on members that do not maintain an office in the United States that is responsible for preparing and maintaining financial and other reports required to be filed by the SEC and FINRA. Proposed FINRA Rules 1190(a) through (c) require such members to: (1) prepare reports, and maintain a general ledger chart of accounts and any description thereof, in English and U.S. dollars; (2) reimburse FINRA for any expenses incurred in connection with examinations to the extent such expenses exceed the cost of examining a member located within the continental U.S. in the geographic location most distant from the district office of appropriate jurisdiction; and (3) ensure the availability of an individual fluent in English and knowledgeable in securities and financial matters to assist FINRA representatives during examinations.

The proposal deletes NASD Rule 1090(d), which requires foreign members to "utilize, either directly or indirectly, the services of a broker/dealer registered with the Commission, a bank or a clearing agency registered with the Commission located in the United States in clearing all transactions involving members of the Association, except where both parties to a transaction agree otherwise." The provision has become outdated and such arrangements are better addressed by FINRA Rule 4311 (Carrying Agreements).

J. Proposed Eliminated Requirements

Finally, the proposal deletes Incorporated NYSE Rule 311 and Incorporated NYSE Rule Interpretations 311(f) and (g), Incorporated NYSE Rules 312, 313, 321, 416 and related supplementary materials and rule interpretations and Incorporated NYSE Rule Interpretation 401/03 as either redundant or obsolete.

Request for Comment

In addition to generally requesting comments, FINRA specifically requests comments regarding:

1. whether the definitions of “Affiliate” and “control” in proposed FINRA Rule 1111(a) and (d), respectively, will increase or otherwise effect an applicant’s costs;
2. whether the de minimis exception in proposed FINRA Rule 1111(c)’s definition of “Associated Person” will result in cost savings for an applicant or present any specific regulatory or marketplace risks that could outweigh any expected cost benefits;
3. any potential costs associated with proposed FINRA Rule 1111(n)’s definition of “sales practice event,” which expands the term to include misconduct not currently included in NASD Rule 1011(n)’s definition of that term;
4. any potential increased costs associated with proposed FINRA Rule 1130’s new application evaluation standard requiring an applicant to fully disclose and establish through documentation all direct and indirect sources of its funding and providing that FINRA shall determine that such sources are otherwise consistent with the standards set forth in proposed FINRA Rule 1130;
5. any unanticipated costs that applicants may incur due to proposed FINRA Rule 1160’s codification of FINRA’s interpretation of NASD Rule 1017 that a CMA is required for any change, directly or indirectly, of control persons of the member (other than the appointment or election of a natural person as an officer or director of the member in the normal course of business);
6. any cost impacts applicants may expect due to proposed FINRA Rule 1160’s CMA waiver provisions;
7. any potential costs or burdens applicants may incur due to proposed FINRA Rule 1160’s new provision requiring those CMA applicants without an existing membership agreement that will continue to operate (*i.e.*, not file a Form BDW in connection with the application) to execute a membership agreement at the conclusion of the CMA review;
8. any potential costs or burdens applicants may incur due to proposed FINRA Rule 1160’s new provisions clarifying that a member firm that has submitted a CMA for approval of a change in ownership or control at least 30 days prior to making such change must unwind the ownership or control change if FINRA subsequently denies the CMA;
9. any additional infrastructure requirements or increased costs members may incur to comply with proposed FINRA Rule 1170’s notification requirements; and
10. any additional or increased costs or burdens applicants or members may incur due to the proposal’s requirements.

We request quantified comments where possible.

Endnotes

1. 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.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. See Form BD (Explanation of Terms) (defining “control affiliate” to mean a “person named in Items 1/A, 9 or in Schedules A, B, or C as a control person or any other individual or organization that directly or indirectly controls, is under common control with, or is controlled by, the applicant, including any current employee, except one performing only clerical, administrative, support or similar functions, or who, regardless of title, performs no executive duties or has no senior policy making authority”).
4. This definition of “Associated Person” only applies to FINRA’s membership rules. For other FINRA rules, the FINRA By-Laws definition of who is an “associated person of a member” applies. See FINRA By-Laws Art. I(rr) (defining “person associated with a member” or “associated person of a member”); see also [Notice to Members 98-38](#) n.5 (May 1998) (citing the same By-Laws definition to clarify the term “associated person”).
5. As proposed in *Regulatory Notice 10-01*, FINRA Rule 1111 defined the term “control” for purposes of the membership rules as “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. A person is presumed to control another person if such 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 person occupying a similar status or performing similar functions) of the other person. Any person that does not meet the provisions of subparagraph (1), (2) or (3) shall be presumed not to control such other person. Any presumption under this definition may be rebutted by evidence, but shall continue until a determination to the contrary has been made by FINRA.”
6. See Incorporated NYSE Rule Interpretation 311(g)/02 (Divisions of Member Organizations — Names) (requiring, among other things, that divisions that are not separate legal entities not be identified by the use of such words as “Company,” “Corporation” or “Incorporation,” which connote separate entities). As noted later, this is one of the provisions FINRA is proposing to delete as either redundant or obsolete.

7. Proposed FINRA Rule 1121 originally required a detailed summary of any business relationship between an applicant and an affiliate:
 - whose financial information is consolidated with that of the applicant;
 - 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 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 or services as part of any operation or function of the applicant required to be supervised by the applicant pursuant to FINRA rules.
8. Eliminating NASD Rule 1017(a)'s exceptions from the criteria requiring a CMA for mergers where both parties are NYSE members and for acquisitions where the acquiring member is an NYSE member does not create a wholly new obligation for FINRA- members that are also NYSE members, as NYSE members have historically been required to submit information and documentation of such changes pursuant to Incorporated NYSE Rules 311 through 313 and 401, the interpretations to those rules and associated regulatory processes.
9. See *Regulatory Notice 09-42* (July 2009) (FINRA Reminds Firms of Their Obligations With Variable Life Settlement Activities) ("before engaging in variable life settlements, a firm must first file a [CMA] and receive approval of this change in business operations under NASD Rule 1017"); *Regulatory Notice 08-66* (November 2008) (FINRA Addresses Firms' Retail Foreign Currency Exchange Activities) ("before engaging in over-the-counter forex business, a firm must first file for and receive approval of change in business operations under NASD Rule 1017").
10. Proposed FINRA Rule 1170 also required timely prior written notice of any:
 - addition, removal or substantial modification of a business relationship between the member and an affiliate requiring disclosure pursuant to proposed FINRA Rule 1121;
 - change or loss of a member's key personnel (*e.g.*, CEO, CFO, etc.);
 - change in a member's service bureau, clearance activities or methods of bookkeeping or recordkeeping;
 - expansion of business requiring the infusion of capital that is 25 percent or more of the member's net capital as calculated from the ending date of the member's previous FOCUS filing period, or requiring additional licenses, registrations, memberships or approvals as required by an SRO or another regulatory agency;
 - expansion of business by adding products or services that are new in terms of the type of investments, transactions or risks from those business products or services offered by the member since the time of the last approval of a membership application;

- increase in the number of sales personnel, office locations or markets made beyond the scope of the safe harbor provisions of proposed FINRA Rule 1160.01;
 - listing of the member (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
 - discovery of any existing or impending condition(s) that the member reasonably believes could lead to capital, liquidity or operational problems or impairment of recordkeeping, clearance or control functions.
11. FINRA will consider whether to address the notification of the deleted events in a separate rulemaking effort involving Incorporated NYSE Rule Interpretation 401/04 (Early Reporting of Developing Problems).

Arbitration Panel Composition

SEC Approves Amendments to Customer Arbitration Code to Simplify Panel Selection in Cases With Three Arbitrators

Effective Date: September 30, 2013

Executive Summary

The SEC approved amendments to FINRA Rule 12403 of the Code of Arbitration Procedure for Customer Disputes (Customer Code) to simplify the arbitration panel selection process in cases with three arbitrators.¹ Under the amended rule, parties in all customer cases use the same panel composition method. Under this method, FINRA will provide the parties with lists of 10 chair-qualified public arbitrators, 10 public arbitrators and 10 non-public arbitrators. The parties may strike four arbitrators on the chair-qualified public list and four arbitrators on the public list. Any party may select an all-public arbitration panel by striking all of the arbitrators on the non-public list. If a party wants a non-public arbitrator on the panel, the party can limit its strikes on the non-public list. Limiting strikes does not guarantee that FINRA will appoint a non-public arbitrator to the panel in every instance as explained below.

The amendments are effective on September 30, 2013, for all customer cases filed on or after the effective date. The amendments are also effective for pending cases in which the 35-day time period for electing a panel composition method has not expired as follows: If a customer does not elect a panel composition method within the 35-day time period, panel composition will proceed under the amended rule, not under the default provision in the current rule.

The text of the amendments is set forth in Attachment A.

September 2013

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives

Key Topics

- ▶ Arbitration
- ▶ Customer Code of Arbitration Procedure
- ▶ Panel Composition

Referenced Rules & Notices

- ▶ Regulatory Notice 11-05
- ▶ FINRA Rule 12401
- ▶ FINRA Rule 12403

Questions concerning this *Notice* should be directed to:

- ▶ Richard W. Berry, Senior Vice President and Director of Case Administration, Operations and Regional Office Services, Dispute Resolution, at (212) 858-4307 or richard.berry@finra.org; or
- ▶ Margo A. Hassan, Assistant Chief Counsel, Dispute Resolution, at (212) 858-4481 or margo.hassan@finra.org.

Background & Discussion

Parties in arbitration participate in selecting the arbitrators who serve on their cases. Since February 1, 2011, FINRA has provided customers in cases with three arbitrators² with a choice between two panel-composition methods.³ The first method—the Majority-Public Panel Option—provides for a mixed panel of one chair-qualified public arbitrator, one public arbitrator and one non-public arbitrator. The Majority-Public Panel Option is the panel-selection method FINRA used in the forum prior to February 1, 2011. The second method—the All-Public Panel Option—was added February 1, 2011, and permits any party to select an arbitration panel consisting of three public arbitrators. FINRA Rule 12403 provides that a customer (not a firm or associated person) may choose a panel-composition method in the statement of claim (or accompanying documentation) or at any time up to 35 days from service of the statement of claim. In the absence of an affirmative choice by the customer for the All-Public Panel Option, the Majority-Public Panel Option is the default composition method.

FINRA staff reviewed the panel-composition elections customers made after implementation of the All-Public Panel Option. In the two years since implementation, customers in approximately three-quarters of eligible cases chose the All-Public Panel Option. Customers using the Majority-Public Panel Option did so by default 77 percent of the time, rather than by making an affirmative choice (*i.e.*, these customers did not make an election in their statement of claim or accompanying documentation, and did not respond to a request that they elect a panel-composition method). After reviewing these data, FINRA became concerned that customers without attorneys, and attorneys new to the practice of securities arbitration, might be using the Majority-Public Panel Option because they were not familiar with the Customer Code or because they did not appreciate the significance of making an election. FINRA also reviewed the awards issued by mixed panels and all-public panels. The awards issued during the first two years since implementation show that customers were awarded damages significantly more often when an all-public panel decided their case.

As a result of reviewing the election and award data, FINRA amended Rule 12403 to simplify the panel-selection process. Under the amended rule, FINRA no longer requires a customer to elect a panel-composition method. Parties in all customer cases with three arbitrators will get the same composition method. FINRA will provide the parties with lists of 10 chair-qualified public arbitrators, 10 public arbitrators and 10 non-public arbitrators. FINRA will permit each party to strike up to four arbitrators on the chair-qualified public list, up to four arbitrators on the public list, and any or all of the arbitrators on the non-public list. Any party may select an all-public arbitration panel by striking all of the arbitrators on the non-public list. If the parties collectively strike all of the non-public arbitrators on the list, or if no selected non-public arbitrators are available to serve, FINRA will not appoint a non-public arbitrator to the panel. If a party wants a non-public arbitrator on the panel, the party can limit its strikes on the non-public list, leaving any or all of the 10 non-public arbitrators on the list. However, leaving non-public arbitrators on the list does not guarantee that FINRA will appoint one to the panel. The parties may strike different non-public arbitrators from the list, and collectively they may strike all of the non-public arbitrators on the list. In addition, the selected non-public arbitrators may not be available to serve. Under these circumstances, FINRA will appoint an all-public panel unless the parties agree to request a supplemental list of non-public arbitrators.

FINRA believes that forum users will benefit by having one panel-composition method for a number of reasons. First, having one panel-composition method simplifies the arbitrator-selection process for all parties and for FINRA staff, while leaving in place the method affirmatively chosen by customers in approximately three-quarters of customer cases. Second, it ensures that every party has an opportunity to see the list of non-public arbitrators and rank or strike any or all of the arbitrators on the list. Third, the proposal ensures that customers will not miss the opportunity to select an all-public panel if that would have been their preference.

Cross References

To implement the rule amendments, FINRA corrected several cross references.

Effective Date

The amendments are effective on September 30, 2013, for all customer cases filed on or after the effective date. The amendments are also effective for pending cases in which the 35-day time period for electing a panel-composition method has not expired as follows: If a customer does not elect a panel-composition method within the 35-day time period, panel composition will proceed under the amended rule, not under the default provision in the current rule.

Endnotes

1. See Securities Exchange Act Rel. No. 70442 (September 18, 2013) (File No. SR-FINRA-2013-023).
2. FINRA Rule 12401 provides that if the amount of a claim is more than \$100,000, exclusive of interest and expenses, or is unspecified, or if the claim does not request money damages, the panel will consist of three arbitrators, unless the parties agree in writing to one arbitrator.
3. See [Regulatory Notice 11-05](#) (February 2011).

Attachment A

New language is underlined; Deletions are in brackets.

Rule 12403. Cases with Three Arbitrators

[(a)] Composition of Panels

[The customer may elect to proceed with panel composition under either of the following options:

(1) Composition Rules for Majority Public Panel

Rule 12403(c) provides for limited strikes on each of the three lists. In each majority public panel case, the panel will consist of two public arbitrators and one non-public arbitrator.

(2) Composition Rules for Optional All Public Panel

Rule 12403(d) provides for limited strikes on the public and public chairperson lists and unlimited strikes on the non-public list. In optional all public panel cases, the panel may consist of three public arbitrators or two public arbitrators and one non-public arbitrator. Under this option, either party can ensure that the panel will have three public arbitrators by striking all of the arbitrators on the non-public list.

(b) Customer Election

(1) The customer may elect in writing to proceed under either the composition rules for majority public panel or the composition rules for optional all public panel in the customer's Statement of Claim, if the customer is a claimant, or at any time up to 35 days from service of the Statement of Claim.

(2) When FINRA serves the Statement of Claim, FINRA will notify the customer in writing that the customer may elect the composition rules for the optional all public panel within 35 days from service of the Statement of Claim.

(3) If the customer declines to make an affirmative election in writing by the 35-day deadline, the composition rules for majority public panel will apply.

(c) Composition Rules for Majority Public Panel**(1) Generating Lists**

(A) The Neutral List Selection System will generate:

- A list of 10 arbitrators from the FINRA non-public arbitrator roster;
- A list of 10 arbitrators from the FINRA public arbitrator roster; and
- A list of 10 public arbitrators from the FINRA chairperson roster.

(B) The Neutral List Selection System will generate the chairperson list first. Chair-qualified arbitrators who were not selected for the chairperson list will be eligible for selection on the public list. An individual arbitrator cannot appear on both the chairperson list and the public list for the same case.

(C) The Neutral List Selection System will exclude arbitrators from the lists based upon current conflicts of interest identified within the Neutral List Selection System.

(2) Sending Lists to Parties

(A) The Director will send the lists generated by the Neutral List Selection System to all parties at the same time, within approximately 30 days after the last answer is due. The parties will also receive employment history for the past 10 years and other background information for each arbitrator listed.

(B) If a party requests additional information about an arbitrator, the Director will request the additional information from the arbitrator, and will send any response to all of the parties at the same time. When a party requests additional information, the Director may, but is not required to, toll the time for parties to return the ranked lists under Rule 12403(c)(3)(C).

(3) Striking and Ranking Arbitrators

(A) Each separately represented party may strike up to four of the arbitrators from each list for any reason by crossing through the names of the arbitrators. At least six names must remain on each list.

(B) Each separately represented party shall rank all remaining arbitrators on the lists in order of preference, with a "1" indicating the party's first choice, a "2" indicating the party's second choice, and so on. Each list of arbitrators must be ranked separately.

(C) The ranked lists must be returned to the Director no more than 20 days after the date upon which the Director sent the lists to the parties. If the Director does not receive a party's ranked lists within that time, the Director will proceed as though the party did not want to strike any arbitrator or have any preferences among the listed arbitrators.

(D) Parties are not required to send a copy of their ranking list to the opposing parties.

(4) Combining Lists

For each arbitrator classification (public, non-public, and chairperson), the Director will prepare combined ranked lists of arbitrators based on the parties' numerical rankings, as follows:

- The Director will add the rankings of all claimants together, and the rankings of all respondents together, to produce separate combined ranked lists for the claimants and the respondents.
- The Director will then add the combined rankings of claimants and the respondents together, to produce a single combined ranking number for each arbitrator, excluding all arbitrators stricken by a party.
- The Director will create separate combined ranked lists for each arbitrator classification.

(5) Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List

(A) The Director will appoint:

- The highest-ranked available non-public arbitrator from the combined non-public arbitrator list;
- The highest-ranked available public arbitrator from the combined public arbitrator list, and
- The highest-ranked available public arbitrator from the combined chairperson list, who will serve as chairperson of the panel.

(B) If the number of arbitrators available to serve from the combined lists is not sufficient to fill an initial panel, the Director will appoint one or more arbitrators of the required classification to complete the panel from names generated randomly by the Neutral List Selection System. If the Director must appoint a non-public arbitrator, the Director may not appoint a non-public arbitrator as defined in Rule 12100(p)(2) or (3), unless the parties agree otherwise. The Director will provide the parties information about the arbitrators as provided in Rule 12403(c)(2) and the parties will have the right to challenge the arbitrators as provided in Rule 12407.

(C) Appointment of arbitrators occurs when the Director sends notice to the parties of the names of the arbitrators on the panel. Before making any decision as an arbitrator or attending a hearing session, the arbitrators must execute FINRA's arbitrator oath or affirmation.

(6) Replacement of Arbitrators

(A) If an arbitrator is removed, or becomes otherwise unable or unwilling to serve, the Director will appoint a replacement arbitrator in accordance with this rule, unless the parties agree in writing to proceed with only the remaining arbitrators.

(B) The Director will appoint as a replacement arbitrator the arbitrator who is the most highly ranked available arbitrator of the required classification remaining on the combined list.

(C) If there are no available arbitrators of the required classification on the consolidated list, the Director will appoint an arbitrator of the required classification to complete the panel from names generated by the Neutral List Selection System. The Director will provide the parties information about the arbitrator as provided in Rule 12403(c)(2) and the parties shall have the right to object to the arbitrator as provided in Rule 12407.

(D) If the Director must appoint a non-public arbitrator under Rule 12403(c)(6)(C), the Director may not appoint a non-public arbitrator as defined in Rule 12100(p)(2) or (3), unless the parties agree otherwise.

(d) Composition Rules for Optional All Public Panel]

[(1)] (a) Generating Lists

[(A)] (1) The Neutral List Selection System will generate:

- [(A)] A list of 10 arbitrators from the FINRA non-public arbitrator roster;
- [(B)] A list of 10 arbitrators from the FINRA public arbitrator roster; and
- [(C)] A list of 10 public arbitrators from the FINRA chairperson roster.

[(B)] (2) The Neutral List Selection System will generate the chairperson list first. Chair-qualified arbitrators who were not selected for the chairperson list will be eligible for selection on the public list. An individual arbitrator cannot appear on both the chairperson list and the public list for the same case.

[(C)] (3) The Neutral List Selection System will exclude arbitrators from the lists based upon current conflicts of interest identified within the Neutral List Selection System.

[(2)] (b) Sending Lists to Parties

[(A)] (1) The Director will send the lists generated by the Neutral List Selection System to all parties at the same time, within approximately 30 days after the last answer is due. The parties will also receive employment history for the past 10 years and other background information for each arbitrator listed.

[(B)] (2) If a party requests additional information about an arbitrator, the Director will request the additional information from the arbitrator, and will send any response to all of the parties at the same time. When a party requests additional information, the Director may, but is not required to, toll the time for parties to return the ranked lists under Rule [12403(d)(3)(C)] 12403(c)(3).

[(3)] (c) Striking and Ranking Arbitrators

[(A)] (1) Non-Public Arbitrator List

[i.] (A) Each separately represented party may strike any or all of the arbitrators from the non-public arbitrator list by crossing through the names of the arbitrators.

[ii.] (B) If any names remain on the non-public arbitrator list, each separately represented party shall rank all remaining arbitrators in order of preference, with a “1” indicating the party’s first choice, a “2” indicating the party’s second choice, and so on.

[(B)] (2) Chairperson and Public Lists

[i.] (A) Each separately represented party may strike up to four of the arbitrators from the chairperson list and up to four of the arbitrators from the public arbitrator list[s] for any reason by crossing through the names of the arbitrators. At least six names must remain on each list.

[ii.] (B) Each separately represented party shall rank all remaining arbitrators on the lists in order of preference, with a “1” indicating the party’s first choice, a “2” indicating the party’s second choice, and so on. Each list of arbitrators must be ranked separately.

[(C)] (3) The ranked lists must be returned to the Director no more than 20 days after the date upon which the Director sent the lists to the parties. If the Director does not receive a party’s ranked lists within that time, the Director will proceed as though the party did not want to strike any arbitrator or have any preferences among the listed arbitrators. A party’s failure to comply with the 20-day timeframe may result in the appointment of a panel consisting of two public arbitrators and one non-public arbitrator.

[(D)] (4) Parties are not required to send a copy of their ranking list to the opposing parties.

[(4)] (d) **Combining Lists**

For each arbitrator classification (public, non-public, and chairperson), the Director will prepare combined ranked lists of arbitrators based on the parties’ numerical rankings, as follows:

[•] (1) The Director will add the rankings of all claimants together, and the rankings of all respondents together, to produce separate combined ranked lists for the claimants and the respondents.

[•] (2) The Director will then add the combined rankings of claimants and the respondents together, to produce a single combined ranking number for each arbitrator, excluding all arbitrators stricken by a party.

[•] (3) The Director will create separate combined ranked lists for each arbitrator classification in cases with both public and non-public arbitrators.

[(5)] (e) Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on the List

[(A)] (1) The Director will appoint:

[•] (A) The highest-ranked available non-public arbitrator from the combined non-public arbitrator list;

[•] (B) The highest-ranked available public arbitrator from the combined public arbitrator list, and

[•] (C) The highest-ranked available public arbitrator from the combined chairperson list, who will serve as chairperson of the panel.

[(B)] (2) If the number of arbitrators available to serve from the combined public or chairperson lists is not sufficient to fill an initial panel, the Director will appoint one or more arbitrators of the required classification to complete the panel from names generated randomly by the Neutral List Selection System. The Director will provide the parties information about the arbitrators as provided in Rule [12403(d)(2)] 12403(b) and the parties will have the right to challenge the arbitrators as provided in Rule 12407.

[(C)] (3) In cases in which the parties collectively strike all of the arbitrators appearing on the non-public list or when all remaining arbitrators on the non-public list are unable or unwilling to serve for any reason:

[i.] (A) The Director will return to the public list and select the next highest ranked available arbitrator (after the public arbitrator position has been filled) to complete the three member panel.

[ii.] (B) In the event no ranked arbitrators remain on the public list or when all remaining arbitrators on the public list are unable or unwilling to serve for any reason, FINRA will select the next highest ranked arbitrator appearing on the chair-qualified list (after the chair position has been filled) to complete the three member panel.

[iii.] (C) If the number of arbitrators available to serve from the chair-qualified list and public list is not sufficient to fill an initial panel, the Director will appoint a public arbitrator to complete the panel from names generated randomly by the Neutral List Selection System. The Director will provide the parties information about the arbitrator as provided in Rule [12403(d)(2)] 12403(b) and the parties will have the right to challenge the arbitrator as provided in Rule 12407.

[(D)] (4) Appointment of arbitrators occurs when the Director sends notice to the parties of the names of the arbitrators on the panel. Before making any decision as an arbitrator or attending a hearing session, the arbitrators must execute FINRA's arbitrator oath or affirmation.

[(6)] (f) Replacement of Public Arbitrators

[(A)] (1) If a public arbitrator is removed, or becomes otherwise unable or unwilling to serve, the Director will appoint a replacement arbitrator in accordance with this rule, unless the parties agree in writing to proceed with only the remaining arbitrators.

[(B)] (2) The Director will appoint as a replacement arbitrator the public arbitrator who is the most highly ranked available public arbitrator remaining on the combined public list.

[(C)] (3) If the next highest ranked available public arbitrator from the combined list is unable or unwilling to serve for any reason, the Director will return to the initial public list and appoint the next highest ranked available arbitrator to complete the three member panel.

[(D)] (4) If all remaining arbitrators on the public list are unable or unwilling to serve for any reason, the Director will appoint a public arbitrator to complete the panel from names generated randomly by the Neutral List Selection System.

[(E)] (5) The Director will provide the parties information about the arbitrator as provided in Rule [12403(d)(2)] 12403(b) and the parties shall have the right to object to the arbitrator as provided in Rule 12407.

[(7)] (g) Replacement of a Chairperson

[(A)] (1) If a chairperson is removed, or becomes otherwise unable or unwilling to serve, the Director will appoint a replacement arbitrator in accordance with this rule, unless the parties agree in writing to proceed with only the remaining arbitrators.

[(B)] (2) The Director will appoint as a replacement arbitrator the chair-qualified arbitrator who is the most highly ranked available arbitrator remaining on the combined chair-qualified list.

[(C)] (3) If the next highest ranked available chair-qualified arbitrator from the combined list is unable or unwilling to serve for any reason, the Director will return to the initial chair-qualified list and appoint the next highest ranked available arbitrator to complete the three member panel.

[(D)] (4) If all remaining arbitrators on the chair-qualified list are unable or unwilling to serve for any reason, the Director will appoint a chair-qualified public arbitrator to complete the panel from names generated randomly by the Neutral List Selection System.

[(E)] (5) The Director will provide the parties information about the arbitrator as provided in Rule [12403(d)(2)] 12403(b) and the parties shall have the right to object to the arbitrator as provided in Rule 12407.

[(8)] (h) Replacement of Non-Public Arbitrators

[(A)] (1) If a non-public arbitrator is removed, or becomes otherwise unable or unwilling to serve, the Director will appoint a replacement arbitrator in accordance with this rule, unless the parties agree in writing to proceed with only the remaining arbitrators.

[(B)] (2) In cases in which the parties collectively do not strike all of the non-public arbitrators from the initial list, the Director will appoint as a replacement arbitrator the non-public arbitrator who is the most highly ranked available non-public arbitrator remaining on the combined non-public list.

[(C)] (3) If the next highest ranked available non-public arbitrator is unable or unwilling to serve for any reason, the Director will return to the initial non-public list and appoint the next highest ranked available arbitrator to complete the three member panel.

[(D)] (4) In the event no ranked arbitrators remain on the non-public list or when all remaining arbitrators on the non-public list are unable or unwilling to serve for any reason, the Director will return to the public list and select the next highest ranked available arbitrator to complete the three member panel.

[i.] (A) In the event no ranked arbitrators remain on the public list or when all remaining arbitrators on the public list are unable or unwilling to serve for any reason, FINRA will select the next highest ranked arbitrator appearing on the chair-qualified list to complete the three member panel.

[ii.] (B) In the event no ranked arbitrators remain on the chair-qualified list or when all remaining arbitrators on the chair-qualified list are unable or unwilling to serve for any reason, the Director will appoint a public arbitrator to complete the panel from names generated randomly by the Neutral List Selection System.

[(E)] (5) The Director will provide the parties information about the arbitrator as provided in Rule [12403(d)(2)] 12403(b) and the parties shall have the right to object to the arbitrator as provided in Rule 12407.

12213. Hearing Locations

(a) U.S. Hearing Location

(1) No change.

(2) Before arbitrator lists are sent to the parties under Rule 12402(c)[, Rule 12403(c) or Rule 12403(d)] or Rule 12403(b), the parties may agree in writing to a hearing location other than the one selected by the Director.

(3) - (4) No change.

(b) Foreign Hearing Location – No change.

12309. Amending Pleadings

(a) – (b) No change.

(c) Amendments to Add Parties

Once the ranked arbitrator lists are due to the Director under Rule 12402(d)[,] or Rule 12403(c) [or Rule 12403(d)], no party may amend a pleading to add a new party to the arbitration until a panel has been appointed and the panel grants a motion to add the party. Motions to add a party after panel appointment must be served on all parties, including the party to be added, and the party to be added may respond to the motion in accordance with Rule 12503 without waiving any rights or objections under the Code.

(d) No change.

12314. Combining Claims

Before ranked arbitrator lists are due to the Director under Rule 12402(d)[,] or Rule 12403(c) [or Rule 12403(d)], the Director may combine separate but related claims into one arbitration. Once a panel has been appointed, the panel may reconsider the Director's decision upon motion of a party.

12404. Additional Parties

(a) If a party is added to an arbitration after the Director sends the lists generated by the Neutral List Selection System to the parties, but before parties must return the ranked lists to the Director, the Director will send the lists to the newly added party, with employment history for the past 10 years and other background information for each arbitrator listed. The newly added party may rank and strike the arbitrators in accordance with Rules 12402(d)[,] or 12403(c)[(3), or 12403(d)(3)]. If the newly added party returns the lists within 20 days after the date upon which the Director sent the lists to the party, the Director will include the new party's lists when combining rankings under Rules 12402(e)[, 12403(c)(4), or 12403(d)(4)] or 12403(d). If the Director does not receive the list within that time, the Director will proceed as though the party did not want to strike any arbitrator or have any preference among the listed arbitrators.

(b) Once the ranked lists are due to the Director under Rules 12402(d)(3)[, 12403(c)(3)(C), or 12403(d)(3)(C)] or Rule 12403(c)(3), no party may amend a pleading to add a new party to the arbitration until a panel is appointed and grants a motion to add the party. Motions to add a party must be served on all parties, including the party to be added, and the party to be added may respond to the motion in accordance with Rule 12503 without waiving any rights or objections under the Code. If the panel grants the motion to add the party, the newly added party may not strike and rank the arbitrators, but may challenge an arbitrator for cause in accordance with Rule 12407.

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12800. Simplified Arbitration

(a) – (d) No change.

(e) Increases in Amount in Dispute

If any pleading increases the amount in dispute to more than \$50,000, the arbitration will no longer be administered under this rule, and the regular provisions of the Code will apply. If an arbitrator has been appointed, that arbitrator will remain on the panel. If a three-arbitrator panel is required or requested under Rule 12401, the remaining arbitrators will be appointed by the Director in accordance with Rule 12403[(c) or Rule 12403(d)]. If no arbitrator has been appointed, the entire panel will be appointed in accordance with the Neutral List Selection System.

(f) No change.

12903. Process Fees Paid by Members

(a) Each member that is a party to an arbitration in which more than \$25,000, exclusive of interest and expenses, is in dispute must pay:

- A non-refundable prehearing process fee of \$750, due at the time the parties are sent arbitrator lists in accordance with Rule 12402(c)[, Rule 12403(c) or Rule 12403(d)] or Rule 12403(b); and

- No change.

(b) – (c) No change.

Suitability

FINRA Highlights Examination Approaches, Common Findings and Effective Practices for Complying With its Suitability Rule

Executive Summary

This *Notice* provides observations from recent FINRA examinations and highlights firms' experiences with FINRA Rule 2111 (Suitability), which became effective on July 9, 2012. It does not create new or alter the existing questions and answers, guidance or interpretations of FINRA Rule 2111 contained in prior *Notices*.

The effective practices highlighted in this *Notice* are provided to help firms enhance compliance and supervision under the suitability rule. Adopting practices discussed in this *Notice* will not ensure rule compliance or result in a safe harbor, but we believe they are positive steps in building a strong compliance environment.

Questions regarding this *Notice* may be directed to

- ▶ Daniel M. Sibears, Executive Vice President, Regulatory Operations/ Shared Services at (202) 728-6911; or
- ▶ Michael Rufino, Senior Vice President and Acting Head of Regulatory Operations/Sales Practice, at (212) 858-4487.

Background

FINRA Rule 2111 generally is modeled after former NASD Rule 2310, incorporates related case law, and includes a few new or modified obligations. The details of the rule requirements and related guidance are available in

September 2013

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Suitability

Referenced Rules and Notices

- ▶ FINRA Rule 2111
- ▶ FINRA Rule 3270
- ▶ FINRA Rule 4512
- ▶ NASD Rule 3010
- ▶ Regulatory Notice 11-02
- ▶ Regulatory Notice 11-25
- ▶ Regulatory Notice 12-25
- ▶ Regulatory Notice 12-55

Regulatory Notices [11-02](#), [11-25](#), [12-25](#) and [12-55](#).

The rule requires a firm or associated person to “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.” Firms and associated persons generally must attempt to obtain and analyze customer-specific information—such as customer’s age, investment experience, time horizon, liquidity needs and risk tolerance—when making recommendations to customers. The rule also recites the three main suitability obligations:

- ▶ reasonable-basis (requires a firm or associated person to perform reasonable diligence to understand the nature of a recommended security or investment strategy involving a security, as well as its potential risks and rewards, and determine whether the recommendation is suitable for at least some investors based on that understanding);
- ▶ customer-specific (requires a firm or associated person to have a reasonable basis to believe that a recommendation is suitable for a particular customer based on that customer’s investment profile); and
- ▶ quantitative (requires a firm or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive).

The rule added recommended investment strategies involving a security or securities, including explicit recommendations to “hold” a security or securities.

For an investment strategy that involves both a security and non-security component, a firm’s suitability obligations apply to the security component but its suitability analysis must be informed by a general understanding of the non-security part of the strategy. A firm’s general understanding of the non-security product would depend on the facts and circumstances; but ordinarily a firm would need to have only basic knowledge of the non-security product. In the case of a recommended investment strategy involving a security and an outside business activity, a firm’s general understanding of the non-security component will be informed by the information and considerations required as part of a notice of an outside business activity pursuant to FINRA Rule 3270 (Outside Business Activities of Registered Persons).

FINRA Rule 2111(b) provides an exemption to customer-specific suitability for recommendations to institutional customers if three criteria are satisfied. First, the customer must meet the FINRA Rule 4512(c) definition of “institutional account.” Second, the firm must have “a reasonable basis to believe the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities.” Third, the

institutional customer must affirmatively indicate “that it is exercising independent judgment in evaluating the member’s or associated person’s recommendations.” In relation to the third requirement, negative consent will not suffice; but the affirmative indication does not necessarily have to be in writing. A firm may use a risk-based approach to document compliance with the institutional-customer exemption.

To assist firms in preparing for the amended rule, FINRA issued [Regulatory Notice 11-02](#), which announced the SEC’s approval of the amendments, provided an initial effective date and discussed its requirements. Subsequently, firms posed a number of questions regarding the rule, leading FINRA to extend the effective date to July 9, 2012, and issue additional guidance in [Regulatory Notices 11-25](#), [12-25](#) and [12-55](#). FINRA also prepared a [New Account Application Template](#) as a resource for firms and conducted a [free webinar](#) on April 18, 2012.

Moreover, a consolidated suitability frequently asked questions (FAQ) document organized by topic is available at <http://www.finra.org/Industry/Issues/Suitability/>.

To further support compliance with the rule, this *Notice* provides information concerning FINRA’s examination approach, common findings and observations of effective practices implemented by firms. Effective practices predominantly implemented by smaller firms are also identified throughout this *Notice*.

Examination Approach

Examinations for compliance with the suitability rule typically begin with an analysis of a firm’s controls. This is largely based on interviewing principals responsible for preparing the firm’s policies and procedures for this area and, considering the products the firm sells and the types of customers with which the firm conducts business, assessing the firm’s readiness to control risks related to suitability.

FINRA examiners tested supervisory and compliance systems and determined that firms, in general, implemented reasonable approaches regarding suitability. The depth and breadth of FINRA examiner testing is generally determined by the supervisory systems and controls the firm developed, the products and strategies the firm recommends, the firm’s business activities, the firm’s customer base, and other relevant information considered by FINRA staff during the examination planning and execution process.

During examinations, FINRA typically asks firms to respond to the following types of questions and information requests and to provide supporting documents:

- ▶ What employee training has the firm implemented regarding changes to the suitability rule?
- ▶ Does the firm offer training for associated persons to address investment strategies

and hold recommendations?

- ▶ How does the firm define investment strategies, including hold recommendations, and how are these topics supervised?
- ▶ Describe the firm's supervisory and compliance procedures for reasonable-basis, customer-specific and quantitative suitability, such as:
 - ▶ the manner in which the firm reasonably detects and prevents transactions in accounts for which customer investment profile information is unavailable or incomplete. To the extent that customer investment profile factors are not incorporated into account documentation, FINRA examiners may ask the firm to explain its efforts to obtain the profile information before making new recommendations to customers and, if any of the information is unavailable, how the firm determines whether there is a reasonable basis to believe that a recommendation is suitable;
 - ▶ the way the firm identifies and supervises accounts using strategies, or accounts with concentrations of particular types of securities, that may not align with the customer's investment profile; and
 - ▶ the manner in which the firm supervises explicit hold recommendations, including the method of documentation the firm uses when documentation occurs, as well as the information the firm considers in conducting the review.
- ▶ What tools (*e.g.*, exception reports) does the firm use to identify in-and-out trading and high turnover rates and commission-equity ratios?
- ▶ How does the firm determine whether customers meet the definition of "institutional account" and are capable of evaluating investment risks independently?
- ▶ What protocols does the firm use to obtain an affirmative acknowledgement that an institutional customer is exercising independent judgment in evaluating the firm's or associated person's recommendations?
- ▶ If the firm uses portfolio analytic tools or models, how does the firm determine whether the tools or models make recommendations subject to the suitability rule or meet the criteria for the safe harbor in Rule 2111.03?
 - ▶ Who develops these tools?
 - ▶ Who uses them (clients, representatives or both)?
 - ▶ How does the firm periodically review and test the effectiveness of the tools?
 - ▶ If the tools or models make recommendations subject to the suitability rule,

how are those recommendations supervised?

After the information is obtained, FINRA examiners conduct a review of internal firm controls to determine whether firm procedures are followed. Examinations are expanded where material deviations are found between procedures and practices. In addition, examiners review transactions and related suitability documentation that raise red flags about potential unsuitable recommendations. Examples of red flag transactions include:

- ▶ those that appear to deviate from the firm's internal suitability guidelines for a particular security;
- ▶ a long-term investment for an investor with a short-term horizon;
- ▶ a speculative investment or strategy held in the account of an investor with a conservative investment objective; and
- ▶ the same security held in the account or strategy implemented for multiple investors of a particular representative despite customer profiles that differ.

While examiners review documents used by firms to supervise suitability decisions and rule requirements, FINRA reminds firms that Rule 2111 generally does not impose explicit documentation requirements. As stated in *Regulatory Notices* [11-25](#), [12-25](#) and [12-55](#), firms may take a risk-based approach to document compliance with the suitability rule. The complexity and risks associated with a particular security or investment strategy will impact the level of documented analysis. Documented analysis may consist of the information obtained by the firm or associated person regarding a particular recommended security or investment strategy to ascertain the suitability of the investment based on the customer's investment profile. Another example of documented analysis could include the source materials obtained to assess potential risks and rewards associated with a recommended security or strategy. Similarly, documented analysis may include those records used to determine whether the recommendation is suitable for at least some investors.

Common Findings

The suitability rule amendments are still relatively new so many firms have not received a cycle examination or had a cycle examination conclude since the rule went into effect. Of the firms examined, most had updated policies, procedures and systems, trained staff and obtained additional customer investment profile information. Nonetheless, a small percentage of firms examined did not take a comprehensive approach to best ensure compliance with the rule.

Among firms where FINRA found deficiencies, inadequate procedures for hold recommendations (*e.g.*, how the firm supervises and, when necessary, documents such recommendations) was the most frequent deficiency. FINRA disposed of the vast majority

of examinations with deficiencies through a Cautionary Action that cited firms for inadequate supervisory procedures under NASD Rule 3010 (Supervision). These informal dispositions reflect FINRA's commitment to recognize reasonable, good faith efforts by firms to update and remediate supervisory and compliance systems. FINRA would, of course, consider disciplinary action for more serious violations, such as unsuitable recommendations.

A few examination findings were referred to FINRA's Enforcement Department and those matters involved suitability violations that were actionable under the predecessor suitability rule.

Observations of Effective Practices

The observations regarding effective practices discussed below recognize that there is no one-size-fits-all approach to compliance and supervision. Rather, the cited practices highlight measures that could bolster a firm's suitability-focused supervisory and compliance procedures. The relevance and feasibility of particular practices vary depending on factors such as a firm's size, business model, products offered and customer base. Firms are not bound by the practices discussed in this *Notice* and may employ other methods to achieve compliance with the suitability rule.

Reasonable-Basis Suitability

As referenced above, reasonable-basis suitability requires a firm or associated person to perform reasonable diligence to understand the nature of a recommended security or investment strategy involving a security, as well as its potential risks and rewards, and to determine whether the recommendation is suitable for at least some investors based on that understanding. FINRA observed during examinations that many firms have in place a new product vetting process that assists them in executing reasonable diligence obligations. While many large firms have extensive frameworks for assessing products, even smaller firms established investment committees to vet complex or risky products to determine whether the product met the reasonable-basis suitability standard for retail customers, and if so, the type of customer profile for which the product would be suitable if recommended.

A firm's vetting of new products does not, standing alone, satisfy the need for associated persons to understand the securities and investment strategies they recommend to customers.¹ In this regard, some firms post due diligence on products (and accompanying documents) to an internal website that associated persons can access when recommending a product. Such information includes audited financial statements, notes of interviews with key individuals of the product sponsor or issuer, and other information relevant to understanding the product and its features. Some firms use the vetting process to aid in product-focused training of their associated persons, supervisors and compliance staff.

A number of firms require associated persons to complete instructor-led or online training prior to engaging in the sale of an approved product. Several firms also require associated persons to pass a test at the conclusion of product training. As an added feature, some firms also implement a mandatory waiting period before an associated person can retake a test that he has failed. Firms also routinely update associated persons on product features during sales meetings to communicate new information regarding the product.

Customer-Specific Suitability

Under the customer-specific suitability standard, the rule requires a broker-dealer or associated person to use reasonable diligence to obtain and analyze a customer's age, investment experience, time horizon, liquidity needs and risk tolerance, in addition to the customer-specific factors from the predecessor rule (other holdings, financial situation and needs, tax status and investment objectives).² The rule requires a firm to seek to obtain and analyze the customer-specific factors listed in the rule when it makes recommendations of securities or investment strategies involving securities to new or existing customers, unless there is a documented reasonable basis to believe that one or more of the factors are not relevant to a customer's investment profile under the circumstances. When customer information is unavailable despite a broker-dealer's reasonable diligence, the firm must carefully consider whether it has a sufficient understanding of the customer to properly evaluate the suitability of a recommendation.

Many firms began collecting the additional information for new customers and supplementing existing customer investment profile information prior to the effective date of the amended rule by updating account forms and using electronic customer relationship management systems to capture this information. Overall, firms made significant technological changes to internal systems to capture the added customer profile data.

Some firms supplemented the technological upgrades with business processes that reassessed their entire client base and challenged its representatives to meet goals for completing customer reviews within a specified timeframe by, for example, periodically posting results by branch office or region. Other firms collected the enhanced customer profile information on a rolling basis as they made new recommendations or conducted quarterly or annual investment reviews with customers. A number of firms implemented systems that flag customer accounts that have recommended transactions but do not have a complete customer investment profile. Some small firms have policies that, although not required by Rule 2111, prohibit recommended transactions unless the customer fully completes or updates account information with all of the factors listed in the amended rule. Here, the firm will designate such an account as restricted to non-recommended transactions if the customer withholds investment profile information.

Some firms also bolstered compliance through heightened customer-specific suitability requirements or specific suitability profiles (*e.g.*, customers who would qualify for complex options trading; customers who have a high-risk tolerance, low liquidity needs and substantial investment experience; customers where the recommended transaction represents a small percentage of a balanced portfolio). These heightened standards are designed to best ensure that a recommended security or strategy matches well with the customer's profile data. For example, some firms combine and assess more granular data focused on a customer's age, retirement status, limited investment experience and low dollar investments to determine whether a particular recommended security or strategy is appropriate or out of line.

In some cases, firms implemented new policies and exception systems that flag vulnerable investors, typically those unable to sustain more than limited losses, such as individuals near or in retirement or other investors who rely on an income stream from an investment portfolio. Exceptions usually take into account factors such as the customer's profile, investment strategies and securities holdings. Some small firms reported conducting targeted educational discussions with vulnerable customers regarding products, markets and risks, as well as more frequent portfolio assessments.

Quantitative Suitability

Quantitative suitability requires a firm or associated person who has actual or *de facto* control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive. FINRA learned over the past year that it is typical for firms to rely on pre-rule amendment policies, procedures and systems to comply with this provision of the rule. In short, most firms already monitored customer accounts for churning and excessive trading.

Still, some firms updated surveillance and monitoring systems, and exception reports, by incorporating other aspects of the rule changes into data analysis and exception reports, such as the additional customer profile information. This approach bolstered compliance with the quantitative suitability requirement. FINRA believes that firms could also evaluate whether their compensation arrangements could incent a salesperson to engage in excessive trading that is unsuitable (or, generally, to make unsuitable recommendations).

Institutional-Customer Exemption

FINRA observed that some firms with an institutional customer base use tailored account opening documents while others use separate forms or certifications to facilitate compliance with the institutional-customer exemption. Through these documents, the institutional customer acknowledges in writing that it will exercise independent judgment in evaluating recommendations. Alternatively, firms contact institutional customers to discuss affirmative indications and document that conversation. Third-party vendors are used by some firms to verify the institutional status and sophistication of customers.

Where institutional customers do not confirm a willingness or capability to exercise independent judgment, some firms take additional steps to adhere to suitability standards. Specifically, an institutional customer may indicate that it will exercise independent judgment only on a trade-by-trade or asset-class-by-asset-class basis. Here, some firms verify and document the circumstances under which an institutional customer exercises independent judgment and flag recommendations that are not covered. To avoid potential suitability breaches with institutional customers, some broker-dealers decide to service only those institutional customers that have made the affirmative indication in terms of all potential trading activity in an account or will designate the account as restricted to non-recommended transactions.

Hold and Other Investment Strategy Recommendations

Although FINRA discovered instances of deficiencies regarding hold recommendations, some firms we examined implemented systems to achieve compliance with the hold and other investment strategy recommendation requirements of the rule. These systems include the following:

- ▶ a “hold ticket” or a “hold blotter” that captures hold and, in certain instances, other types of strategy recommendations;
- ▶ notes of discussions with clients regarding explicit hold or other strategy recommendations by associated persons maintained in customer files;
- ▶ firm branch office inspections focused on the documentation of hold and other strategy conversations with clients;
- ▶ modified new account forms to include specific investment strategies (determined by the firm) that could be identified if an associated person recommends them at the time of account opening;
- ▶ new or amended account opening forms that must be signed by the customer when associated persons recommend changes to a previously recommended account investment strategy; and
- ▶ a prohibition on associated persons engaging firm clients in the associated persons’ outside business activities.

As referenced, some firms integrate explicit hold recommendation reviews into branch office inspections. This helps firms determine whether internal procedures regarding hold recommendations are implemented by a particular branch and whether various branches are operating as expected or in an inconsistent manner. If the latter, remedial actions may follow at a regional or national level to better ensure that explicit hold recommendations are properly made, supervised and, when necessary, documented.

Some small firms use clearing firm platforms to capture explicit hold recommendations or other strategies. The practice is for small firm representatives to rely on client notes capabilities offered by clearing firms. Notes capabilities permit registered representatives of small firms to capture the substance of conversations with clients at a granular level (e.g., substance and time of conversation, name of security or type of strategy) and thereby provide an audit trail. Moreover, some small firms counsel their registered representatives to use the notes functionality to capture whether recommendations were made relative to the transfer of positions from another broker-dealer. In particular, some small firms memorialize disclosures to customers that transferred securities—that the firm does not follow—will not be the subject of hold or sell recommendations.

Common feedback from firms is that the hold and strategy aspects of the rule create behavioral and cultural challenges since, historically, it was not customary for registered representatives to consider an explicit hold as a recommendation or to document a strategy. In response, many firms have provided initial training on these aspects of the rule and conducted ongoing training by way of periodic sales meetings, continuing education, annual compliance meetings, onsite inspections and compliance alerts to remind their representatives of procedures on when and how to document hold and other strategy recommendations.

FINRA reminds firms that Rule 2111 generally does not impose explicit documentation requirements. A firm may use a risk-based approach to documenting and supervising compliance with the suitability rule. The type or form of documentation that may be needed is dependent on the facts and circumstances of the investment strategy or hold recommendation, including the complexity and risks associated with the security or investment strategy at the time of the recommendation. Irrespective of the method a firm uses to capture hold and other strategy recommendations when necessary, the firm must have a supervisory system in place to adequately supervise investment strategies.

Supervision

FINRA examiners observed that firms use various approaches to establish and implement a system of reasonable supervision and compliance over the areas covered by the suitability rule. Examinations show that effective procedures delineate who is responsible for conducting a specific review, what will be reviewed, the frequency of reviews and required documentation to evidence the review. A notable practice is a standardized approach to monitoring and updating policies and procedures as functions, personnel and systems change within a firm.

When customer accounts are following a particular investment strategy, firms take the strategy into consideration when determining the suitability of transactions meant to implement the strategy. This approach helps firms identify potential misalignments of strategies, recommendations and securities positions. To detect potential red flags based

on securities positions, some small firms look beyond an individual customer's account. Firms look for concentrated positions of a security in the accounts serviced by specific registered representatives, or look across customer accounts or branch offices for an accumulation of a security that is not readily explained (e.g., a security not followed by the firm). These red flags then become the subject of review by the firm.

Conclusion

Examinations indicate that firms for the most part adopted policies, procedures and systems to address the requirements of the suitability rule. Ongoing and future examinations will determine whether this trend continues.

Importantly, firms have responded to feedback received through examinations by addressing deficiencies. This leads to stronger internal controls around suitability practices. FINRA encourages firms to carefully consider the effective practices cited in this *Notice* in the near term rather than wait for a regulatory examination. In this manner, firms can determine whether additional efforts are warranted to improve approaches to suitability determinations and the supervision of recommendations. The combination of executive leadership, policies, procedures, suitability-related technologies, training and new product vetting will help ensure that customers are well served when recommendations are made and that the suitability rule serves its intended investor protection purpose.

Endnotes

1. See [Regulatory Notice 11-25](#) (May 2011) (FAQ 11).
2. See FINRA Rule 2111(a) and [Regulatory Notice 11-02](#) (January 2011) (discussion on SEC approved FINRA Rule 2111 and additional customer investment profile information that should be gathered and analyzed as part of a suitability analysis). As noted in [Regulatory Notice 11-25](#) (May 2011) (additional guidance provided to firms on suitability and customer's investment profile), firms were not required to seek to obtain all the customer-specific factors listed in the rule by its implementation date.

Election Notice

Upcoming Election to Fill FINRA District Committee Vacancies

Nomination Deadline: October 4, 2013

Executive Summary

This *Notice* notifies member firms of the upcoming nomination and election process to fill forthcoming vacancies on FINRA District Committees.

All eligible candidates will be placed on the ballot if they submit a candidate nomination and profile form to the FINRA Corporate Secretary by Friday, October 4, 2013. The candidate profile form is available online at www.finra.org/Notices/DistrictElection/090413 and as an attachment to this *Notice*.

The seats open for election are included in Attachment A. A list of the current District Committee members is available at www.finra.org/districtcommittees.

Note: This *Notice* was distributed electronically to the executive representative of each FINRA member firm and is posted on FINRA's website. Executive representatives should circulate this *Notice* to their firm's branch managers.

Questions concerning this *Election Notice* may be directed to

- ▶ Marcia Asquith, Senior Vice President and Corporate Secretary, at (202) 728-8949 or via email to CorporateSecretary@finra.org.
- ▶ Jennifer Piorko Mitchell, Assistant Corporate Secretary, at (202) 728-8949 or via email to Jennifer.Mitchell@finra.org.
- ▶ Chip Jones, Senior Vice President, Member Relations, at (240) 386-4797 or via email to chip.jones@finra.org.

September 4, 2013

Suggested Routing

- ▶ Branch Managers
- ▶ Executive Representatives
- ▶ Senior Management



Background

The FINRA District Committees serve an important role in the self-regulatory process by, among other things:

- ▶ serving on disciplinary panels in accordance with FINRA rules;
- ▶ alerting FINRA to industry trends that could present regulatory concerns; and
- ▶ consulting with FINRA on proposed policies and rule changes.

Committee members must have the experience, ability and commitment to fulfill these responsibilities, including:

- ▶ understanding the issues facing the securities industry and possessing the ability to apply knowledge and expertise to these issues to develop solutions;
- ▶ educating firms in their district on the responsibilities of FINRA;
- ▶ attending regularly and participating in a collegial manner in District Committee meetings; and
- ▶ remaining objective and unbiased, regardless of the interest of their firm, in the performance of District Committee matters.

Committee members also must adhere to the following prohibitions and restrictions:

- ▶ being sensitive to conflicts, such as those that can arise from firm-related work and service on industry committees, or as an expert witness, hearing panelist or arbitrator, and refraining from participating in a particular matter when a conflict exists;
- ▶ refraining from using membership on the District Committee for commercial purposes, for qualifying as an expert or suggesting special access to FINRA; and
- ▶ keeping sensitive, non-public or proprietary information confidential.

District Committees from districts 1, 2, 3, 4, 5, 6, 7, 8, 9 and 11 comprise three small, one mid-size and three large firm representatives that are elected by firms of the same size. The District Committee from District 10 comprises six small, two mid-size and six large firm representatives that are elected by member firms of the same size.¹

Terms & Vacancies

The full term for a District Committee member is three years. There is no limit on the number of terms that a member of a District Committee may serve, except that a District Committee member may not serve two full terms consecutively. Terms of District Committee members will terminate if they do not remain eligible for the seat for which they were elected.

Terms of all of the individuals elected during this election will begin on January 1, 2014.

Full Term Vacancies

In this election, the District Committees for Districts 1, 2, 3, 4, 5, 6, 7, 8, 9 and 11 each have two full-term vacancies to fill: one representing a small firm seat and one representing a large firm seat. District 10 has four full-term vacancies to fill: two representing small firm seats and two representing large firm seats.

Firm size categories are:

- ▶ **Small firm**—a firm that employs at least one and no more than 150 registered persons.²
- ▶ **Mid-size firm**—a firm that employs at least 151 and no more than 499 registered persons;³ and
- ▶ **Large firm**—a firm that employs 500 or more registered persons.⁴

The individuals elected to fill the above vacancies will be elected to three-year terms expiring December 31, 2016.

Partial Term Vacancy

In addition to the vacancies listed above, Districts 1, 2 and 10 each have an additional vacancy to fill. District 1 has a small firm vacancy and District 2 has a mid-size firm vacancy to fill. The individuals elected to fill these vacancies will serve a term expiring December 31, 2014. District 10 has a large firm vacancy to fill. The individual elected to fill this vacancy will serve a term expiring December 31, 2015.

Nomination Process and Eligibility

All candidates who submit their names and meet the qualifications set forth in Article VIII, Section 8.2 of the FINRA Regulation By-Laws (see below) will be included on their district's ballot. FINRA encourages current and former committee members to assist FINRA by soliciting candidates for committee service.

Individuals who seek a seat on the District Committee within their district must complete a candidate nomination and profile form and submit it to FINRA via email to CorporateSecretary@finra.org by **October 4, 2013**.

The candidate nomination and profile form is available online at www.finra.org/Notices/DistrictElection/090413 and as an attachment to this *Notice*.

Article VIII, Section 8.2 of the FINRA Regulation By-Laws requires for eligibility that District Committee members:

1. be associated with a FINRA member firm eligible to vote in the district for District Committee elections and registered in the capacity of a branch manager or principal or denoted as a corporate officer of the FINRA member;
2. work primarily from such FINRA member firm's principal office or a branch office that is located within the district where the member would serve on a District Committee; and
3. represent and be directly elected by the applicable classification of FINRA members based on the size of the firm with which he or she is associated: small, mid-size or large.

The names of all qualified individuals will be included on the ballot for the appropriate seat. Ballots will be mailed on or around October 16, 2013.

Additional information on District Committee election procedures may be found in [Article VIII of FINRA Regulation's By-Laws](#).

Firm Contact Information

Firms are reminded to accurately maintain their executive representative's name and email address, as well as their firm's main postal address in the FINRA Contact System. This will ensure that important mailings, such as election information, are properly directed. A firm's failure to keep this information accurate may jeopardize the firm's ability to participate in elections.

To update an executive representative name, mailing address and email address, firms may access the FINRA Contact System, via the Firm Gateway, at <https://firms.finra.org/fcs>. For assistance updating FCS, contact FINRA's Call Center at (301) 590-6500.

Endnotes

1. On May 4, 2011, the SEC approved amendments to FINRA Regulation's By-Laws to, among other things, adjust the size and composition of District Committees, over a three-year transition period, to align more closely with the industry representation on the FINRA Board of Governors. The By-Law change also replaced the District Nominating Committees with a process of direct nomination and election based on firm size. See Securities Exchange Act Release No. 64363 (April 28, 2011). The By-Law change adjusts the composition of the District Committees over a three-year transition period to align more closely with the industry representation by firm size on the Board of Governors. All District Committees except District 10 (New York) are adjusted from nine to seven members and District 10 is adjusted from 12 to 14 members.
2. See Article I (jj) of the FINRA Regulation By-Laws.
3. See Article I (aa) of the FINRA Regulation By-Laws.
4. See Article I (y) of the FINRA Regulation By-Laws.
5. Under NASD Rule 1160, firms must 1) update their contact information promptly, but in any event not later than 30 days following any change in such information, as well as 2) review and, if necessary, update the information within 17 business days after the end of each calendar year. Additionally, firms must comply with any FINRA request for such information promptly, but in any event not later than 15 days following the request, or such longer period agreed to by FINRA staff. See NASD Rule 1160 and [Regulatory Notice 07-42](#) (September 2007).

Attachment A—District Committee Positions to Be Elected

District 1

Northern California (the counties of Monterey, San Benito, Fresno and Inyo, and the remainder of the state north or west of such counties), northern Nevada (the counties of Esmeralda and Nye), and the remainder of the state north or west of such counties) and Hawaii

District Committee for District 1

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.
- ▶ Committee member to be elected to serve a term expiring December 31, 2014:
One small firm representative.

District 2

Southern California (that part of the state south or east of the counties of Monterey, San Benito, Fresno and Inyo), southern Nevada (that part of the state south or east of the counties of Esmeralda and Nye) and the former U.S. Trust Territories

District Committee for District 2

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.
- ▶ Committee member to be elected to serve a term expiring December 31, 2014:
One mid-size firm representative.

District 3

Alaska, Arizona, Colorado, Idaho, Montana, New Mexico, Oregon, Utah, Washington and Wyoming

District Committee for District 3

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.

District 4

Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota and South Dakota

District Committee for District 4

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.

District 5

Alabama, Arkansas, Louisiana, Mississippi, Oklahoma and Tennessee

District Committee for District 5

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.

District 6

Texas

District Committee for District 6

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.

District 7

Florida, Georgia, North Carolina, Puerto Rico, Panama, South Carolina and the Virgin Islands

District Committee for District 7

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.

District 8

Illinois, Indiana, Kentucky, Michigan, Ohio and Wisconsin

District Committee for District 8

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.

District 9

Delaware, the District of Columbia, Maryland, New Jersey, New York (except for the counties of Nassau and Suffolk, and the five boroughs of New York City), Pennsylvania, Virginia and West Virginia

District Committee for District 9

- ▶ Committee members to be elected to terms expiring December 31, 2016:
One small firm representative and one large firm representative.

District 10

New York (the counties of Nassau and Suffolk, and the five boroughs of New York City)

District Committee for District 10

- ▶ Committee members to be elected to terms expiring December 31, 2016:
Two small firm representatives and two large firm representatives.
- ▶ Committee member to be elected to term expiring December 31, 2015:
One large firm representative.

District 11

Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont

District Committee for District 11

- ▶ Committee members to be elected to terms expiring December 31, 2015:
One small firm representative and one large firm representative.

Attachment B

Candidate Profile Form — District Committee Election

Please complete all sections and email this document to CorporateSecretary@finra.org. An electronic version of this form is also available at www.finra.org/Notices/DistrictElection/090413

Name: _____ Date: _____

(As you would like it to appear on official correspondence)

Current Registration

Title/Primary Responsibility: _____

Firm CRD#: _____ Individual CRD#: _____

FINRA District No.: _____ Number of Registered Reps. at Firm: _____

Address

Street Address: _____ Suite/Floor: _____

City: _____ State: _____

Email: _____

Phone: _____

District Committee Seat Sought

- Small Firm (150 or fewer registered representatives)
- Mid-Size Firm (151 to 499 registered representatives)
- Large Firm (500 or more registered representatives)

Eligibility (Check all that apply)

- Associated with FINRA member firm eligible to vote in the district for District Committee elections
- Work primarily from FINRA member firm's principal or branch office in the district of the District Committee sought
- Position

Registered as

- branch manager
- principal

OR

- Denoted as a corporate officer of the FINRA member firm.

Election Notice

FINRA Small Firm Advisory Board Election

Nomination Deadline: October 4, 2013

Executive Summary

The purpose of this *Notice* is to inform FINRA small firm members¹ of the upcoming Small Firm Advisory Board (SFAB) election. One seat on the SFAB is up for election: a New York Region seat.

The SFAB provides guidance to FINRA staff, particularly regarding the potential impact of proposed regulatory initiatives on FINRA's small firms, and meets five times a year primarily in Washington, D.C., prior to each FINRA Board of Governors meeting. SFAB members are expected to attend SFAB meetings in person, and may be requested to attend certain regional, district and other FINRA meetings. Potential candidates should ensure that their other commitments will allow for their in-person attendance at all SFAB meetings.

Any eligible candidate wishing to have their name added to the ballot must submit the relevant information via the candidate profile form to FINRA's Corporate Secretary no later than Friday, October 4, 2013. The candidate profile form is available online at www.finra.org/notices/SFAB Election/090413 and as an attachment to this *Notice*.

On or about Wednesday, October 16, 2013, FINRA will mail the official *Election Notice* and ballots to the executive representatives of small firms in the New York Region to elect its regional representative on the SFAB. Voting will conclude in November 2013 and new members will take office in January 2014.

Questions regarding this *Election Notice* may be directed to:

- ▶ Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, at (202) 728-8949;
- ▶ Jennifer Piorko Mitchell, Assistant Corporate Secretary, FINRA, at (202) 728-8949; or
- ▶ Chip Jones, Senior Vice President, Member Relations, FINRA, at (240) 386-4797.

September 4, 2013

Suggested Routing

- ▶ Executive Representatives
- ▶ Senior Management

Composition of the FINRA Small Firm Advisory Board

The SFAB comprises 10 members, as follows:

- ▶ five regional members elected by small firms in the five FINRA regions (one from each region); and
- ▶ five at-large members appointed by FINRA.

Additionally, the FINRA Board's Small Firm Governors² serve as ex-officio members of the SFAB.

The five regional members represent the following geographic regions:

- ▶ **Midwest Region:** Illinois, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota and Wisconsin (Districts 4 and 8)
- ▶ **New York Region:** New York (the counties of Nassau and Suffolk, and the five boroughs of New York City) (District 10)
- ▶ **North Region:** Connecticut, Delaware, the District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York (except for the counties of Nassau and Suffolk, and the five boroughs of New York City), Pennsylvania, Rhode Island, Vermont, Virginia and West Virginia (Districts 9 and 11)
- ▶ **South Region:** Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Panama, Puerto Rico and the Virgin Islands (Districts 5, 6 and 7)
- ▶ **West Region:** Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, Wyoming and the former U.S. Trust Territories (Districts 1, 2 and 3)

As mentioned above, one seat on the SFAB is up for election, a New York Region seat.

Candidate Eligibility

Any senior member of a small firm whose primary place of business and whose firm has its main office (as indicated in FINRA records) in the New York region is eligible to have his or her name placed on the SFAB ballot for that region. Senior members of firms include owners, chief executive officers, presidents, chief compliance officers, chief operating officers, the firm's FINOP or individuals of comparable status. There may be only one candidate per firm on each ballot.

Eligible individuals must complete the attached SFAB candidate profile form³ and submit it, through their firm's Executive Representative, to FINRA's Corporate Secretary. SFAB candidate profiles must be received by FINRA's Corporate Secretary no later than **Friday, October 4, 2013**.

FINRA's Corporate Secretary will confirm the firm's status as a small firm and the candidate's eligibility, and include certified candidates on the ballot. Individuals have a continuing obligation to satisfy the firm-size requirement on the date the candidacy is certified by the Corporate Secretary and the date the ballots are mailed. Individuals who fail to meet this requirement will be disqualified from election.

SFAB members must also continue to meet their qualifications for election at all times during their terms of office.

Voting Eligibility

FINRA small firms are eligible to vote for candidates running for the SFAB seat representing the region corresponding to the district to which they are assigned in the Central Registration Depository. Only those firms eligible to vote for the New York region seats will receive ballots. The size of each firm and the location of each firm's main office will be verified on the day the ballots are mailed.

Firms may vote for only one candidate listed on the ballot.

Terms of SFAB Members

The successful candidate will be the individual who receives the most votes and will be elected to serve a three-year term.

The term of an SFAB member shall terminate immediately upon a determination by the SFAB, by a majority vote of the remaining members, that the member no longer satisfies the eligibility criteria. Additionally, the FINRA Board may remove from the SFAB, a member who is unable or fails to discharge the member's duties or violates SFAB policies.

Once an individual has completed a full three-year elected term on the SFAB, he or she is ineligible to run for re-election to the SFAB for another three years.

Endnotes

1. A small firm is defined as a firm that employs at least one and no more than 150 registered persons. See Article I (ww) of the FINRA By-Laws.
2. A Small Firm Governor is defined as a member of the FINRA Board elected by small firm members. In order to be eligible to serve, a Small Firm Governor must be registered with a member that is a small firm and must be an Industry Governor. See Article I (xx) of the FINRA By-Laws.
3. The SFAB candidate profile form is also available at www.finra.org/notices/SFABElection/090413.

Attachment A

Candidate Nomination and Profile Form — SFAB Election

Please complete all sections and email this document to CorporateSecretary@finra.org. An electronic version of this form is also available at www.finra.org/notices/SFABElection/090413.

Current Registration

Name: _____ CRD#: _____

(As you would like it to appear on official correspondence)

Firm Name: _____ Firm #: _____

FINRA District No.: _____ Number of Registered Reps. at Firm: _____

Title/Primary Responsibility: _____

Address

Street Address: _____ Suite/Floor: _____

City: _____ State: _____

Email: _____

Phone: _____

SFAB Seat Sought

New York Region

- ▶ New York (the counties of Nassau and Suffolk, and the five boroughs of New York City) (District 10)

Eligibility Checklist (must meet all three)

1. Senior member of a small firm.
 - ▶ Senior members include owners, chief executive officers, presidents, chief compliance officers, chief operating officers, the firm's FINOP or individuals of comparable status.
2. Firm's main office is in the New York Region.
 - ▶ Location of firm's main office: _____
3. Your primary place of business is in the same region as the firm's main office.

Information Notice

Continuing Education

New S901 Regulatory Element Continuing Education Program

Background and Discussion

In October 2011, FINRA established a new representative registration category, qualification examination and continuing education requirements for certain operations personnel (Operations Professionals). Under FINRA Rule 1250, individuals registered as Operations Professionals are subject to FINRA's Regulatory Element and Firm Element Continuing Education requirements.

As announced in [Regulatory Notice 11-33](#), FINRA will implement the new S901 Regulatory Element Program for Operations Professionals, the continuing education requirement for Series 99 registered persons who do not hold any other FINRA registration, on October 17, 2013.

The S901 Regulatory Element Program is divided into four modules, the first three of which are the same for all participants: Client Confidentiality and Responsibilities of Registered Persons, Operations Workflow, and Product and Market Knowledge. For the fourth module, participants will be required to self-select one of four functional areas—New Accounts; Trading and Settlement; Operations Generalist; or Treasury, Custody and Control—that most closely resembles their current responsibilities in order to provide a more personalized educational experience.

To help individuals become familiar with the new program, FINRA has made available online the S901 [Content Outline](#), an [animated orientation](#) and a brief [sample case](#).

Operation Professionals may schedule an appointment online for their Regulatory Element CE sessions through the Pearson VUE (www.pearsonvue.com/finra) and Prometric (www.prometric.com/finra) test center websites or by telephone.

Additional information about the S901 Regulatory Element Program, including fees and how to register, is available at www.finra.org/ce/training.

September 20, 2013

Suggested Routing

- ▶ Compliance
- ▶ Continuing Education
- ▶ Operations Professionals
- ▶ Registered Representatives
- ▶ Registration
- ▶ Training

Key Topic(s)

- ▶ Continuing Education
- ▶ Regulatory Element Program

Referenced Rules & Notices

- ▶ FINRA Rule 1230(b)(6)
- ▶ FINRA Rule 1250
- ▶ Regulatory Notice 11-33
- ▶ Regulatory Notice 11-42

FINRA reminds member firms that, as noted in [Regulatory Notice 11-33](#), FINRA Rule 1230(b)(6) (operations professional registration category) includes an exception from the requirement to take the Series 99 qualification examination for those who currently hold certain eligible registrations or who do not hold an eligible registration, but prefer an alternative to taking the Series 99 examination. Individuals who avail themselves of the exception are subject to the Regulatory Element Program appropriate for the other registration category. For example, a person who registers as an Operations Professional by holding a General Securities Representative registration (Series 7) under the exception is subject to the S101 Regulatory Element Program in lieu of the S901 Regulatory Element Program, and a person who registers by holding a General Securities Principal registration (Series 24) is subject to the S201 Regulatory Element Program in lieu of the S901 Regulatory Element Program.

Questions about this *Notice* may be directed to:

- ▶ Roni Meikle, Director, Continuing Education, at (212) 858-4084; or
- ▶ Patricia DeVita, Manager, Continuing Education, at (212) 858- 4013.