

OMB APPROVAL

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Page 1 of * 183

SECURITIES AND EXCHANGE COMMISSION
 WASHINGTON, D.C. 20549
 Form 19b-4

File No.* SR - 2019 - * 030

Amendment No. (req. for Amendments *)

Filing by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial *



Amendment *



Withdrawal



Section 19(b)(2) *



Section 19(b)(3)(A) *



Section 19(b)(3)(B) *



Rule

Pilot



Extension of Time Period
for Commission Action *



Date Expires *

☐ 19b-4(f)(1)

☐ 19b-4(f)(2)

☐ 19b-4(f)(3)

☐ 19b-4(f)(4)

☐ 19b-4(f)(5)

☐ 19b-4(f)(6)

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1) *



Section 806(e)(2) *



Security-Based Swap Submission pursuant
to the Securities Exchange Act of 1934

Section 3C(b)(2) *



Exhibit 2 Sent As Paper Document



Exhibit 3 Sent As Paper Document



Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to Amend the Membership Application Program ("MAP") Rules to Help Further Address the Issue of Pending Arbitration Claims, as well as Arbitration Awards and Settlement agreements Related to Arbitrations That Have Not Been Paid in Full in Accordance with Their Terms

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * Victoria

Last Name * Crane

Title * Vice President and Associate General Counsel

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Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

(Title *)

Date 12/13/2019

Senior Vice President and Deputy General Counsel

By Patrice M. Gliniecki

(Name *)

Patrice Gliniecki,

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFT website.

Form 19b-4 Information *

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change *

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies *

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit Sent As Paper Document

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Exhibit 3 - Form, Report, or Questionnaire

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit Sent As Paper Document

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Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

Add Remove View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “SEA”),¹ Financial Industry Regulatory Authority, Inc. (“FINRA”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend the Membership Application Program (“MAP”) rules to help further address the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms.² Specifically, the proposed rule change would: (1) amend Rule 1014 (Department Decision) to: (a) create a rebuttable presumption that an application for new membership should be denied if the applicant or its associated persons are subject to a pending arbitration claim, and (b) permit an applicant to overcome a presumption of denial by demonstrating its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement or pending arbitration claim; (2) adopt a new requirement for a member, that is not

¹ 15 U.S.C. 78s(b)(1).

² Effective May 8, 2019, FINRA adopted the NASD Rule 1010 Series (Membership Proceedings), among other rules, in the consolidated FINRA rulebook, without substantive change. The MAP rules now reside under the FINRA Rule 1000 Series (Member Application and Associated Person Registration) as FINRA Rules 1011 through 1019. See Securities Exchange Act Release No. 85589 (April 10, 2019), 84 FR 15646 (April 16, 2019) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2019-009). For purposes of this filing, all references to the MAP rules are to the FINRA Rule 1000 Series. The proposed rule change would also update cross-references and make other non-substantive, technical changes, and make corresponding changes to the Forms NMA and CMA. FINRA is separately developing changes to the MAP rules in connection with the retrospective review of this rule set. See Regulatory Notice 18-23 (July 2018) (“Notice 18-23”) (requesting comment on a proposal regarding the MAP rules).

otherwise required to submit an application for continuing membership for a specified change in ownership, control or business operations, including business expansion, to seek a materiality consultation if the member or its associated persons have a defined “covered pending arbitration claim,” unpaid arbitration award, or an unpaid arbitration settlement; (3) amend Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations) to require a member to demonstrate its ability to satisfy an unpaid arbitration award or unpaid settlement related to an arbitration before effecting the proposed change thereunder; (4) amend Rule 1013 (New Member Application and Interview) and Rule 1017 to require an applicant to provide prompt written notification of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before a decision on an application constituting final action on FINRA is served on the applicant; and (5) make other non-substantive and technical changes in the specified MAP rules due to the proposed amendments.³

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

³ For example, the proposed rule change would require the renumbering of some paragraphs in Rules 1011 and 1014 and the updating of cross-references.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval of the proposed rule change.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

The MAP rules govern the way in which FINRA reviews a new membership application (“NMA”) and a continuing membership application (“CMA”).⁴ These rules require an applicant to demonstrate its ability to comply with applicable securities laws and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. FINRA evaluates an applicant’s financial, operational, supervisory and compliance systems to ensure that the applicant meets the standards set forth in the MAP rules. Among other factors, the MAP rules require FINRA to consider whether persons associated with an applicant have material disciplinary actions taken against them by industry authorities, customer complaints, adverse arbitrations, pending arbitration claims, unpaid arbitration awards, pending or unadjudicated matters, civil actions, remedial actions imposed or other industry-related matters that could pose a threat to public investors.⁵

⁴ Unless otherwise specified, the term “application” refers to either an NMA (or Form NMA) or CMA (or Form CMA), depending on context.

⁵ See generally Rules 1014(a)(3) and 1014(a)(10).

FINRA is proposing to amend the MAP rules in several ways. First, FINRA is proposing to amend one standard for admission and the corresponding factors therein relating to the presumption to deny an application for new or continuing membership. Second, FINRA is proposing to clarify the various ways in which an applicant for new or continuing membership may demonstrate its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or a pending arbitration claim during the application review process, and to preclude an applicant from effecting any contemplated change in ownership, control or business operations until such demonstration is made and FINRA approves the application. Third, FINRA is proposing to mandate a member firm to seek a materiality consultation in two situations in which specified pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements are involved. Finally, FINRA is proposing to require an applicant for new or continuing membership to notify FINRA of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before FINRA renders a decision on the application.

FINRA believes that these proposed amendments to select portions of the MAP rules would enable FINRA to take a stronger approach to addressing the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms, in connection with the application review process. In addition, the proposed amendments would enable FINRA to consider the adequacy of the supervision of individuals with pending arbitration claims. As described below, the proposed amendments are intended to address concerns regarding situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those

claims should they go to award or result in a settlement, and concerns about the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

The proposed rule change would impact members that have elected to be treated as capital acquisition brokers (“CABs”) and are subject to CAB rules. CAB Rules 111 through 118 incorporate by reference several MAP rules, including Rules 1011, 1013, 1014 and 1017.⁶ The proposed amendments would make conforming changes to CAB Rules 111 through 118, as applicable.

Proposed Rule Change

A. Rule 1014(a)(3) – Compliance with Industry Rules, Regulations, and Laws

Rule 1014(a) sets forth 14 standards for admission FINRA must consider in determining whether to approve an application. Currently, Rule 1014(a)(3) (“Standard 3”) requires FINRA to determine whether an applicant for new or continuing membership and its associated persons “are capable of complying with” the federal securities laws, the rules and regulations thereunder, and FINRA rules. Standard 3 sets forth six factors that FINRA must consider in making that determination.⁷ One factor, set forth under Rule

⁶ See generally CAB Rule 111 (Membership Proceedings) (referencing Rule 1011), CAB Rule 112 (New Member Application and Interview) (referencing Rule 1013), CAB Rule 113 (Department Decision) (referencing Rule 1014), and CAB Rule 116 (Application for Approval of Change in Ownership, Control, or Business Operations) (referencing Rule 1017).

⁷ See Rule 1014(a)(3)(A) – (F).

1014(a)(3)(B), requires FINRA to consider whether an applicant's or its associated person's record reflects a sales practice event, a pending arbitration, or a pending private civil action. Another factor appears under Rule 1014(a)(3)(C) and requires FINRA to consider, among other regulatory history, whether an applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant's net capital, and any other member with respect to which these persons were a controlling person or a five percent lender of its net capital, is subject to unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.

Further, under Rule 1014(b)(1), where an applicant or its associated person is subject to certain regulatory history enumerated in Standard 3, "a presumption exists that the application should be denied."⁸ Rule 1014(a)(3)(C) is one of several factors that trigger the presumption. The existence of such an event "[raises] a question of capacity to comply with the federal securities laws and the rules of [FINRA]," which should result in a rebuttable presumption to deny the application.⁹ However, the existence of a record of a pending arbitration, as set forth in Rule 1014(a)(3)(B), is currently not among the enumerated factors that trigger the presumption to deny an application.

⁸ See also Rule 1017(h)(1), which pertains to CMAs and contains language identical to Rule 1014(b)(1). FINRA would make conforming changes to Rule 1017(h)(1).

⁹ See Notice to Members 04-10 (February 2004).

1. Rebuttable Presumption to Deny an NMA (Proposed Rule 1014(b)(1))

FINRA is concerned about prospective applicants for new membership hiring principals and registered persons with pending arbitration claims without having to demonstrate how those claims would be paid if they go to award or result in a settlement. In addition, FINRA is concerned about a new member's supervision of such individuals who may have a history of noncompliance. Accordingly, FINRA is proposing to amend Rule 1014(b)(1) to specify that a presumption of denial would exist if a new member applicant or its associated persons are the subject of a pending arbitration claim. Creating a presumption of denial in connection with a pending arbitration claim for an NMA would shift the burden to the new member applicant to demonstrate how its pending arbitration claims would be paid should they go to award or result in a settlement. In addition, the proposed amendment would spotlight the firm's supervision of individuals with pending arbitration claims. This presumption of denial for a pending arbitration claim would not apply to an existing member firm filing a CMA. Instead, consistent with today's practice, FINRA would continue to consider whether an applicant's or its associated persons are the subject of a pending arbitration claim in determining whether the applicant for continuing membership is "capable of complying with" applicable federal securities laws and FINRA rules.¹⁰

¹⁰ For purposes of determining whether an applicant meets Standard 3, FINRA's consideration of an applicant's or associated person's pending arbitration claim would be separated from Rule 1014(a)(3)(B) and moved to proposed Rule 1014(a)(3)(E).

2. Evidence of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements, or for New Member Applications, Pending Arbitration Claims (Proposed IM-1014-1)

Proposed IM-1014-1 would provide that an applicant may demonstrate its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement or a pending arbitration claim, through an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms of documentation that FINRA may determine to be acceptable.¹¹ In addition, under the proposed interpretive material, an applicant may provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable in the area as to the value of the arbitration claims (which might be zero). Proposed IM-1014-1 would also provide that to overcome the presumption to deny the application, the applicant must guarantee that any funds used to evidence the applicant's ability to satisfy any awards, settlements, or claims will be used for that purpose. Any demonstration by an applicant of its ability to satisfy these outstanding obligations would be subject to a reasonableness assessment by FINRA.

¹¹ FINRA expects to make conforming amendments to Forms NMA and CMA. FINRA notes that Form CMA currently instructs the applicant to provide supporting documentation to show that such applicant is able to meet Standard 3. Specifically, if the CMA involves a transfer of assets with no corresponding transfer of associated liabilities, and there are pending arbitration claims or closed or settled arbitration matters, Form CMA requires the applicant to provide a written "Arbitration Plan," explaining, among other things, how the applicant will handle the arbitrations and awards that may result. An applicant may show that it has a reserve fund or will retain the proceeds of the asset transfer to satisfy the award. See Form CMA, Standard 3, Question 2.d. (within the section titled, "Provide supporting documents").

B. Materiality Consultation

A member is required to file a CMA when it plans to undergo an event specified under Rule 1017 (e.g., acquisition or transfer of the member's assets, or a business expansion). In some cases, a change contemplated by a firm may not clearly fall within one of the events described in Rule 1017, and so before taking steps to prepare a CMA, a member has the option of seeking guidance, or a materiality consultation, from FINRA on whether such proposed event would require a CMA.¹² The materiality consultation process is voluntary, and FINRA has published guidelines about this process on FINRA.org.¹³ A request for a materiality consultation, for which there is no fee, is a written request from a member firm for FINRA's determination on whether a contemplated change in business operations or activities is material and would therefore require a CMA or whether the contemplated change can fit within the framework of the firm's current activities and structure without the need to file a CMA for FINRA's approval. The characterization of a contemplated change as material depends on an assessment of all the relevant facts and circumstances, including, among others, the nature of the contemplated change, the effect the contemplated change may have on the

¹² See IM-1011-1 (stating, "[f]or any expansion beyond these [safe harbor] limits, a member should contact its district office prior to implementing the change to determine whether the proposed expansion requires an application under Rule 1017."); see also Notice to Members 00-73 (October 2000) ("Notice 00-73") (stating, whether, based upon all the facts and circumstances, a change and expansion that falls outside of the safe harbor provisions are material, "[a] member may, but is not required to, contact the District Office to obtain guidance on this issue.").

¹³ See The Materiality Consultation Process for Continuing Membership Applications, <https://www.finra.org/rules-guidance/guidance/materiality-consultation-process>.

firm's capital, the qualifications and experience of the firm's personnel, and the degree to which the firm's existing financial, operational, supervisory and compliance systems can accommodate the contemplated change.¹⁴ Through this consultation, FINRA may communicate with the member to obtain further documents and information regarding the contemplated change and its anticipated impact on the member. Where FINRA determines that a contemplated change is material, FINRA will instruct the member to file a CMA if it intends to proceed with such change. Ultimately, the member is responsible for compliance with Rule 1017. If FINRA determines during the materiality consultation that the contemplated business change is material, then the member potentially could be subject to disciplinary action for failure to file a CMA under Rule 1017.¹⁵

To help further incentivize payment of arbitration awards and settlements, FINRA is proposing to preclude a member from effecting specified changes in ownership, control, or business operations, including business expansions involving a "covered pending arbitration claim" (as defined under proposed Rule 1011(c)), unpaid arbitration award, or unpaid settlement related to an arbitration without first seeking a materiality consultation from FINRA as described below.¹⁶

¹⁴ See Notice 00-73.

¹⁵ See Notice 00-73.

¹⁶ In a separate proposal, FINRA is proposing to mandate materiality consultations under other circumstances. See Notice 18-23 (seeking comment on a proposal to the MAP rules that would, among other things, codify the materiality consultation process and mandate a consultation under specified circumstances such as where an applicant seeks to engage in, for the first time, retail foreign currency exchange activities, variable life settlement sales to retail customers, options activities, or municipal securities activities).

1. Mandatory Materiality Consultation for Business Expansion to Add One or More Associated Persons Involved in Sales (Proposed IM-1011-2 and Proposed Rules 1011(c)(1) and 1017(a)(6)(B))

Rule 1017 specifies the changes in a member's ownership, control, or business operations that require a CMA and FINRA's approval.¹⁷ Among the events that require a CMA are a "material change in business operations," which is defined to include, but is 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 15c3-1.¹⁸ In addition, a CMA is required for business expansions to increase the number of associated persons involved in sales, offices, or markets made that are a material change in business

¹⁷ See Rule 1017(a). The events that require a member to file a CMA for approval before effecting the proposed event are:

- a merger of the member with another member, unless both members are members of the New York Stock Exchange, Inc. ("NYSE") or the surviving entity will continue to be a member of the NYSE;
- a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE;
- direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the NYSE;
- a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or
- a material change in business operations as defined in Rule 1011(k).

¹⁸ See Rule 1011(k).

operations.¹⁹ However, IM-1011-1 (Safe Harbor for Business Expansions) creates a safe harbor for incremental increases in these three categories of business expansions that will be presumed not to be material. Under this safe harbor provision, a member, subject to specified conditions and thresholds, may undergo such business expansions without filing a CMA.²⁰

FINRA is concerned that the changes in a member firm's ownership, control, or business operations as currently described in Rule 1017, and the availability of the safe harbor for a business expansion to increase the number of associated persons involved in sales could allow a member to, for example, hire principals and registered representatives with substantial pending arbitration claims without giving consideration to how the firm would supervise such individual or the potential financial impact on the firm if the individual, while employed at the hiring firm, engages in additional potential misconduct that results in a customer arbitration. Accordingly, FINRA is proposing to add new interpretive material, IM-1011-2 (Business Expansions and Covered Pending Arbitration Claims), to provide that if a member is contemplating to add one or more associated persons involved in sales and one or more of those associated persons has a "covered pending arbitration claim" (as that term is defined under proposed Rule 1011(c)(1)), an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member

¹⁹ See Rule 1017(b)(2)(C) (stating, "If the application requests approval of an increase in Associated Persons involved in sales, offices, or markets made, the application shall set forth the increases in such areas during the preceding 12 months.").

²⁰ The safe harbor is unavailable to a member that has a membership agreement that contains a specific restriction as to one or more of the three areas of expansion or to a member that has a "disciplinary history" as defined in IM-1011-1.

is not otherwise required to file a CMA, the member may not effect the contemplated business expansion unless the member complies with the requirements in proposed Rule 1017(a)(6)(B).

Proposed Rule 1017(a)(6)(B) would require a member firm to file a CMA for approval of the business expansion described in proposed IM-1011-2 unless the member first submits a written request to FINRA seeking a materiality consultation for the contemplated business expansion. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, FINRA would consider the written request and other information or documents the member provides to determine in the public interest and the protection of investors that either: (1) the member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated business expansion; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated business expansion unless FINRA approves the CMA.

A materiality consultation for this type of business expansion would allow FINRA to, among other things, assess the nature of the anticipated activities of the principals and registered representatives with arbitration claims, unpaid arbitration awards or arbitration settlements; the impact on the firm's supervisory and compliance structure, personnel and finances; and any other impact on investor protection raised by adding such individuals. If FINRA determines that a member must file a CMA, it would be subject to the application review process set forth under the MAP rules, including a review of any record of a pending arbitration claim and the presumption of denial with

respect to any unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.

For purposes of a business expansion to add one or more associated persons involved in sales, FINRA is proposing to define, under proposed Rule 1011(c)(1), a “covered pending arbitration claim” as: (1) an investment-related, consumer-initiated claim filed against the associated person in any arbitration forum that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the hiring member’s excess net capital. For purposes of this definition, the claim would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees, and shall be the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

FINRA believes that the definition of a “covered pending arbitration claim” for purposes of a business expansion as described in proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) is appropriate because if an individual has substantial arbitration claims, those claims could be an indication that the individual may engage in future potential misconduct that could result in additional arbitration claims.²¹ Under such

²¹ Recent academic studies provide evidence that the past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events. See Hammad Qureshi and Jonathan Sokobin, Do Investors Have Valuable Information About Brokers? (FINRA Office of the Chief Economist Working Paper, August 2015). See also Mark Egan, Gregor Matvos, and Amit Seru, The Market for Financial Adviser Misconduct, J. Pol. Econ. 127, No. 1 (February 2019): 233-295.

circumstances, if the customer names the hiring member firm in any such additional arbitration claims, FINRA is concerned whether a hiring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims including a customer award or settlement. By requiring a materiality consultation if a member firm is contemplating hiring an individual with a “covered pending arbitration claim,” FINRA would be able to assess, among other things, the adequacy of any supervisory plan the member firm has in place for the individual. In addition, the materiality consultation would allow FINRA to discuss with the member firm the potential impact on its finances if the member firm hires the individual and the individual engages in future potential misconduct while employed at the member firm that results in an arbitration claim against the member firm.

If the SEC approves the proposed rule change, FINRA will reassess the definition of “covered pending arbitration claim” for purposes of proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) after FINRA has had experience with the application of the rule to determine its impact and if the definition requires modification. In addition, FINRA invites comment on the proposed definition.

2. Mandatory Materiality Consultation for Any Acquisition or Transfer of Member’s Assets (Proposed Rule 1017(a)(6)(A) and Proposed Rule 1011(c)(2))

Rule 1017(a) requires a member to file a CMA for direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member’s assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the

aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are NYSE members.²²

FINRA is concerned that this 25 percent threshold could permit a firm with pending arbitration claims that ultimately produce awards or settlements to avoid satisfying those awards or settlements by transferring assets without encumbrance and then closing down. Accordingly, FINRA is proposing to amend Rule 1017(a) to add new subparagraph (6)(A) to provide that if a member is contemplating any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim (as that term is defined under proposed Rule 1011(c)(2)), an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, the member may not effect the contemplated transaction unless the member first submits a written request to FINRA seeking a materiality consultation for the contemplated acquisition or transfer. Similar to proposed subparagraph (6)(B) in Rule 1017(a), the written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, FINRA would consider the written request and other information or documents provided by the member to determine in the public interest and the protection of investors that either: (1) the member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated acquisition or transfer; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated business acquisition or transfer unless FINRA approves the CMA.

²² See supra note 17.

During the course of this consultation, FINRA would consider, among other relevant facts and circumstances, whether the contemplated acquisition or transfer could result in non-payment of an arbitration claim should it go to award or result in a settlement, or the continued non-payment of such arbitration award or settlement. If FINRA determines that a member must file a CMA, it would be subject to the application review process set forth under the MAP rules, including a review of any record of a pending arbitration claim and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.

For purposes of this proposed amendment, FINRA is proposing to define, under proposed Rule 1011(c)(2), a “covered pending arbitration claim” as: (1) an investment-related, consumer-initiated claim filed against the transferring member or its associated persons in any arbitration forum that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member’s excess net capital. For purposes of this definition, the claim amount would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees, and shall be the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

FINRA believes that the definition of a “covered pending arbitration claim” for purposes of a direct or indirect acquisition or transfer as described in proposed Rule 1017(a)(6)(A) is an appropriate measure because a member with substantial arbitration

claims that is seeking to transfer its assets could be an indication of attempts to insulate itself from responsibility for the payment of pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements particularly when there is no corresponding transfer of liabilities. Under such circumstances, FINRA is concerned whether a transferring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims, including a customer award or settlement. By requiring a materiality consultation where a member firm is contemplating any direct or indirect acquisition or transfer involving a “covered pending arbitration claim,” FINRA would be able to assess, among other things, the adequacy of any plan the member firm has in place to satisfy pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements.

As noted above, FINRA invites comment on the proposed definition and if the SEC approves the proposed rule change, FINRA will reassess the definition of “covered pending arbitration claim” for purposes of proposed Rule 1017(a)(6)(A) after FINRA has had experience with the application of the rule to determine its impact and if the definition requires modification.

C. Other Proposed Amendments

1. Notification of Changes

Rule 1013(a) sets forth a detailed list of items that must be submitted with an NMA.²³ Rule 1017(b) sets forth the documents or information required to accompany a

²³ The list of items set forth under Rule 1013(a) includes, among other things, documentation of disciplinary history and certain regulatory, civil, and criminal actions, arbitrations, and customer complaints for the applicant and its associated persons.

CMA, depending on the nature of the CMA. FINRA is proposing to amend Rules 1013 and 1017 to add new paragraphs that would appear as proposed Rules 1013(c) and 1017(h), to require an applicant to provide prompt notification, in writing, of any pending arbitration claim involving the applicant or its associated persons that is filed, awarded, settled or becomes unpaid before a decision on the application constituting final action of FINRA is served on the applicant.²⁴ Thus, any such unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or pending arbitration claim (for a new member applicant only) that comes to light in this manner during the application review process would result in FINRA being able to presumptively deny the application under the applicable factors set forth in Standard 3 and the ability of the applicant to overcome such presumption by demonstrating its ability to satisfy the obligation, as discussed above.

2. Timing and Conditions for Effecting Change Under Rule 1017

Rule 1017(c) describes the timing and conditions for effecting a change under Rule 1017.²⁵ Rule 1017(c)(1) requires a member to file a CMA for approval of a change in ownership or control at least 30 days before the change is expected to occur. While a

²⁴ FINRA expects to make conforming changes to Forms NMA and CMA, but notes that Form CMA currently requires the applicant seeking approval of an asset transfer to promptly update the information provided regarding arbitration claims. Such update should include new arbitrations filed, settlements made and awards granted against the applicant. See Form CMA, Standard 3, Question 4.b.

²⁵ In a separate proposal, FINRA is considering whether to eliminate the timing considerations for filing a CMA depending upon the type of contemplated change or event to require that any change specified under Rule 1017 should not be permitted until such time as the CMA has been approved by FINRA. See Notice 18-23 (seeking comment on a proposal to the MAP rules that would, among other things, delete Rule 1017(c) in its entirety).

member may effect the change prior to the conclusion of FINRA's review of the CMA, FINRA may place interim restrictions on the member based upon the standards in Rule 1014 pending a final determination.²⁶ Under Rule 1017(c)(2), a member may file a CMA to remove or modify a membership agreement restriction at any time, but any such existing restriction shall remain in effect during the pendency of the proceeding. Finally, Rule 1017(c)(3) permits a member to file a CMA for approval of a material change in business operations at any time, but the member may not effect such change until the conclusion of the proceeding, unless FINRA and the member otherwise agree.

FINRA is proposing to amend Rule 1017(c) by adding new subparagraph (4) to provide that, notwithstanding the existing timing and conditions for effecting a change as described under Rule 1017(c)(1) through (3), where a member or an associated person has an unpaid arbitration award or unpaid settlement related to an arbitration at the time of filing a CMA, the member may not effect such change until demonstrating that it has the ability to satisfy such obligations in accordance with Rule 1014 and proposed IM-1014-1, as discussed above, and obtaining approval of the CMA.²⁷

²⁶ Interim restrictions are meant for the protection of investors and ordinarily would not prevent a transaction from moving forward. However, there may be some instances where the protection of investors will require that interim restrictions will prohibit or delay a transaction from closing. See Notice to Members 02-54 (August 2002).

²⁷ FINRA expects to make conforming changes to Forms NMA and CMA. FINRA notes that where an applicant is seeking FINRA's approval of a CMA to transfer assets with no corresponding transfer of associated liabilities, and there is an unpaid arbitration award, Form CMA currently requires the applicant to provide proof that the award was satisfied in full and in the case of an unpaid award, the applicant must pay the award in full before closing the transaction. See Form CMA, Standard 3, Question 2.a. (within the section titled, "Provide supporting documents").

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval of the proposed rule change.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,²⁸ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will allow FINRA to better take into account the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms, in connection with the NMA or CMA processes. FINRA believes that the proposed amendments will strengthen FINRA's ability to consider the adequacy of the supervision of individuals with pending arbitration claims and, therefore, who may have a history of noncompliance, and how a member firm will address the payment of an existing or potential arbitration claim should it go to award or result in a settlement. In addition, FINRA believes that the proposed amendments will give FINRA the authority to carefully assess, at an earlier stage of a member's contemplated business transaction or expansion, the relevant facts and circumstances surrounding pending arbitration claims.

²⁸ 15 U.S.C. 78o-3(b)(6).

Among other things, the proposed amendments will help address concerns regarding situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the adequacy of the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

A. Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet its regulatory objectives.

B. Regulatory Need

The MAP rules are intended to promote investor protection by applying uniform standards for admission and by reviewing changes to ownership, control, or business operations. While the current MAP rules give FINRA the ability to review pending arbitration claims, unpaid arbitration awards, and unpaid arbitration settlements in

determining whether to grant or deny an application, the proposed amendments would strengthen the MAP rules when claimants may need additional protections. Currently, claimants may be at risk if the individuals or firms responsible actively maneuver to avoid payment of awards (e.g., by joining or transferring assets to a different member firm).²⁹

C. Economic Baseline

The economic baseline for the proposed amendments is the current set of MAP rules and related guidance, and FINRA practices. The current rules include unpaid arbitration awards and settlements, but not pending arbitration claims, in the presumption of denial; the definition of a material change in business operations and the availability of a safe harbor for some business expansions; and the requirements for a member firm to file a CMA relating to asset acquisitions or transfers. The proposed amendments would affect prospective and existing member firms, and associated persons. The proposed amendments would also affect the current and future customers of prospective and existing member firms including those that have brought or may bring claims against member firms and associated persons.

²⁹ FINRA identified five customer arbitration claims that (a) closed between 2015 and 2017 and resulted in an award that went unpaid and (b) the associated persons responsible for the unpaid awards transitioned from one member firm to another while the claim was pending. The total amount of unpaid awards relating to the five customer claims was \$2.5 million. Three of the four associated persons relating to the unpaid awards were suspended or barred from the industry by FINRA. The fourth associated person declared bankruptcy but was no longer registered as a broker.

1. NMAs

In order to get a better understanding of the potential scope of the proposed amendments, FINRA reviewed 317 NMAs that it received from January 2015 through December 2017.³⁰ Among these applications, FINRA identified few new member applicants or their associated persons as having a pending arbitration claim at the time of FINRA's receipt of the NMA.³¹ Among the 317 NMAs, FINRA identified 13 NMAs (or four percent) where the new member applicant or its associated persons had a pending arbitration claim at the time of receipt of the application.³² Under the proposed amendments, FINRA could have presumptively denied these NMAs. FINRA also

³⁰ These NMAs were either approved in whole or with restrictions, denied, withdrawn, rejected, or lapsed.

³¹ The statistics on pending arbitration claims in this discussion relate only to claims in the arbitration forum administered by FINRA. The proposed amendments also would apply to claims in other venues. Information describing claims in other arbitration forums, however, is generally not available. FINRA's estimates of the number of firms that may be impacted by the proposed amendments are therefore likely lower than the true number. Further, FINRA is not able to estimate the total amount of monetary compensation claimants received from the arbitration cases discussed because information that identifies the settlement amount relating to a particular case is not available.

³² Among these 13 NMAs, there were seven pending customer arbitration claims filed against associated persons prior to FINRA's receipt of the application, and among these seven customer claims, three resulted in a settlement, one closed by hearing, and three were withdrawn. The total amount of compensatory damages sought by customers was over \$1.9 million (including the claims that resulted in a settlement). In the case closed by hearing, the customer was awarded compensatory damages of approximately \$76,000.

identified one NMA as relating to a customer claim that resulted in an award that went unpaid.³³

2. CMAs

FINRA also reviewed 1,051 CMAs that it received from January 2015 through December 2017.³⁴ This sample of CMAs only provides a potential indication of the member firms that could be impacted by the proposed amendments. A member firm may elect to proceed with effecting a change in business operations because it independently determines, without seeking guidance from FINRA through a materiality consultation, that such contemplated change falls within the safe harbor parameters or that such transaction does not represent a material change in business operations that would require a CMA. In these cases, a member firm is not obligated to proactively notify FINRA of the independent determination.³⁵ Thus, the number of member firms that potentially may be subject to the proposed amendments, including those that effect an increase in the number of associated persons involved in sales under the safe harbor or effect some other change in business operations that is, in the member firm's view, not material, may be different than the member firms that filed a CMA and are part of the sample.

³³ The firm withdrew the NMA. The customer arbitration claim resulted in an award prior to FINRA's receipt of the NMA. The amount of the damages that went unpaid is approximately \$250,000. The associated person who failed to pay the awarded damages has been suspended by FINRA.

³⁴ The CMAs were either approved in whole or with restrictions, denied, withdrawn, rejected, or lapsed.

³⁵ Under IM-1011-1, a firm would remain obligated to keep records of increases in personnel, offices, and markets made to determine whether they are within the safe harbor.

Of the 1,051 CMAs, 65 involved the hiring of associated persons. FINRA identified four of the 65 CMAs where the associated person being hired had a pending customer arbitration claim. Under the proposed amendments, the pending customer arbitration claims for all four of the CMAs would have been considered covered pending arbitration claims.³⁶ An additional 154 of the 1,051 CMAs were identified as relating to asset acquisitions (17) or transfers (137). FINRA identified 44 CMAs (29 percent of 154) where the transferring member or an associated person of the transferring member had a pending customer arbitration claim at the time of the filing.³⁷ Under the proposed amendments, the pending customer arbitration claims for 25 of the 44 CMAs would have

³⁶ From January 2015 to December 2017, among all member firms, 480 associated persons were hired with a pending arbitration claim at the time of hiring. These pending claims would have been considered “covered pending arbitration claims” under the proposed amendments for 186 of the associated persons (39 percent of 480) and would not have been considered covered pending arbitration claims for the remaining 294 associated persons (or 61 percent of 480). FINRA does not know how many of the associated persons were involved in sales. This estimate, therefore, provides an upper bound for the number of materiality consultations member firms would have been required to seek under the proposed amendments. See supra note 29 for a discussion of the unpaid awards relating to associated persons who transitioned from one member firm to another while the claim was pending.

³⁷ Thirty-four of the CMAs were approved, and 10 were withdrawn or not substantially completed and therefore rejected. There were 300 pending customer arbitration claims as of the receipt of the CMAs. The pending claims included claims made against the applicant or its associated persons. Of the 300 pending arbitration claims, 184 resulted in a settlement, 48 closed by hearing or on the papers, 52 closed by other means including 32 that were withdrawn, and 16 remained open. Customers requested a total of \$311.3 million in compensatory relief (including the claims that resulted in a settlement); and in the claims resulting in an arbitration award in favor of customers, customers were awarded approximately \$9.9 million in compensatory damages.

been considered covered pending arbitration claims. FINRA also identified five of the CMAs as relating to six customer claims that resulted in an award that went unpaid.³⁸

D. Economic Impact

FINRA believes that the proposed amendments to the MAP rules would enhance the review of applications by strengthening the MAP rules in relation to pending arbitration claims and unpaid arbitration awards and settlements.

The proposed amendments would benefit claimants and potential claimants by decreasing the risk that firms are avoiding the payment of awards or settlements by transferring their assets, including capital and customer accounts, to another firm. Firms can shift their assets to another firm by starting a new firm, or by selling or transferring assets to an existing firm. A decrease in the ability of firms to avoid satisfying their arbitration awards or settlements in this manner may result in a higher likelihood that they are paid in full in accordance with their terms. The proposed amendments could also benefit the current and future customers of new member applicants and member firms that seek a materiality consultation by increasing FINRA's ability to assess, among other things, the adequacy of the supervisory plan the member firm has in place for the associated persons who may have a history of non-compliance.

³⁸ Three of the CMAs were withdrawn, and two were approved. Three of the six customer claims were closed prior to the filing of the CMA, whereas the other three were still pending. For the two approved CMAs, the cases which resulted in an unpaid customer award closed at least one year after the decision was served. Five of the six customer awards went unpaid by a member firm, whereas the other went unpaid by an associated person. The total amount of damages that went unpaid is approximately \$3.4 million. The member firms have either cancelled their membership or were expelled by FINRA, and the associated person has been suspended by FINRA.

1. Rebuttable Presumption to Deny an NMA

Proposed Rule 1014(b)(1) would specify that a presumption of denial would exist if a new member applicant or its associated persons are subject to a pending arbitration claim. By establishing a presumption of denial, the proposed rule change would shift the burden to the new member applicant to demonstrate how pending arbitration claims would be paid if they go to an award. Proposed Rule 1014(b)(1) would impose both direct and indirect costs on new member applicants.

New member applicants with pending arbitration claims would incur direct costs. The costs include the time and expense of firm staff and outside experts to demonstrate the ability to satisfy the claims. The costs would be in addition to the costs new member applicants incur to demonstrate their ability to meet the 14 standards for admission under Rule 1014(a). In addition, new member applicants and their associated persons may incur the opportunity costs associated with setting aside funds that may otherwise be used for new business. A new member applicant may incur more opportunity costs than is necessary if it sets aside more capital than the actual amount of the award.

New member applicants may also incur indirect costs if the rebuttal process delays the applicant's ability to begin earning revenues or otherwise negatively impacts the business. The magnitude of these costs is related to the ability of the new member applicant and FINRA to adequately gauge the likelihood and size of an award or settlement. However, as noted above, FINRA estimates that few associated persons related to new member applicants will have pending arbitration claims at the time of the

filing.³⁹ The majority of new member applicants are therefore unlikely to be affected by the proposed amendments.

2. Materiality Consultations

The proposed amendments would also mandate a member firm to seek a materiality consultation for specified business changes—hiring an associated person involved in sales, or any direct or indirect acquisition or transfer of assets—where the member firm or associated person, as applicable, has an unpaid arbitration award or settlement related to an arbitration, or a defined covered pending arbitration claim, unless the member firm is otherwise required to file a CMA. FINRA believes that an unpaid arbitration award or settlement poses a severe risk to claimants that would warrant a materiality consultation under any circumstances. FINRA also believes that the proposed definition of a covered pending arbitration claim, which focuses on investment-related, consumer-initiated claims (individually or, if there is more than one claim, in the aggregate) that exceed the excess net capital of the transferring or hiring member firm (as applicable), represents an objective benchmark that would provide FINRA the opportunity to review the specified business changes to assess whether they may adversely affect former, current or future customers in a material way.

For a member firm transferring assets, FINRA believes that the relative size of covered pending arbitration claims may signal that the firm may be attempting to avoid the payment of awards or settlements by transferring assets, including capital and customer accounts, to another firm. For member firms adding one or more associated persons involved in sales, the relative size of the covered pending arbitration claims may

³⁹ See supra note 32 and accompanying text.

foreshadow future potential misconduct by such individuals that could result in additional arbitration claims.⁴⁰ Under such circumstances, if the customer names the hiring member firm in any such additional arbitration claims, FINRA is concerned whether a hiring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims, including a customer award or settlement.

Member firms that would be required to seek a materiality consultation would incur direct costs. Similar to the additional direct costs associated with NMAs, the costs may include the time and expense of firm staff and outside experts to provide information and documents that demonstrate the ability to satisfy the unpaid awards or settlements, or covered pending arbitration claims. Member firms that would be required to seek a materiality consultation and their associated persons may also incur the opportunity costs associated with setting aside funds that may otherwise be used for new business.

Member firms that seek a materiality consultation may also incur costs relating to a delay in effecting the contemplated expansion or transaction. A delay may negatively impact the value of the expansion or transaction and may lead to a loss of business opportunities. Given the experience of FINRA, this delay is anticipated to be small as the time for a materiality consultation has recently averaged 12 days; this time period, however, may lengthen depending on the complexity of the contemplated expansion or transaction.

Business activities that decrease the amount of excess net capital available may increase the likelihood that member firms would be required to seek a materiality consultation. In response, member firms may constrain business activities to maintain a

⁴⁰ See supra note 21.

level of excess net capital in order to demonstrate their ability to pay pending arbitration claims (or pay unpaid awards or settlements) in the event a materiality consultation is required. As described in the Economic Baseline, a number of CMAs relate to the hiring of an associated person with a covered pending arbitration claim or the acquisition or transfer of a member's assets where the transferring member or an associated person of the transferring member had a covered pending arbitration claim.⁴¹

FINRA may require member firms that seek a materiality consultation to file a CMA. FINRA would then consider whether the member firm meets each of the 14 standards under Rule 1014. These members would therefore incur costs in addition to the costs to seek a materiality consultation. This includes the fees associated with a CMA, time of firm staff, and submission of additional documentation. The filing of a CMA would also cause an additional delay to effectuate the contemplated expansion or transaction. This may cause member firms, associated persons and the customers of member firms to lose the benefits associated with the business opportunities. A determination that a CMA must be filed, however, would indicate that the risks to claimants, and therefore the potential benefits of a closer examination, are high. An

⁴¹ See the discussion in the Economic Baseline. Customers may have an incentive to file an arbitration claim for the sole purpose of disrupting a contemplated transaction. This incentive could increase the number of member firms that would be required to seek a materiality consultation and potentially file a CMA and incur the associated costs. FINRA has no reasonable basis on which to predict the frequency of this occurring if the proposed amendments are adopted. SIFMA suggested that the definition of a covered pending arbitration claim should be limited to claims filed prior to the public announcement of the contemplated transaction. FINRA would review customer claims as part of a materiality consultation and consider the facts and circumstances of the case as well as its timing. The potential disruption to contemplated transactions from these claims, therefore, is expected to be limited.

examination may include the regulatory history of a member to determine whether it is able to satisfy any pending arbitration claims should they go to award, as well as the adequacy of any supervisory plan for an individual with a pending arbitration claim that the firm is contemplating hiring.⁴² If the actual risks to claimants are low (e.g., the amount settled or eventually awarded is a small percentage of the amount claimed), then the greater costs to member firms to file a CMA would not also result in a similar increase in customer protections.

The proposed amendments are not designed to impose disproportionate costs based on firm size. Instead, the costs the proposed amendments would impose are dependent on the compensatory loss amounts of pending customer arbitration claims, or the presence of an unpaid arbitration award or an unpaid settlement related to an arbitration, and the financial capacity of the member firm. In addition, the costs member firms may incur to seek a materiality consultation (and potentially file a CMA) as a result of the proposed amendments, including any burden on competition, are borne at their discretion, in their decision to hire or acquire or transfer the member's assets. Member firms would incur the additional costs if they choose to hire an associated person involved in sales who has a covered pending arbitration claim, or where the transferring member or an associated person of the transferring member has a covered pending arbitration claim.

⁴² Individuals with pending arbitration claims may engage in future potential misconduct that could result in additional arbitration claims, including claims that name the hiring member. See supra note 21.

The member firms that would be required to seek a materiality consultation (and potentially file a CMA) as a result of the proposed amendments may range in size.⁴³ For example, as described in the Economic Baseline, FINRA identified four member firms that filed a CMA relating to the hiring of an associated person with a covered pending arbitration claim. All four member firms were small.⁴⁴ Similarly, FINRA identified 25 CMAs as relating to the asset acquisitions or transfers of 26 member firms where the transferring members had covered pending customer arbitration claims. Among the 26 transferring members, 13 members were small, nine members were mid-size, and four members were large.⁴⁵

An associated person, as a respondent to a pending claim, may also incur costs as a result of the proposed amendments. New member applicants and existing member firms may be less likely to hire associated persons with a pending claim in order to avoid the costs associated with the proposed amendments. An associated person, as a

⁴³ The definition of firm size is based on Article I of the FINRA By-Laws. A firm is defined as “small” if it has at least one and no more than 150 registered persons, “mid-size” if it has at least 151 and no more than 499 registered persons, and “large” if it has 500 or more registered persons.

⁴⁴ During the sample period and among all member firms, FINRA also identified 186 associated persons who were hired with a covered pending arbitration claim at the time of the hiring. See supra note 36. The percentage of small member firms that hired the 186 associated persons (90 percent) is similar to the proportion of small member firms industry-wide as of year-end 2017 (90 percent). See 2018 FINRA Industry Snapshot, https://www.finra.org/sites/default/files/2018_finra_industry_snapshot.pdf.

⁴⁵ As a result of the safe harbor provision, the member firms that would have been subject to the proposed amendments during the sample period may be different than the member firms that filed a CMA. The number and composition of member firms that would have been required to file a materiality consultation under the proposed rule change is therefore not known.

respondent to a pending claim, may therefore experience fewer career opportunities within the brokerage industry.

3. Other Proposed Amendments

Two other proposed amendments would have additional economic effects. First, the proposed amendments would require applicants to provide prompt notification of a pending arbitration claim that is filed, awarded, settled, or becomes unpaid before a decision on the application is served. These notifications would further improve the ability of FINRA to oversee and review the pending arbitrations of applicants to ensure that arbitration awards and settlements are paid in full in accordance with their terms. Applicants that provide notification would incur additional costs including the time of firm staff and the expense to submit additional documentation.

A number of the applicants for new membership or member firms that filed a CMA during the sample period would have been required to promptly notify FINRA of changes to pending arbitration claims. FINRA identified 13 of the 317 NMAs (or four percent) from January 2015 through December 2017 as having changes in the status of a pending arbitration claim involving the applicant or its associated persons before a decision constituting final action was served on the applicant (or the application was

otherwise withdrawn),⁴⁶ and 156 of the 1,051 CMAs (or 15 percent) as also having similar changes to the status of a pending arbitration claim.⁴⁷

Second, the proposed amendments would clarify the manner in which an applicant may demonstrate its ability to satisfy pending arbitration claims or unpaid arbitration awards or settlements. The clarification would improve the efficiency of the MAP process by increasing the ability of applicants to anticipate the information necessary to demonstrate their ability to satisfy outstanding obligations, and reduce the need for applicants to submit additional information after the initial filing.

E. Alternatives Considered

FINRA considered a range of suggestions in developing the proposed amendments as set forth in Regulatory Notice 18-06. The proposed amendments reflect

⁴⁶ The arbitration claims consisted of 11 customer claims and one intra-industry claim. Among the 11 customer claims, three resulted in a settlement, three closed by hearing, four were withdrawn, and one remained open. The total amount of compensatory damages sought by customers was \$5.8 million (including the cases closed by settlement). In the cases closed by hearing, the customers were awarded compensatory damages of approximately \$146,000. None of the awarded damages went unpaid.

⁴⁷ The arbitration claims consisted of 913 customer claims of which 497 resulted in a settlement, 184 closed by hearing or on the papers, 174 were closed by other means including 95 that were withdrawn, and 58 remained open. The total amount of compensatory damages sought by customers was \$856.0 million. In the cases closed by hearing or on the papers, the customer was awarded compensatory damages of approximately \$20.5 million. Two of the customer cases resulted in an award that went unpaid. One of the cases is referred to above in the discussion in the Economic Baseline. The other case relates to two associated persons who left the applicant before a decision constituting final action was served. The amount of the awarded damages that went unpaid is approximately \$70,000. The associated persons who failed to pay the awarded damages have been suspended or barred by FINRA. The CMA was approved with restrictions. For applicants with changes to a pending arbitration claim before a decision constituting final action was served (or the application was otherwise withdrawn), the median number of changes is two.

the changes that FINRA believes at this time to be the most appropriate for the reasons discussed herein.

An alternative to the proposed amendments includes a rebuttable presumption of denial for a CMA if the applicant or its associated persons are the subject of a pending arbitration claim. This alternative would increase the costs to member firms that file a CMA, including member firms that initially sought a materiality consultation under the proposed amendments. Member firms may incur costs to demonstrate their ability to satisfy the claims. This includes the opportunity costs associated with setting aside funds that may otherwise be used for other business opportunities.

A presumption of denial would reduce the risks associated with firms avoiding the payment of claims should they go to award. As part of a materiality consultation, however, FINRA would examine the regulatory history of a member firm to determine whether it is able to satisfy pending arbitration claims should they go to award, as well as the adequacy of any supervisory plan for an individual with a pending arbitration claim that the firm is contemplating hiring.⁴⁸ The additional protections from extending a presumption of denial for pending arbitration claims to CMAs, therefore, may not justify the additional costs to member firms.⁴⁹

⁴⁸ See supra note 21.

⁴⁹ Several commenters suggested alternatives to the proposed amendments that would require a presumption of denial when pending arbitration claims exceed certain thresholds. See GSU, PIABA, and UNLV. Although member firms with pending arbitration claims that exceed the thresholds may be at higher risk of nonpayment, FINRA believes that it would still be able to adequately assess these firms' ability to pay the claims should they go to award without the presumption of denial.

Other alternatives to the proposed amendments include expanding or narrowing the conditions for member firms to seek a materiality consultation or file a CMA.⁵⁰ Expanding (narrowing) the requirements for member firms to seek a materiality consultation or to file a CMA may decrease (increase) the ability of firms to avoid satisfying their outstanding obligations by transferring their assets to another firm. By expanding (narrowing) the requirements, however, additional (fewer) member firms would incur the associated costs. FINRA believes that the requirements under the proposed amendments for member firms to seek a materiality consultation provide for the additional investor protections but minimize the costs when the risk of members not satisfying their outstanding obligations is low.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 18-06 (February 2018) ("Notice"). FINRA received nine comment letters in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters

⁵⁰ For example, commenters suggested expanding the requirement to seek materiality consultations for business expansions. Suggestions include omitting the qualifying term "involved in sales" (NASAA) and expanding to principals, control persons, or officers (GSU). Another commenter, however, suggested excluding business expansions from the requirement to seek a materiality consultation if the expansion is in connection with another corporate event such as a merger, acquisition, or asset transfer (FSI). Commenters also suggested narrowing the requirement to seek materiality consultations for asset acquisitions or transfers. Suggestions include permitting smaller acquisitions or transfers to proceed without a materiality consultation (GSU) or excluding covered pending arbitration claims altogether (FSI).

received in response to the Notice is attached as Exhibit 2b.⁵¹ Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.

Eight commenters supported the proposal as set forth in the Notice either absolutely or with some qualifications.⁵² One commenter raised concerns outside the scope of the Notice.⁵³ A summary of the comments and FINRA's responses are discussed below.⁵⁴

A. Rebuttable Presumption to Deny an NMA

FINRA is proposing to amend Standard 3 to create a rebuttable presumption to deny an NMA where the applicant or its associated person is subject to a pending arbitration claim. Three commenters expressly supported the proposed amendment.⁵⁵ No commenters opposed this proposed amendment.

B. Rebuttable Presumption to Deny a CMA

In the Notice, FINRA requested comment on whether the presumption of denial in connection with a pending arbitration claim should be applied to a CMA as well. Six commenters responded with three expressing opposition to this approach.⁵⁶ In general, these three commenters noted that a CMA already requires an applicant to provide information pertaining to pending arbitration claims and how an applicant will handle the

⁵¹ All references to commenters are to the comment letters as listed in Exhibit 2b.

⁵² See Colorado, Cornell, GSU, FSI, NASAA, PIABA, SIFMA, and UNLV.

⁵³ See IBN.

⁵⁴ Comments that speak to the economic impacts of the proposed rule change are addressed in Item 4 above.

⁵⁵ See SIFMA, Cornell, and GSU.

⁵⁶ See Cornell, NASAA, and SIFMA.

arbitrations and the awards that may result. NASAA further expressed the belief that creating a presumption to deny a CMA may disincentivize a firm from taking on potential liability through an acquisition, which could result in more unpaid arbitration awards.

The other three commenters supported extending the presumption to deny an application with pending arbitration claims to a CMA but recommended various conditions on when the presumption should apply.⁵⁷

GSU recommended that the presumption to deny a CMA should be triggered when the applicant or its associated person has a pending arbitration claim or unpaid settlement for an amount exceeding \$15,000, contending that such dollar limit would provide some balance to the proposed rule change by tying the presumption to CMAs with claims that are required to be reported to FINRA. PIABA recommended that two preconditions for the presumption to deny a CMA should apply—one for the associated person and the other for the member firm. With respect to the associated person, PIABA stated that the presumption to deny a CMA should be triggered when more than five claims are pending against any control person, principal, registered representative, or other associated person of the member, as such number of claims may signal problems within the member and may be an indicator of potential future investor harm. If the member can overcome the presumptive denial of a CMA, and it still desires to hire or continue the employment of individuals with five or more pending arbitration claims, PIABA recommended that those individuals with such claims pending against them should be subject to heightened supervision and not be permitted to serve in a supervisory capacity until all pending arbitration claims against them have in fact been resolved, and

⁵⁷ See GSU, PIABA, and UNLV.

the corresponding awards or settlements, if any, have been paid in full. PIABA further stated that following the conclusion of such proceedings, the decision related to an individual's supervision or supervisory capacity should rest with the member, and recommended that FINRA's rules should be modified to ensure that such individual is not permitted to move from one firm to another without regard to problems that occurred at the former firm.

As for the member firm, PIABA stated that the presumption should be applied based upon the aggregate amount of damages pleaded in all pending arbitration claims, taking the nature and quality of those claims into account, compared to the value of cash assets and insurance held by the member firm. If this ratio indicates a substantial risk of insolvency or presents the inability to pay all pending legitimate claims in full, then the presumption should apply. PIABA further stated that FINRA should be permitted to look beyond the damages described in a statement of claim, and discuss the issues related to damages directly with investors, their representative and FINRA members and their counsel, in confidential sessions, prior to applying a presumptive CMA denial. UNLV recommended that the presumption apply to a CMA where there is a covered pending arbitration claim.

The existence of a specified regulatory history currently enumerated under Standard 3 that triggers the presumption to deny an application is intended to encourage compliance with unpaid arbitration awards, other unpaid adjudicated customer awards and unpaid arbitration settlements, and their existence raise the question of an applicant's capacity to comply with applicable securities laws and regulations, and with applicable

FINRA rules.⁵⁸ Standard 3, as proposed, would not diminish FINRA's ability to assess whether the applicant and its associated persons are able to meet this standard. FINRA would continue to consider an applicant's or its associated person's pending arbitration claims, among other regulatory history, in determining whether an applicant for continuing membership is "capable of complying with" the federal securities laws and FINRA rules. Accordingly, while FINRA appreciates the commenters' recommendations, FINRA has determined, at this time, not to apply the presumption of denial for pending arbitration claims to a CMA.

C. Evidence of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements, or Pending Arbitration Claims

1. Types of Evidence

Proposed IM-1014-1 would provide that an applicant may demonstrate, in a variety of ways, that it has the financial resources to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or a pending arbitration claim. Some examples include an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer.

With the exception of SIFMA, none of the commenters expressed views on the types of documentation an applicant may present to evidence the ability to satisfy an award, settlement or claim. SIFMA expressed concern about proposed IM-1014-1

⁵⁸ See Rule 1014(a)(3)(C) (providing, in part, that a presumption of denial applies if the applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant's net capital, and any other member with respect to which these persons were a control person or a five percent lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements).

requiring an applicant to show proof of insurance coverage, asserting that having insurance coverage does not necessarily correspond to having the ability to pay the award, settlement or claim. FINRA notes that the supporting documentation listed in the proposed interpretive material are examples of what an applicant may produce to FINRA to evidence the ability to satisfy the award, settlement or claim, and is not intended to be an exhaustive list by which a member can show its financial resources.⁵⁹

2. Guarantee

In the Notice, FINRA requested comment on whether an applicant, if it designates a clearing deposit or the proceeds from an asset transfer for purposes of showing the ability to satisfy a pending arbitration claim, should be required to provide some form of guarantee that such funds will be used to satisfy the award, settlement or claim. Three commenters expressed their general support for a guarantee,⁶⁰ with two of these commenters making additional recommendations.⁶¹

Emphasizing the need to secure funds or to prevent them from being depleted for other purposes, PIABA recommended that applicants hold the funds in an escrow account with clear instructions to the third party escrow agent (unaffiliated with the member firm)

⁵⁹ FINRA notes that similar examples appear in other FINRA rules. See, e.g., Section 4(i)(3) of Schedule A to the FINRA By-Laws (describing the circumstances under which a CMA for an acquisition or transfer of 25 percent or more of the member's assets may qualify for a fee waiver where the applicant can demonstrate in the CMA the ability to satisfy in full any unpaid customer-related claim (e.g., sufficient capital or escrow funds, proof of adequate insurance for customer related claims)). Form CMA also includes various examples. See supra note 11.

⁶⁰ See NASAA, PIABA, and UNLV.

⁶¹ See NASAA and PIABA.

to disburse the funds under specified circumstances.⁶² PIABA also suggested strict penalties in the event of a breach of that guarantee, such as the immediate suspension of a member's broker-dealer license. NASAA noted that circumstances sometimes change during the pendency of a planned business transaction and that an applicant may need to reallocate the prior designated funds. To account for potentially changing business circumstances and given the fungibility of money, NASAA stated that an applicant should not be duty bound to satisfy an arbitration award or settlement from the funds they may have initially identified. Instead, FINRA's rules should allow an applicant the flexibility to amend its application and designate a different source of available funds to satisfy pending claims or unpaid arbitration awards or settlements if necessary.

In light of the comments received, FINRA has modified proposed IM-1014-1 to provide that to overcome the presumption to deny the application, the applicant must guarantee that any funds used to evidence the applicant's ability to satisfy any awards, settlements, or claims, will be used for that purpose. As proposed, IM-1014-1 would not preclude an applicant from designating a different source of funds to satisfy an award, settlement or claim, provided the source of funds is acceptable to FINRA. Moreover, Section 1(c) of Article IV of the FINRA By-Laws already requires an applicant to keep its application current by submitting supplementary amendments as necessary.⁶³ A change in source of available funds to satisfy pending arbitration claims or unpaid

⁶² PIABA's other recommendation was to have the guarantee secured by a lien in favor of FINRA or the investor.

⁶³ See Section 1(c) of Article IV of the FINRA By-Laws.

arbitration awards or settlements would require the application to be updated in accordance with the FINRA By-Laws.

3. Valuation of Claim Through Independent Legal Counsel

Proposed IM-1014-1 would also permit an applicant to provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable as to the value of the arbitration claim in an effort to lend support to the applicant's ability to demonstrate that it has the financial resources to satisfy the claim, award or settlement. Two commenters suggested that the proposed provision should not require that counsel be "independent."⁶⁴ FSI stated that a firm should be able to rely on the opinion of in-house counsel as such counsel would be more familiar with the firm and its risk profile, adding that obtaining an opinion from external legal counsel could be costly and would not increase the regulatory value of the opinion offered. NASAA stated that it did not believe that the expert opinion necessarily needed to be from an "independent" source and instead, FINRA should have the authority to assess the veracity and reasonableness of an offered expert opinion on a case-by-case basis and to require such qualifications and degree of independence from the applicant as FINRA reasonably believes warranted in each instance. In addition, NASAA recommended that proposed IM-1014-1 should compel an applicant to obtain a written opinion of a legal or financial expert to support the applicant's assertion that it can satisfy an unpaid award or settlement obligation it intends to assume, rather than giving the applicant the discretion to provide such opinion.

FINRA believes that it would be appropriate and consistent with current FINRA Rules to provide a member with the option to derive support for the valuation of an

⁶⁴ See FSI and NASAA.

arbitration claim through a legal opinion from an independent, reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claim.⁶⁵

D. Materiality Consultations

1. The Process

Proposed IM-1011-2 and proposed Rule 1017(a)(6) would require a member to seek a materiality consultation under specified circumstances. FSI, while not expressly opposed to the underlying concept of mandating materiality consultations, stated that the proposed rules do not set forth clear parameters around the process, such as the time in which FINRA must issue a decision and the remedy a member firm has if it does not agree with FINRA's decision on the materiality consultation. FINRA notes that the materiality consultation process is well established, and a description of the process and the information that should be included in a request for a materiality consultation, among other information, is detailed on FINRA.org.⁶⁶ In addition, FINRA notes that if this proposed rule change is approved by the Commission, FINRA will update the materiality consultation process as detailed on its website as necessary.

2. Mandatory Materiality Consultation for Business Expansion to Add One or More Associated Persons Involved in Sales with Covered Pending Arbitration Claims

As set forth in the Notice, proposed IM-1011-2 would require a member to seek a materiality consultation before effecting a business expansion that would involve adding

⁶⁵ See, e.g., Rule 2040 (Payments to Unregistered Persons) (providing in supplementary material that a member, if uncertain about whether an unregistered person may be required to be registered under SEA Section 15(a), can derive support from the member's determination by, among other things, a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area).

⁶⁶ See supra note 13 and accompanying text.

one or more associated persons involved in sales with a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration.⁶⁷ Thus, a member would not be permitted to effect the contemplated business expansion until FINRA determined whether or not a CMA would be required for such contemplated business expansion.

Four commenters expressed support for this proposed requirement,⁶⁸ with some commenters suggesting modifications. For example, NASAA recommended omitting the qualifying term “involved in sales” so that the proposed rule would apply to any associated person, irrespective of the nature of his or her employment at the member firm, who is subject to a claim, award or settlement, explaining that firms may assign an associated person with pending claims or unpaid awards to administrative, non-sales roles in order to circumvent a materiality consultation. GSU suggested that proposed IM-1011-2 should be expanded to apply to principals, control persons or officers as occasionally, associated persons from problematic firms may move on to become officers at larger firms.⁶⁹ If a materiality consultation results in the requirement to file a CMA,

⁶⁷ FINRA notes that the term, “associated person involved in sales” as used in proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) is derived from the safe harbor provision under IM-1011-1.

⁶⁸ See SIFMA, NASAA, GSU, and Cornell.

⁶⁹ FINRA notes that the proposed amendments relating to requiring a materiality consultation for asset acquisitions or transfers would apply to principals, control persons or officers with covered pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements moving between firms.

Cornell recommended that proposed IM-1011-2 should require the member to file the CMA within a specified timeframe (e.g., 30 days after FINRA's finding of materiality).⁷⁰

FSI raised a concern that proposed IM-1011-2 could require a member to undergo a materiality consultation to add a single registered person with a pending arbitration claim. FSI recommended that proposed IM-1011-2 should exclude such a business expansion when adding associated persons involved in sales to a member's roster if done in connection with another corporate event such as a merger, acquisition, asset transfer or some other business expansion. FSI also recommended that the proposed rule exclude pending arbitration claims, explaining that a member should not be potentially compelled to undergo an application review process so that FINRA can assess the member's decision to hire one registered person with a pending arbitration claim, particularly when the claim is unsubstantiated. FSI noted that the proposed provision would have a negative impact on a member's recruiting efforts by overreaching into a member's routine hiring decisions.

As noted above, proposed IM-1011-2 is intended to address situations in which a member wants to hire an associated person who engages in sales with the public and has a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration and, therefore, may have a history of noncompliance. In the Notice, proposed IM-1011-2 also included a description of the possible outcomes of FINRA's determination on a materiality consultation; that is, either a member firm would

⁷⁰ FINRA does not believe that it is necessary to require the applicant to file the CMA within a specified time period because if a CMA is required, the applicant would not be able to effect the transaction without FINRA's approval of the CMA and, therefore, FINRA believes the applicant would be incentivized to file the CMA for approval as soon as possible.

not be required to file a CMA in accordance with Rule 1017 and may effect the contemplated business expansion or the member must file a CMA in accordance with Rule 1017 and would not be permitted to effect the contemplated business expansion without FINRA's approval of the CMA.

For clarity, FINRA has modified the language in proposed IM-1011-2 in two ways. First, proposed IM-1011-2 expressly states that the safe harbor for business expansions in IM-1011-1 is not available if a member firm is seeking to add one or more associated persons involved in sales with a covered pending arbitration claim (as defined in proposed Rule 1011(c)(1)), unpaid arbitration award, or unpaid settlement related to an arbitration. Second, proposed IM-1011-2, as modified, directs member firms to proposed Rule 1017(a)(6)(B) under which the description of the possible outcomes of FINRA's determination on a materiality consultation now resides. Proposed IM-1011-2, as modified, and proposed Rule 1017(a)(6)(B) are intended to clarify that a member firm, before it considers hiring one or more associated persons involved in sales with a covered pending arbitration claim (as defined in proposed Rule 1011(c)(1)), unpaid arbitration award, or unpaid settlement related to an arbitration, must first seek a materiality consultation from FINRA.

Requiring a materiality consultation in this situation would give FINRA the opportunity to assess, among other things, the adequacy of any supervisory plan the member firm has in place for the individual, and to discuss with the member firm the potential impact on its finances if the member firm hires the individual and the individual engages in future potential misconduct while employed at the member firm that results in

an arbitration claim against the member firm. FINRA notes that, in general, materiality consultations are not lengthy processes, taking on average 12 days.

In addition, FINRA notes that with respect to pending arbitration claims, a materiality consultation would only be required if those claims individually or in the aggregate are substantial, i.e., exceed the hiring firm's excess net capital. As described above, mandating a materiality consultation where a member is seeking to increase the number of associated persons involved in sales with covered pending arbitration claims, unpaid arbitration awards or unpaid settlements is to provide FINRA the opportunity to assess the relevant facts and circumstances of hiring such individuals and the impact, if any, on the member's supervisory and compliance structure, among other considerations.

3. Mandatory Materiality Consultation for Any Acquisition or Transfer of Member's Assets (Proposed Rule 1017(a)(6)(A))

Proposed Rule 1017(a)(6)(A) would require a member to seek a materiality consultation before effecting any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration.⁷¹ The proposed rule would require a member to wait for FINRA's determination on whether or not a CMA would be required for the contemplated acquisition or transfer.

⁷¹ In the Notice, this provision previously appeared as proposed paragraph (a)(4) in Rule 1017. The proposed rule change would renumber this provision as paragraph (a)(6)(A) in Rule 1017.

Several commenters supported proposed Rule 1017(a)(6)(A) either unequivocally or with a minor qualification.⁷² GSU expressed its support for the proposed provision insofar as it would prevent a member from acquiring or transferring a large amount of assets without first undergoing a materiality consultation in situations involving covered pending arbitration claims, unpaid arbitration awards or settlements, but recommended that smaller acquisitions or transfers involving such claims, awards or settlements should be permitted to proceed without a materiality consultation or CMA. Specifically, GSU recommended that FINRA should set a threshold of 10 percent, explaining that this threshold would allow the “occasional transfer” of customer accounts from one firm to another, but not allow an associated person to move a “meaningful percentage of his accounts to another firm.”

FSI stated that proposed Rule 1017(a)(6)(A) should exclude covered pending arbitration claims, noting that asset transfers that do not require a CMA under the current MAP rules should not be required to undergo a materiality consultation solely because the member or its associated person has a pending arbitration claim. FSI stated that proposed Rule 1017(a)(6)(A) could be interpreted as requiring a member that transfers any asset, no matter how immaterial, to undergo a materiality consultation and then potentially, a CMA, where the member or any of its associated persons may be subject to unsubstantiated, pending, investor arbitration claims.

While FINRA appreciates the commenters’ recommendation and concerns, FINRA has determined not to modify the proposal. As noted above, FINRA believes that the definition of a covered pending arbitration claim is sufficiently narrowly tailored to

⁷² See, e.g., Cornell, GSU, NASAA, and SIFMA.

limit the extent to which a member would have to seek a materiality consultation, but would also capture those transactions that could result in investors not being paid should the claims go to award.

In the Notice, FINRA requested comment on whether proposed Rule 1017(a)(6)(A) should be limited to asset acquisitions or transfers involving a principal, control person or officer who has a covered pending arbitration claim, unpaid arbitration award, or unpaid arbitration settlement. Two commenters responded, opposing such limitation because it may provide an opportunity for circumvention.⁷³ NASAA stated that narrowing the scope of the proposed provision could allow a member to make staffing changes by temporarily shifting its principals, control persons or officers into administrative or other positions that fall outside the proposed provision. PIABA stated that a member's solvency may be jeopardized by an associated person who is not a principal, control person or officer, but who may be engaged in selling away activities or "running a large scheme" without the member's knowledge.

FINRA has determined not to limit proposed Rule 1017(a)(6)(A) to asset acquisitions or transfers involving principals, control persons or officers. FINRA believes that to help further address the issue of unpaid arbitration awards, the proposal should apply more broadly.

4. Definition of "Covered Pending Arbitration Claim"

The Notice defined the term "covered pending arbitration claim" for business expansions, and asset acquisitions and transfers as: (1) an investment-related, consumer-initiated claim filed against the associated person (for business expansions), or filed

⁷³ See NASAA and PIABA.

against the transferring member or its associated persons (for asset acquisitions and transfers) that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. Under both circumstances, the definition provided that such claim amount would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney's fees.

Two commenters discussed this definition.⁷⁴ FSI stated that the nexus between an associated person's pending arbitration claim and a firm's excess net capital is unclear as the firm at which the misconduct occurred would be the one to cover the claim, not the firm that is obligated to file the materiality consultation. NASAA recommended that the definition should expressly state that it includes all investment-related arbitration claims filed in any arbitration forum (e.g., FINRA arbitration forum, a private alternative dispute resolution forum) or judicial (state or federal) forum). In addition, NASAA stated that the "claim amount" was unclear as to its treatment of pending claims for which there may be joint liability between more than one person or for which an associated person reasonably expects to be indemnified, explaining that pending claims with joint liability should be assessed to each respondent maximally, as if no other person could be potentially liable.

In response to comments, FINRA has modified the definition to clarify that a covered pending arbitration claim would include those filed in any arbitration forum, and that a pending claim with joint liability would be assessed to each respondent, as if no other person could be potentially liable. In addition, FINRA emphasizes that the

⁷⁴ See FSI and NASAA.

definition would be applied only for purposes of determining whether a materiality consultation would be required or not. The term is not intended to speak to whether the member would be responsible for satisfying the covered pending arbitration claim.

In the Notice, FINRA requested comment on whether the definition of “covered pending arbitration claim” should be limited to claims filed prior to a specified time period or event such as a public announcement of the contemplated transaction. Two commenters addressed this question.⁷⁵ SIFMA stated that the definition should include only those pending arbitration claims filed prior to public announcement of the contemplated transaction. PIABA stated that the definition should be broad and not be limited to claims filed prior to a specific date, but if a date is specified, then FINRA should require that any funds received in consideration for the transaction be frozen or subject to a lien in favor of the investor, pending the resolution of all pending arbitration claims filed within a certain period following the transaction closing.

FINRA has determined not to limit the proposed definition to only those claims filed prior to a specified date. At this time, FINRA believes that the definition of a covered pending arbitration claim is sufficiently narrowly tailored without adding a time limitation relating to when the arbitration claims are filed.

E. Written Notification of Any Pending Arbitration Claim that is Filed, Awarded, Settled or Becomes Unpaid Before Final Action is Served on Applicant

FINRA is proposing to add a new provision to the application review process to require an applicant to provide prompt notification, in writing, of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before a decision constituting final

⁷⁵ See PIABA and SIFMA.

action of FINRA is served on the applicant. Two commenters expressed their views on proposed Rules 1013(c) and 1017(h).⁷⁶

Cornell noted that the proposed provisions would enhance FINRA's ability to monitor when pending arbitration claims are filed or when awards become unpaid during the application review process. NASAA recommended moving the language from proposed Rule 1013(c) to Rule 1013(a)(1)(H), which currently provides that an NMA must include documentation of disciplinary history and certain regulatory, civil, and criminal actions, arbitrations, and customer complaints for the applicant and its associated persons, unless such history has been reported to the Central Registration Depository (CRD®). At this time, FINRA intends to retain the language as a standalone provision under proposed Rule 1013(c) to maintain clear parity with the language appearing under proposed Rule 1017(h). However, FINRA will consider NASAA's recommendation in connection with its separate proposal to substantially restructure the MAP rules.⁷⁷

F. Other Comments

UNLV recommended that FINRA consider proposing a rule to protect investors when FINRA members try to convert themselves into another area of the securities industry while facing covered pending arbitration claims or outstanding unpaid arbitration awards. IBN expressed the view that "[a]rbitration has nothing to do with the law it is about feelings[.]" suggesting that there needs to be two sets of rulebooks, one for small firms and the other for large firms. While FINRA acknowledges the commenters'

⁷⁶ See Cornell and NASAA.

⁷⁷ See Notice 18-23.

concerns, their recommendations are beyond the scope of this proposed rulemaking and, therefore, FINRA has not addressed them here.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.⁷⁸

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

11. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Regulatory Notice 18-06 (February 2018).

Exhibit 2b. List of commenters in response to Regulatory Notice 18-06 (February 2018).

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15 U.S.C 78s(b)(2).

Exhibit 2c. Comment Letters received in response to Regulatory Notice 18-06
(February 2018).

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2019-030)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend the Membership Application Program (“MAP”) Rules to Address the Issue of Pending Arbitration Claims

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend the Membership Application Program (“MAP”) rules to help further address the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

accordance with their terms.³ Specifically, the proposed rule change would: (1) amend Rule 1014 (Department Decision) to: (a) create a rebuttable presumption that an application for new membership should be denied if the applicant or its associated persons are subject to a pending arbitration claim, and (b) permit an applicant to overcome a presumption of denial by demonstrating its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement or pending arbitration claim; (2) adopt a new requirement for a member, that is not otherwise required to submit an application for continuing membership for a specified change in ownership, control or business operations, including business expansion, to seek a materiality consultation if the member or its associated persons have a defined “covered pending arbitration claim,” unpaid arbitration award, or an unpaid arbitration settlement; (3) amend Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations) to require a member to demonstrate its ability to satisfy an unpaid arbitration award or unpaid settlement related to an arbitration before effecting the proposed change thereunder; (4) amend Rule 1013 (New Member Application and Interview) and Rule 1017 to require an applicant to provide prompt written notification of

³ Effective May 8, 2019, FINRA adopted the NASD Rule 1010 Series (Membership Proceedings), among other rules, in the consolidated FINRA rulebook, without substantive change. The MAP rules now reside under the FINRA Rule 1000 Series (Member Application and Associated Person Registration) as FINRA Rules 1011 through 1019. See Securities Exchange Act Release No. 85589 (April 10, 2019), 84 FR 15646 (April 16, 2019) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2019-009). For purposes of this filing, all references to the MAP rules are to the FINRA Rule 1000 Series. The proposed rule change would also update cross-references and make other non-substantive, technical changes, and make corresponding changes to the Forms NMA and CMA. FINRA is separately developing changes to the MAP rules in connection with the retrospective review of this rule set. See Regulatory Notice 18-23 (July 2018) (“Notice 18-23”) (requesting comment on a proposal regarding the MAP rules).

any pending arbitration claim that is filed, awarded, settled or becomes unpaid before a decision on an application constituting final action on FINRA is served on the applicant; and (5) make other non-substantive and technical changes in the specified MAP rules due to the proposed amendments.⁴

The text of the proposed rule change is available on FINRA's website at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background

The MAP rules govern the way in which FINRA reviews a new membership application ("NMA") and a continuing membership application ("CMA").⁵ These rules require an applicant to demonstrate its ability to comply with applicable securities laws

⁴ For example, the proposed rule change would require the renumbering of some paragraphs in Rules 1011 and 1014 and the updating of cross-references.

⁵ Unless otherwise specified, the term "application" refers to either an NMA (or Form NMA) or CMA (or Form CMA), depending on context.

and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. FINRA evaluates an applicant's financial, operational, supervisory and compliance systems to ensure that the applicant meets the standards set forth in the MAP rules. Among other factors, the MAP rules require FINRA to consider whether persons associated with an applicant have material disciplinary actions taken against them by industry authorities, customer complaints, adverse arbitrations, pending arbitration claims, unpaid arbitration awards, pending or unadjudicated matters, civil actions, remedial actions imposed or other industry-related matters that could pose a threat to public investors.⁶

FINRA is proposing to amend the MAP rules in several ways. First, FINRA is proposing to amend one standard for admission and the corresponding factors therein relating to the presumption to deny an application for new or continuing membership. Second, FINRA is proposing to clarify the various ways in which an applicant for new or continuing membership may demonstrate its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or a pending arbitration claim during the application review process, and to preclude an applicant from effecting any contemplated change in ownership, control or business operations until such demonstration is made and FINRA approves the application. Third, FINRA is proposing to mandate a member firm to seek a materiality consultation in two situations in which specified pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements are involved. Finally, FINRA is proposing to require an applicant for new or

⁶ See generally Rules 1014(a)(3) and 1014(a)(10).

continuing membership to notify FINRA of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before FINRA renders a decision on the application.

FINRA believes that these proposed amendments to select portions of the MAP rules would enable FINRA to take a stronger approach to addressing the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms, in connection with the application review process. In addition, the proposed amendments would enable FINRA to consider the adequacy of the supervision of individuals with pending arbitration claims. As described below, the proposed amendments are intended to address concerns regarding situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and concerns about the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

The proposed rule change would impact members that have elected to be treated as capital acquisition brokers (“CABs”) and are subject to CAB rules. CAB Rules 111 through 118 incorporate by reference several MAP rules, including Rules 1011, 1013,

1014 and 1017.⁷ The proposed amendments would make conforming changes to CAB Rules 111 through 118, as applicable.

Proposed Rule Change

A. Rule 1014(a)(3) – Compliance with Industry Rules, Regulations, and Laws

Rule 1014(a) sets forth 14 standards for admission FINRA must consider in determining whether to approve an application. Currently, Rule 1014(a)(3) (“Standard 3”) requires FINRA to determine whether an applicant for new or continuing membership and its associated persons “are capable of complying with” the federal securities laws, the rules and regulations thereunder, and FINRA rules. Standard 3 sets forth six factors that FINRA must consider in making that determination.⁸ One factor, set forth under Rule 1014(a)(3)(B), requires FINRA to consider whether an applicant’s or its associated person’s record reflects a sales practice event, a pending arbitration, or a pending private civil action. Another factor appears under Rule 1014(a)(3)(C) and requires FINRA to consider, among other regulatory history, whether an applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant’s net capital, and any other member with respect to which these persons were a controlling person or a five percent lender of its net capital, is subject to unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.

⁷ See generally CAB Rule 111 (Membership Proceedings) (referencing Rule 1011), CAB Rule 112 (New Member Application and Interview) (referencing Rule 1013), CAB Rule 113 (Department Decision) (referencing Rule 1014), and CAB Rule 116 (Application for Approval of Change in Ownership, Control, or Business Operations) (referencing Rule 1017).

⁸ See Rule 1014(a)(3)(A) – (F).

Further, under Rule 1014(b)(1), where an applicant or its associated person is subject to certain regulatory history enumerated in Standard 3, “a presumption exists that the application should be denied.”⁹ Rule 1014(a)(3)(C) is one of several factors that trigger the presumption. The existence of such an event “[raises] a question of capacity to comply with the federal securities laws and the rules of [FINRA],” which should result in a rebuttable presumption to deny the application.¹⁰ However, the existence of a record of a pending arbitration, as set forth in Rule 1014(a)(3)(B), is currently not among the enumerated factors that trigger the presumption to deny an application.

1. Rebuttable Presumption to Deny an NMA (Proposed Rule 1014(b)(1))

FINRA is concerned about prospective applicants for new membership hiring principals and registered persons with pending arbitration claims without having to demonstrate how those claims would be paid if they go to award or result in a settlement. In addition, FINRA is concerned about a new member’s supervision of such individuals who may have a history of noncompliance. Accordingly, FINRA is proposing to amend Rule 1014(b)(1) to specify that a presumption of denial would exist if a new member applicant or its associated persons are the subject of a pending arbitration claim. Creating a presumption of denial in connection with a pending arbitration claim for an NMA would shift the burden to the new member applicant to demonstrate how its pending arbitration claims would be paid should they go to award or result in a settlement. In addition, the proposed amendment would spotlight the firm’s supervision of individuals

⁹ See also Rule 1017(h)(1), which pertains to CMAs and contains language identical to Rule 1014(b)(1). FINRA would make conforming changes to Rule 1017(h)(1).

¹⁰ See Notice to Members 04-10 (February 2004).

with pending arbitration claims. This presumption of denial for a pending arbitration claim would not apply to an existing member firm filing a CMA. Instead, consistent with today's practice, FINRA would continue to consider whether an applicant's or its associated persons are the subject of a pending arbitration claim in determining whether the applicant for continuing membership is "capable of complying with" applicable federal securities laws and FINRA rules.¹¹

2. Evidence of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements, or for New Member Applications, Pending Arbitration Claims
(Proposed IM-1014-1)

Proposed IM-1014-1 would provide that an applicant may demonstrate its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement or a pending arbitration claim, through an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms of documentation that FINRA may determine to be acceptable.¹² In addition, under the proposed interpretive material, an

¹¹ For purposes of determining whether an applicant meets Standard 3, FINRA's consideration of an applicant's or associated person's pending arbitration claim would be separated from Rule 1014(a)(3)(B) and moved to proposed Rule 1014(a)(3)(E).

¹² FINRA expects to make conforming amendments to Forms NMA and CMA. FINRA notes that Form CMA currently instructs the applicant to provide supporting documentation to show that such applicant is able to meet Standard 3. Specifically, if the CMA involves a transfer of assets with no corresponding transfer of associated liabilities, and there are pending arbitration claims or closed or settled arbitration matters, Form CMA requires the applicant to provide a written "Arbitration Plan," explaining, among other things, how the applicant will handle the arbitrations and awards that may result. An applicant may show that it has a reserve fund or will retain the proceeds of the asset transfer to satisfy the award. See Form CMA, Standard 3, Question 2.d. (within the section titled, "Provide supporting documents").

applicant may provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable in the area as to the value of the arbitration claims (which might be zero). Proposed IM-1014-1 would also provide that to overcome the presumption to deny the application, the applicant must guarantee that any funds used to evidence the applicant's ability to satisfy any awards, settlements, or claims will be used for that purpose. Any demonstration by an applicant of its ability to satisfy these outstanding obligations would be subject to a reasonableness assessment by FINRA.

B. Materiality Consultation

A member is required to file a CMA when it plans to undergo an event specified under Rule 1017 (e.g., acquisition or transfer of the member's assets, or a business expansion). In some cases, a change contemplated by a firm may not clearly fall within one of the events described in Rule 1017, and so before taking steps to prepare a CMA, a member has the option of seeking guidance, or a materiality consultation, from FINRA on whether such proposed event would require a CMA.¹³ The materiality consultation process is voluntary, and FINRA has published guidelines about this process on FINRA.org.¹⁴ A request for a materiality consultation, for which there is no fee, is a written request from a member firm for FINRA's determination on whether a

¹³ See IM-1011-1 (stating, "[f]or any expansion beyond these [safe harbor] limits, a member should contact its district office prior to implementing the change to determine whether the proposed expansion requires an application under Rule 1017."); see also Notice to Members 00-73 (October 2000) ("Notice 00-73") (stating, whether, based upon all the facts and circumstances, a change and expansion that falls outside of the safe harbor provisions are material, "[a] member may, but is not required to, contact the District Office to obtain guidance on this issue.").

¹⁴ See The Materiality Consultation Process for Continuing Membership Applications, <https://www.finra.org/rules-guidance/guidance/materiality-consultation-process>.

contemplated change in business operations or activities is material and would therefore require a CMA or whether the contemplated change can fit within the framework of the firm's current activities and structure without the need to file a CMA for FINRA's approval. The characterization of a contemplated change as material depends on an assessment of all the relevant facts and circumstances, including, among others, the nature of the contemplated change, the effect the contemplated change may have on the firm's capital, the qualifications and experience of the firm's personnel, and the degree to which the firm's existing financial, operational, supervisory and compliance systems can accommodate the contemplated change.¹⁵ Through this consultation, FINRA may communicate with the member to obtain further documents and information regarding the contemplated change and its anticipated impact on the member. Where FINRA determines that a contemplated change is material, FINRA will instruct the member to file a CMA if it intends to proceed with such change. Ultimately, the member is responsible for compliance with Rule 1017. If FINRA determines during the materiality consultation that the contemplated business change is material, then the member potentially could be subject to disciplinary action for failure to file a CMA under Rule 1017.¹⁶

To help further incentivize payment of arbitration awards and settlements, FINRA is proposing to preclude a member from effecting specified changes in ownership, control, or business operations, including business expansions involving a "covered pending arbitration claim" (as defined under proposed Rule 1011(c)), unpaid arbitration

¹⁵ See Notice 00-73.

¹⁶ See Notice 00-73.

award, or unpaid settlement related to an arbitration without first seeking a materiality consultation from FINRA as described below.¹⁷

1. Mandatory Materiality Consultation for Business Expansion to Add One or More Associated Persons Involved in Sales (Proposed IM-1011-2 and Proposed Rules 1011(c)(1) and 1017(a)(6)(B))

Rule 1017 specifies the changes in a member's ownership, control, or business operations that require a CMA and FINRA's approval.¹⁸ Among the events that require a CMA are a "material change in business operations," which is defined to include, but is not limited to: (1) removing or modifying a membership agreement restriction; (2) market

¹⁷ In a separate proposal, FINRA is proposing to mandate materiality consultations under other circumstances. See Notice 18-23 (seeking comment on a proposal to the MAP rules that would, among other things, codify the materiality consultation process and mandate a consultation under specified circumstances such as where an applicant seeks to engage in, for the first time, retail foreign currency exchange activities, variable life settlement sales to retail customers, options activities, or municipal securities activities).

¹⁸ See Rule 1017(a). The events that require a member to file a CMA for approval before effecting the proposed event are:

- a merger of the member with another member, unless both members are members of the New York Stock Exchange, Inc. ("NYSE") or the surviving entity will continue to be a member of the NYSE;
- a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE;
- direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the NYSE;
- a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or
- a material change in business operations as defined in Rule 1011(k).

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 15c3-1.¹⁹ In addition, a CMA is required for business expansions to increase the number of associated persons involved in sales, offices, or markets made that are a material change in business operations.²⁰ However, IM-1011-1 (Safe Harbor for Business Expansions) creates a safe harbor for incremental increases in these three categories of business expansions that will be presumed not to be material. Under this safe harbor provision, a member, subject to specified conditions and thresholds, may undergo such business expansions without filing a CMA.²¹

FINRA is concerned that the changes in a member firm's ownership, control, or business operations as currently described in Rule 1017, and the availability of the safe harbor for a business expansion to increase the number of associated persons involved in sales could allow a member to, for example, hire principals and registered representatives with substantial pending arbitration claims without giving consideration to how the firm would supervise such individual or the potential financial impact on the firm if the individual, while employed at the hiring firm, engages in additional potential misconduct that results in a customer arbitration. Accordingly, FINRA is proposing to add new interpretive material, IM-1011-2 (Business Expansions and Covered Pending Arbitration

¹⁹ See Rule 1011(k).

²⁰ See Rule 1017(b)(2)(C) (stating, "If the application requests approval of an increase in Associated Persons involved in sales, offices, or markets made, the application shall set forth the increases in such areas during the preceding 12 months.").

²¹ The safe harbor is unavailable to a member that has a membership agreement that contains a specific restriction as to one or more of the three areas of expansion or to a member that has a "disciplinary history" as defined in IM-1011-1.

Claims), to provide that if a member is contemplating to add one or more associated persons involved in sales and one or more of those associated persons has a “covered pending arbitration claim” (as that term is defined under proposed Rule 1011(c)(1)), an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, the member may not effect the contemplated business expansion unless the member complies with the requirements in proposed Rule 1017(a)(6)(B).

Proposed Rule 1017(a)(6)(B) would require a member firm to file a CMA for approval of the business expansion described in proposed IM-1011-2 unless the member first submits a written request to FINRA seeking a materiality consultation for the contemplated business expansion. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, FINRA would consider the written request and other information or documents the member provides to determine in the public interest and the protection of investors that either: (1) the member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated business expansion; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated business expansion unless FINRA approves the CMA.

A materiality consultation for this type of business expansion would allow FINRA to, among other things, assess the nature of the anticipated activities of the principals and registered representatives with arbitration claims, unpaid arbitration awards or arbitration settlements; the impact on the firm’s supervisory and compliance structure, personnel and finances; and any other impact on investor protection raised by

adding such individuals. If FINRA determines that a member must file a CMA, it would be subject to the application review process set forth under the MAP rules, including a review of any record of a pending arbitration claim and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.

For purposes of a business expansion to add one or more associated persons involved in sales, FINRA is proposing to define, under proposed Rule 1011(c)(1), a “covered pending arbitration claim” as: (1) an investment-related, consumer-initiated claim filed against the associated person in any arbitration forum that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the hiring member’s excess net capital. For purposes of this definition, the claim would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees, and shall be the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

FINRA believes that the definition of a “covered pending arbitration claim” for purposes of a business expansion as described in proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) is appropriate because if an individual has substantial arbitration claims, those claims could be an indication that the individual may engage in future potential

misconduct that could result in additional arbitration claims.²² Under such circumstances, if the customer names the hiring member firm in any such additional arbitration claims, FINRA is concerned whether a hiring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims including a customer award or settlement. By requiring a materiality consultation if a member firm is contemplating hiring an individual with a “covered pending arbitration claim,” FINRA would be able to assess, among other things, the adequacy of any supervisory plan the member firm has in place for the individual. In addition, the materiality consultation would allow FINRA to discuss with the member firm the potential impact on its finances if the member firm hires the individual and the individual engages in future potential misconduct while employed at the member firm that results in an arbitration claim against the member firm.

If the SEC approves the proposed rule change, FINRA will reassess the definition of “covered pending arbitration claim” for purposes of proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) after FINRA has had experience with the application of the rule to determine its impact and if the definition requires modification. In addition, FINRA invites comment on the proposed definition.

2. Mandatory Materiality Consultation for Any Acquisition or Transfer of Member’s Assets (Proposed Rule 1017(a)(6)(A) and Proposed Rule 1011(c)(2))

²² Recent academic studies provide evidence that the past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events. See Hammad Qureshi and Jonathan Sokobin, Do Investors Have Valuable Information About Brokers? (FINRA Office of the Chief Economist Working Paper, August 2015). See also Mark Egan, Gregor Matvos, and Amit Seru, The Market for Financial Adviser Misconduct, J. Pol. Econ. 127, No. 1 (February 2019): 233-295.

Rule 1017(a) requires a member to file a CMA for direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are NYSE members.²³

FINRA is concerned that this 25 percent threshold could permit a firm with pending arbitration claims that ultimately produce awards or settlements to avoid satisfying those awards or settlements by transferring assets without encumbrance and then closing down. Accordingly, FINRA is proposing to amend Rule 1017(a) to add new subparagraph (6)(A) to provide that if a member is contemplating any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim (as that term is defined under proposed Rule 1011(c)(2)), an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, the member may not effect the contemplated transaction unless the member first submits a written request to FINRA seeking a materiality consultation for the contemplated acquisition or transfer. Similar to proposed subparagraph (6)(B) in Rule 1017(a), the written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, FINRA would consider the written request and other information or documents provided by the member to determine in the public interest and the protection of investors that either: (1) the member is not required to file a CMA in accordance with

²³ See supra note 18.

Rule 1017 and may effect the contemplated acquisition or transfer; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated business acquisition or transfer unless FINRA approves the CMA.

During the course of this consultation, FINRA would consider, among other relevant facts and circumstances, whether the contemplated acquisition or transfer could result in non-payment of an arbitration claim should it go to award or result in a settlement, or the continued non-payment of such arbitration award or settlement. If FINRA determines that a member must file a CMA, it would be subject to the application review process set forth under the MAP rules, including a review of any record of a pending arbitration claim and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements.

For purposes of this proposed amendment, FINRA is proposing to define, under proposed Rule 1011(c)(2), a “covered pending arbitration claim” as: (1) an investment-related, consumer-initiated claim filed against the transferring member or its associated persons in any arbitration forum that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member’s excess net capital. For purposes of this definition, the claim amount would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees, and shall be the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

FINRA believes that the definition of a “covered pending arbitration claim” for purposes of a direct or indirect acquisition or transfer as described in proposed Rule 1017(a)(6)(A) is an appropriate measure because a member with substantial arbitration claims that is seeking to transfer its assets could be an indication of attempts to insulate itself from responsibility for the payment of pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements particularly when there is no corresponding transfer of liabilities. Under such circumstances, FINRA is concerned whether a transferring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims, including a customer award or settlement. By requiring a materiality consultation where a member firm is contemplating any direct or indirect acquisition or transfer involving a “covered pending arbitration claim,” FINRA would be able to assess, among other things, the adequacy of any plan the member firm has in place to satisfy pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements.

As noted above, FINRA invites comment on the proposed definition and if the SEC approves the proposed rule change, FINRA will reassess the definition of “covered pending arbitration claim” for purposes of proposed Rule 1017(a)(6)(A) after FINRA has had experience with the application of the rule to determine its impact and if the definition requires modification.

C. Other Proposed Amendments

1. Notification of Changes

Rule 1013(a) sets forth a detailed list of items that must be submitted with an NMA.²⁴ Rule 1017(b) sets forth the documents or information required to accompany a CMA, depending on the nature of the CMA. FINRA is proposing to amend Rules 1013 and 1017 to add new paragraphs that would appear as proposed Rules 1013(c) and 1017(h), to require an applicant to provide prompt notification, in writing, of any pending arbitration claim involving the applicant or its associated persons that is filed, awarded, settled or becomes unpaid before a decision on the application constituting final action of FINRA is served on the applicant.²⁵ Thus, any such unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or pending arbitration claim (for a new member applicant only) that comes to light in this manner during the application review process would result in FINRA being able to presumptively deny the application under the applicable factors set forth in Standard 3 and the ability of the applicant to overcome such presumption by demonstrating its ability to satisfy the obligation, as discussed above.

2. Timing and Conditions for Effecting Change Under Rule 1017

²⁴ The list of items set forth under Rule 1013(a) includes, among other things, documentation of disciplinary history and certain regulatory, civil, and criminal actions, arbitrations, and customer complaints for the applicant and its associated persons.

²⁵ FINRA expects to make conforming changes to Forms NMA and CMA, but notes that Form CMA currently requires the applicant seeking approval of an asset transfer to promptly update the information provided regarding arbitration claims. Such update should include new arbitrations filed, settlements made and awards granted against the applicant. See Form CMA, Standard 3, Question 4.b.

Rule 1017(c) describes the timing and conditions for effecting a change under Rule 1017.²⁶ Rule 1017(c)(1) requires a member to file a CMA for approval of a change in ownership or control at least 30 days before the change is expected to occur. While a member may effect the change prior to the conclusion of FINRA's review of the CMA, FINRA may place interim restrictions on the member based upon the standards in Rule 1014 pending a final determination.²⁷ Under Rule 1017(c)(2), a member may file a CMA to remove or modify a membership agreement restriction at any time, but any such existing restriction shall remain in effect during the pendency of the proceeding. Finally, Rule 1017(c)(3) permits a member to file a CMA for approval of a material change in business operations at any time, but the member may not effect such change until the conclusion of the proceeding, unless FINRA and the member otherwise agree.

FINRA is proposing to amend Rule 1017(c) by adding new subparagraph (4) to provide that, notwithstanding the existing timing and conditions for effecting a change as described under Rule 1017(c)(1) through (3), where a member or an associated person has an unpaid arbitration award or unpaid settlement related to an arbitration at the time of filing a CMA, the member may not effect such change until demonstrating that it has

²⁶ In a separate proposal, FINRA is considering whether to eliminate the timing considerations for filing a CMA depending upon the type of contemplated change or event to require that any change specified under Rule 1017 should not be permitted until such time as the CMA has been approved by FINRA. See Notice 18-23 (seeking comment on a proposal to the MAP rules that would, among other things, delete Rule 1017(c) in its entirety).

²⁷ Interim restrictions are meant for the protection of investors and ordinarily would not prevent a transaction from moving forward. However, there may be some instances where the protection of investors will require that interim restrictions will prohibit or delay a transaction from closing. See Notice to Members 02-54 (August 2002).

the ability to satisfy such obligations in accordance with Rule 1014 and proposed IM-1014-1, as discussed above, and obtaining approval of the CMA.²⁸

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval of the proposed rule change.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,²⁹ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will allow FINRA to better take into account the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms, in connection with the NMA or CMA processes. FINRA believes that the proposed amendments will strengthen FINRA's ability to consider the adequacy of the supervision of individuals with pending arbitration claims and, therefore, who may

²⁸ FINRA expects to make conforming changes to Forms NMA and CMA. FINRA notes that where an applicant is seeking FINRA's approval of a CMA to transfer assets with no corresponding transfer of associated liabilities, and there is an unpaid arbitration award, Form CMA currently requires the applicant to provide proof that the award was satisfied in full and in the case of an unpaid award, the applicant must pay the award in full before closing the transaction. See Form CMA, Standard 3, Question 2.a. (within the section titled, "Provide supporting documents").

²⁹ 15 U.S.C. 78o-3(b)(6).

have a history of noncompliance, and how a member firm will address the payment of an existing or potential arbitration claim should it go to award or result in a settlement. In addition, FINRA believes that the proposed amendments will give FINRA the authority to carefully assess, at an earlier stage of a member's contemplated business transaction or expansion, the relevant facts and circumstances surrounding pending arbitration claims.

Among other things, the proposed amendments will help address concerns regarding situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the adequacy of the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

1. Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet its regulatory objectives.

2. Regulatory Need

The MAP rules are intended to promote investor protection by applying uniform standards for admission and by reviewing changes to ownership, control, or business operations. While the current MAP rules give FINRA the ability to review pending arbitration claims, unpaid arbitration awards, and unpaid arbitration settlements in determining whether to grant or deny an application, the proposed amendments would strengthen the MAP rules when claimants may need additional protections. Currently, claimants may be at risk if the individuals or firms responsible actively maneuver to avoid payment of awards (e.g., by joining or transferring assets to a different member firm).³⁰

3. Economic Baseline

The economic baseline for the proposed amendments is the current set of MAP rules and related guidance, and FINRA practices. The current rules include unpaid arbitration awards and settlements, but not pending arbitration claims, in the presumption of denial; the definition of a material change in business operations and the availability of a safe harbor for some business expansions; and the requirements for a member firm to file a CMA relating to asset acquisitions or transfers. The proposed amendments would affect prospective and existing member firms, and associated persons. The proposed amendments would also affect the current and future customers of prospective and

³⁰ FINRA identified five customer arbitration claims that (a) closed between 2015 and 2017 and resulted in an award that went unpaid and (b) the associated persons responsible for the unpaid awards transitioned from one member firm to another while the claim was pending. The total amount of unpaid awards relating to the five customer claims was \$2.5 million. Three of the four associated persons relating to the unpaid awards were suspended or barred from the industry by FINRA. The fourth associated person declared bankruptcy but was no longer registered as a broker.

existing member firms including those that have brought or may bring claims against member firms and associated persons.

A. NMAs

In order to get a better understanding of the potential scope of the proposed amendments, FINRA reviewed 317 NMAs that it received from January 2015 through December 2017.³¹ Among these applications, FINRA identified few new member applicants or their associated persons as having a pending arbitration claim at the time of FINRA's receipt of the NMA.³² Among the 317 NMAs, FINRA identified 13 NMAs (or four percent) where the new member applicant or its associated persons had a pending arbitration claim at the time of receipt of the application.³³ Under the proposed amendments, FINRA could have presumptively denied these NMAs. FINRA also

³¹ These NMAs were either approved in whole or with restrictions, denied, withdrawn, rejected, or lapsed.

³² The statistics on pending arbitration claims in this discussion relate only to claims in the arbitration forum administered by FINRA. The proposed amendments also would apply to claims in other venues. Information describing claims in other arbitration forums, however, is generally not available. FINRA's estimates of the number of firms that may be impacted by the proposed amendments are therefore likely lower than the true number. Further, FINRA is not able to estimate the total amount of monetary compensation claimants received from the arbitration cases discussed because information that identifies the settlement amount relating to a particular case is not available.

³³ Among these 13 NMAs, there were seven pending customer arbitration claims filed against associated persons prior to FINRA's receipt of the application, and among these seven customer claims, three resulted in a settlement, one closed by hearing, and three were withdrawn. The total amount of compensatory damages sought by customers was over \$1.9 million (including the claims that resulted in a settlement). In the case closed by hearing, the customer was awarded compensatory damages of approximately \$76,000.

identified one NMA as relating to a customer claim that resulted in an award that went unpaid.³⁴

B. CMAs

FINRA also reviewed 1,051 CMAs that it received from January 2015 through December 2017.³⁵ This sample of CMAs only provides a potential indication of the member firms that could be impacted by the proposed amendments. A member firm may elect to proceed with effecting a change in business operations because it independently determines, without seeking guidance from FINRA through a materiality consultation, that such contemplated change falls within the safe harbor parameters or that such transaction does not represent a material change in business operations that would require a CMA. In these cases, a member firm is not obligated to proactively notify FINRA of the independent determination.³⁶ Thus, the number of member firms that potentially may be subject to the proposed amendments, including those that effect an increase in the number of associated persons involved in sales under the safe harbor or effect some other change in business operations that is, in the member firm's view, not material, may be different than the member firms that filed a CMA and are part of the sample.

³⁴ The firm withdrew the NMA. The customer arbitration claim resulted in an award prior to FINRA's receipt of the NMA. The amount of the damages that went unpaid is approximately \$250,000. The associated person who failed to pay the awarded damages has been suspended by FINRA.

³⁵ The CMAs were either approved in whole or with restrictions, denied, withdrawn, rejected, or lapsed.

³⁶ Under IM-1011-1, a firm would remain obligated to keep records of increases in personnel, offices, and markets made to determine whether they are within the safe harbor.

Of the 1,051 CMAs, 65 involved the hiring of associated persons. FINRA identified four of the 65 CMAs where the associated person being hired had a pending customer arbitration claim. Under the proposed amendments, the pending customer arbitration claims for all four of the CMAs would have been considered covered pending arbitration claims.³⁷ An additional 154 of the 1,051 CMAs were identified as relating to asset acquisitions (17) or transfers (137). FINRA identified 44 CMAs (29 percent of 154) where the transferring member or an associated person of the transferring member had a pending customer arbitration claim at the time of the filing.³⁸ Under the proposed amendments, the pending customer arbitration claims for 25 of the 44 CMAs would have

³⁷ From January 2015 to December 2017, among all member firms, 480 associated persons were hired with a pending arbitration claim at the time of hiring. These pending claims would have been considered “covered pending arbitration claims” under the proposed amendments for 186 of the associated persons (39 percent of 480) and would not have been considered covered pending arbitration claims for the remaining 294 associated persons (or 61 percent of 480). FINRA does not know how many of the associated persons were involved in sales. This estimate, therefore, provides an upper bound for the number of materiality consultations member firms would have been required to seek under the proposed amendments. See supra note 30 for a discussion of the unpaid awards relating to associated persons who transitioned from one member firm to another while the claim was pending.

³⁸ Thirty-four of the CMAs were approved, and 10 were withdrawn or not substantially completed and therefore rejected. There were 300 pending customer arbitration claims as of the receipt of the CMAs. The pending claims included claims made against the applicant or its associated persons. Of the 300 pending arbitration claims, 184 resulted in a settlement, 48 closed by hearing or on the papers, 52 closed by other means including 32 that were withdrawn, and 16 remained open. Customers requested a total of \$311.3 million in compensatory relief (including the claims that resulted in a settlement); and in the claims resulting in an arbitration award in favor of customers, customers were awarded approximately \$9.9 million in compensatory damages.

been considered covered pending arbitration claims. FINRA also identified five of the CMAs as relating to six customer claims that resulted in an award that went unpaid.³⁹

4. Economic Impact

FINRA believes that the proposed amendments to the MAP rules would enhance the review of applications by strengthening the MAP rules in relation to pending arbitration claims and unpaid arbitration awards and settlements.

The proposed amendments would benefit claimants and potential claimants by decreasing the risk that firms are avoiding the payment of awards or settlements by transferring their assets, including capital and customer accounts, to another firm. Firms can shift their assets to another firm by starting a new firm, or by selling or transferring assets to an existing firm. A decrease in the ability of firms to avoid satisfying their arbitration awards or settlements in this manner may result in a higher likelihood that they are paid in full in accordance with their terms. The proposed amendments could also benefit the current and future customers of new member applicants and member firms that seek a materiality consultation by increasing FINRA's ability to assess, among other things, the adequacy of the supervisory plan the member firm has in place for the associated persons who may have a history of non-compliance.

³⁹ Three of the CMAs were withdrawn, and two were approved. Three of the six customer claims were closed prior to the filing of the CMA, whereas the other three were still pending. For the two approved CMAs, the cases which resulted in an unpaid customer award closed at least one year after the decision was served. Five of the six customer awards went unpaid by a member firm, whereas the other went unpaid by an associated person. The total amount of damages that went unpaid is approximately \$3.4 million. The member firms have either cancelled their membership or were expelled by FINRA, and the associated person has been suspended by FINRA.

A. Rebuttable Presumption to Deny an NMA

Proposed Rule 1014(b)(1) would specify that a presumption of denial would exist if a new member applicant or its associated persons are subject to a pending arbitration claim. By establishing a presumption of denial, the proposed rule change would shift the burden to the new member applicant to demonstrate how pending arbitration claims would be paid if they go to an award. Proposed Rule 1014(b)(1) would impose both direct and indirect costs on new member applicants.

New member applicants with pending arbitration claims would incur direct costs. The costs include the time and expense of firm staff and outside experts to demonstrate the ability to satisfy the claims. The costs would be in addition to the costs new member applicants incur to demonstrate their ability to meet the 14 standards for admission under Rule 1014(a). In addition, new member applicants and their associated persons may incur the opportunity costs associated with setting aside funds that may otherwise be used for new business. A new member applicant may incur more opportunity costs than is necessary if it sets aside more capital than the actual amount of the award.

New member applicants may also incur indirect costs if the rebuttal process delays the applicant's ability to begin earning revenues or otherwise negatively impacts the business. The magnitude of these costs is related to the ability of the new member applicant and FINRA to adequately gauge the likelihood and size of an award or settlement. However, as noted above, FINRA estimates that few associated persons related to new member applicants will have pending arbitration claims at the time of the

filing.⁴⁰ The majority of new member applicants are therefore unlikely to be affected by the proposed amendments.

B. Materiality Consultations

The proposed amendments would also mandate a member firm to seek a materiality consultation for specified business changes—hiring an associated person involved in sales, or any direct or indirect acquisition or transfer of assets—where the member firm or associated person, as applicable, has an unpaid arbitration award or settlement related to an arbitration, or a defined covered pending arbitration claim, unless the member firm is otherwise required to file a CMA. FINRA believes that an unpaid arbitration award or settlement poses a severe risk to claimants that would warrant a materiality consultation under any circumstances. FINRA also believes that the proposed definition of a covered pending arbitration claim, which focuses on investment-related, consumer-initiated claims (individually or, if there is more than one claim, in the aggregate) that exceed the excess net capital of the transferring or hiring member firm (as applicable), represents an objective benchmark that would provide FINRA the opportunity to review the specified business changes to assess whether they may adversely affect former, current or future customers in a material way.

For a member firm transferring assets, FINRA believes that the relative size of covered pending arbitration claims may signal that the firm may be attempting to avoid the payment of awards or settlements by transferring assets, including capital and customer accounts, to another firm. For member firms adding one or more associated persons involved in sales, the relative size of the covered pending arbitration claims may

⁴⁰ See supra note 33 and accompanying text.

foreshadow future potential misconduct by such individuals that could result in additional arbitration claims.⁴¹ Under such circumstances, if the customer names the hiring member firm in any such additional arbitration claims, FINRA is concerned whether a hiring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims, including a customer award or settlement.

Member firms that would be required to seek a materiality consultation would incur direct costs. Similar to the additional direct costs associated with NMAs, the costs may include the time and expense of firm staff and outside experts to provide information and documents that demonstrate the ability to satisfy the unpaid awards or settlements, or covered pending arbitration claims. Member firms that would be required to seek a materiality consultation and their associated persons may also incur the opportunity costs associated with setting aside funds that may otherwise be used for new business.

Member firms that seek a materiality consultation may also incur costs relating to a delay in effecting the contemplated expansion or transaction. A delay may negatively impact the value of the expansion or transaction and may lead to a loss of business opportunities. Given the experience of FINRA, this delay is anticipated to be small as the time for a materiality consultation has recently averaged 12 days; this time period, however, may lengthen depending on the complexity of the contemplated expansion or transaction.

Business activities that decrease the amount of excess net capital available may increase the likelihood that member firms would be required to seek a materiality consultation. In response, member firms may constrain business activities to maintain a

⁴¹ See supra note 22.

level of excess net capital in order to demonstrate their ability to pay pending arbitration claims (or pay unpaid awards or settlements) in the event a materiality consultation is required. As described in the Economic Baseline, a number of CMAs relate to the hiring of an associated person with a covered pending arbitration claim or the acquisition or transfer of a member's assets where the transferring member or an associated person of the transferring member had a covered pending arbitration claim.⁴²

FINRA may require member firms that seek a materiality consultation to file a CMA. FINRA would then consider whether the member firm meets each of the 14 standards under Rule 1014. These members would therefore incur costs in addition to the costs to seek a materiality consultation. This includes the fees associated with a CMA, time of firm staff, and submission of additional documentation. The filing of a CMA would also cause an additional delay to effectuate the contemplated expansion or transaction. This may cause member firms, associated persons and the customers of member firms to lose the benefits associated with the business opportunities. A determination that a CMA must be filed, however, would indicate that the risks to claimants, and therefore the potential benefits of a closer examination, are high. An examination may include the regulatory history of a member to determine whether it is

⁴² See the discussion in the Economic Baseline. Customers may have an incentive to file an arbitration claim for the sole purpose of disrupting a contemplated transaction. This incentive could increase the number of member firms that would be required to seek a materiality consultation and potentially file a CMA and incur the associated costs. FINRA has no reasonable basis on which to predict the frequency of this occurring if the proposed amendments are adopted. SIFMA suggested that the definition of a covered pending arbitration claim should be limited to claims filed prior to the public announcement of the contemplated transaction. FINRA would review customer claims as part of a materiality consultation and consider the facts and circumstances of the case as well as its timing. The potential disruption to contemplated transactions from these claims, therefore, is expected to be limited.

able to satisfy any pending arbitration claims should they go to award, as well as the adequacy of any supervisory plan for an individual with a pending arbitration claim that the firm is contemplating hiring.⁴³ If the actual risks to claimants are low (e.g., the amount settled or eventually awarded is a small percentage of the amount claimed), then the greater costs to member firms to file a CMA would not also result in a similar increase in customer protections.

The proposed amendments are not designed to impose disproportionate costs based on firm size. Instead, the costs the proposed amendments would impose are dependent on the compensatory loss amounts of pending customer arbitration claims, or the presence of an unpaid arbitration award or an unpaid settlement related to an arbitration, and the financial capacity of the member firm. In addition, the costs member firms may incur to seek a materiality consultation (and potentially file a CMA) as a result of the proposed amendments, including any burden on competition, are borne at their discretion, in their decision to hire or acquire or transfer the member's assets. Member firms would incur the additional costs if they choose to hire an associated person involved in sales who has a covered pending arbitration claim, or where the transferring member or an associated person of the transferring member has a covered pending arbitration claim.

⁴³ Individuals with pending arbitration claims may engage in future potential misconduct that could result in additional arbitration claims, including claims that name the hiring member. See supra note 22.

The member firms that would be required to seek a materiality consultation (and potentially file a CMA) as a result of the proposed amendments may range in size.⁴⁴ For example, as described in the Economic Baseline, FINRA identified four member firms that filed a CMA relating to the hiring of an associated person with a covered pending arbitration claim. All four member firms were small.⁴⁵ Similarly, FINRA identified 25 CMAs as relating to the asset acquisitions or transfers of 26 member firms where the transferring members had covered pending customer arbitration claims. Among the 26 transferring members, 13 members were small, nine members were mid-size, and four members were large.⁴⁶

An associated person, as a respondent to a pending claim, may also incur costs as a result of the proposed amendments. New member applicants and existing member firms may be less likely to hire associated persons with a pending claim in order to avoid the costs associated with the proposed amendments. An associated person, as a

⁴⁴ The definition of firm size is based on Article I of the FINRA By-Laws. A firm is defined as “small” if it has at least one and no more than 150 registered persons, “mid-size” if it has at least 151 and no more than 499 registered persons, and “large” if it has 500 or more registered persons.

⁴⁵ During the sample period and among all member firms, FINRA also identified 186 associated persons who were hired with a covered pending arbitration claim at the time of the hiring. See supra note 37. The percentage of small member firms that hired the 186 associated persons (90 percent) is similar to the proportion of small member firms industry-wide as of year-end 2017 (90 percent). See 2018 FINRA Industry Snapshot, https://www.finra.org/sites/default/files/2018_finra_industry_snapshot.pdf.

⁴⁶ As a result of the safe harbor provision, the member firms that would have been subject to the proposed amendments during the sample period may be different than the member firms that filed a CMA. The number and composition of member firms that would have been required to file a materiality consultation under the proposed rule change is therefore not known.

respondent to a pending claim, may therefore experience fewer career opportunities within the brokerage industry.

C. Other Proposed Amendments

Two other proposed amendments would have additional economic effects. First, the proposed amendments would require applicants to provide prompt notification of a pending arbitration claim that is filed, awarded, settled, or becomes unpaid before a decision on the application is served. These notifications would further improve the ability of FINRA to oversee and review the pending arbitrations of applicants to ensure that arbitration awards and settlements are paid in full in accordance with their terms. Applicants that provide notification would incur additional costs including the time of firm staff and the expense to submit additional documentation.

A number of the applicants for new membership or member firms that filed a CMA during the sample period would have been required to promptly notify FINRA of changes to pending arbitration claims. FINRA identified 13 of the 317 NMAs (or four percent) from January 2015 through December 2017 as having changes in the status of a pending arbitration claim involving the applicant or its associated persons before a decision constituting final action was served on the applicant (or the application was

otherwise withdrawn),⁴⁷ and 156 of the 1,051 CMAs (or 15 percent) as also having similar changes to the status of a pending arbitration claim.⁴⁸

Second, the proposed amendments would clarify the manner in which an applicant may demonstrate its ability to satisfy pending arbitration claims or unpaid arbitration awards or settlements. The clarification would improve the efficiency of the MAP process by increasing the ability of applicants to anticipate the information necessary to demonstrate their ability to satisfy outstanding obligations, and reduce the need for applicants to submit additional information after the initial filing.

5. Alternatives Considered

FINRA considered a range of suggestions in developing the proposed amendments as set forth in Regulatory Notice 18-06. The proposed amendments reflect

⁴⁷ The arbitration claims consisted of 11 customer claims and one intra-industry claim. Among the 11 customer claims, three resulted in a settlement, three closed by hearing, four were withdrawn, and one remained open. The total amount of compensatory damages sought by customers was \$5.8 million (including the cases closed by settlement). In the cases closed by hearing, the customers were awarded compensatory damages of approximately \$146,000. None of the awarded damages went unpaid.

⁴⁸ The arbitration claims consisted of 913 customer claims of which 497 resulted in a settlement, 184 closed by hearing or on the papers, 174 were closed by other means including 95 that were withdrawn, and 58 remained open. The total amount of compensatory damages sought by customers was \$856.0 million. In the cases closed by hearing or on the papers, the customer was awarded compensatory damages of approximately \$20.5 million. Two of the customer cases resulted in an award that went unpaid. One of the cases is referred to above in the discussion in the Economic Baseline. The other case relates to two associated persons who left the applicant before a decision constituting final action was served. The amount of the awarded damages that went unpaid is approximately \$70,000. The associated persons who failed to pay the awarded damages have been suspended or barred by FINRA. The CMA was approved with restrictions. For applicants with changes to a pending arbitration claim before a decision constituting final action was served (or the application was otherwise withdrawn), the median number of changes is two.

the changes that FINRA believes at this time to be the most appropriate for the reasons discussed herein.

An alternative to the proposed amendments includes a rebuttable presumption of denial for a CMA if the applicant or its associated persons are the subject of a pending arbitration claim. This alternative would increase the costs to member firms that file a CMA, including member firms that initially sought a materiality consultation under the proposed amendments. Member firms may incur costs to demonstrate their ability to satisfy the claims. This includes the opportunity costs associated with setting aside funds that may otherwise be used for other business opportunities.

A presumption of denial would reduce the risks associated with firms avoiding the payment of claims should they go to award. As part of a materiality consultation, however, FINRA would examine the regulatory history of a member firm to determine whether it is able to satisfy pending arbitration claims should they go to award, as well as the adequacy of any supervisory plan for an individual with a pending arbitration claim that the firm is contemplating hiring.⁴⁹ The additional protections from extending a presumption of denial for pending arbitration claims to CMAs, therefore, may not justify the additional costs to member firms.⁵⁰

⁴⁹ See supra note 22.

⁵⁰ Several commenters suggested alternatives to the proposed amendments that would require a presumption of denial when pending arbitration claims exceed certain thresholds. See GSU, PIABA, and UNLV. Although member firms with pending arbitration claims that exceed the thresholds may be at higher risk of nonpayment, FINRA believes that it would still be able to adequately assess these firms' ability to pay the claims should they go to award without the presumption of denial.

Other alternatives to the proposed amendments include expanding or narrowing the conditions for member firms to seek a materiality consultation or file a CMA.⁵¹ Expanding (narrowing) the requirements for member firms to seek a materiality consultation or to file a CMA may decrease (increase) the ability of firms to avoid satisfying their outstanding obligations by transferring their assets to another firm. By expanding (narrowing) the requirements, however, additional (fewer) member firms would incur the associated costs. FINRA believes that the requirements under the proposed amendments for member firms to seek a materiality consultation provide for the additional investor protections but minimize the costs when the risk of members not satisfying their outstanding obligations is low.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 18-06 (February 2018) ("Notice"). FINRA received nine comment letters in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of the comment letters received in response to the Notice is attached as Exhibit 2b.⁵² Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.

⁵¹ For example, commenters suggested expanding the requirement to seek materiality consultations for business expansions. Suggestions include omitting the qualifying term "involved in sales" (NASAA) and expanding to principals, control persons, or officers (GSU). Another commenter, however, suggested excluding business expansions from the requirement to seek a materiality consultation if the expansion is in connection with another corporate event such as a merger, acquisition, or asset transfer (FSI). Commenters also suggested narrowing the requirement to seek materiality consultations for asset acquisitions or transfers. Suggestions include permitting smaller acquisitions or transfers to proceed without a materiality consultation (GSU) or excluding covered pending arbitration claims altogether (FSI).

⁵² All references to commenters are to the comment letters as listed in Exhibit 2b.

Eight commenters supported the proposal as set forth in the Notice either absolutely or with some qualifications.⁵³ One commenter raised concerns outside the scope of the Notice.⁵⁴ A summary of the comments and FINRA's responses are discussed below.⁵⁵

1. Rebuttable Presumption to Deny an NMA

FINRA is proposing to amend Standard 3 to create a rebuttable presumption to deny an NMA where the applicant or its associated person is subject to a pending arbitration claim. Three commenters expressly supported the proposed amendment.⁵⁶ No commenters opposed this proposed amendment.

2. Rebuttable Presumption to Deny a CMA

In the Notice, FINRA requested comment on whether the presumption of denial in connection with a pending arbitration claim should be applied to a CMA as well. Six commenters responded with three expressing opposition to this approach.⁵⁷ In general, these three commenters noted that a CMA already requires an applicant to provide information pertaining to pending arbitration claims and how an applicant will handle the arbitrations and the awards that may result. NASAA further expressed the belief that creating a presumption to deny a CMA may disincentivize a firm from taking on potential liability through an acquisition, which could result in more unpaid arbitration awards.

⁵³ See Colorado, Cornell, GSU, FSI, NASAA, PIABA, SIFMA, and UNLV.

⁵⁴ See IBN.

⁵⁵ Comments that speak to the economic impacts of the proposed rule change are addressed in Item B above.

⁵⁶ See SIFMA, Cornell, and GSU.

⁵⁷ See Cornell, NASAA, and SIFMA.

The other three commenters supported extending the presumption to deny an application with pending arbitration claims to a CMA but recommended various conditions on when the presumption should apply.⁵⁸

GSU recommended that the presumption to deny a CMA should be triggered when the applicant or its associated person has a pending arbitration claim or unpaid settlement for an amount exceeding \$15,000, contending that such dollar limit would provide some balance to the proposed rule change by tying the presumption to CMAs with claims that are required to be reported to FINRA. PIABA recommended that two preconditions for the presumption to deny a CMA should apply—one for the associated person and the other for the member firm. With respect to the associated person, PIABA stated that the presumption to deny a CMA should be triggered when more than five claims are pending against any control person, principal, registered representative, or other associated person of the member, as such number of claims may signal problems within the member and may be an indicator of potential future investor harm. If the member can overcome the presumptive denial of a CMA, and it still desires to hire or continue the employment of individuals with five or more pending arbitration claims, PIABA recommended that those individuals with such claims pending against them should be subject to heightened supervision and not be permitted to serve in a supervisory capacity until all pending arbitration claims against them have in fact been resolved, and the corresponding awards or settlements, if any, have been paid in full. PIABA further stated that following the conclusion of such proceedings, the decision related to an individual's supervision or supervisory capacity should rest with the member, and

⁵⁸ See GSU, PIABA, and UNLV.

recommended that FINRA's rules should be modified to ensure that such individual is not permitted to move from one firm to another without regard to problems that occurred at the former firm.

As for the member firm, PIABA stated that the presumption should be applied based upon the aggregate amount of damages pleaded in all pending arbitration claims, taking the nature and quality of those claims into account, compared to the value of cash assets and insurance held by the member firm. If this ratio indicates a substantial risk of insolvency or presents the inability to pay all pending legitimate claims in full, then the presumption should apply. PIABA further stated that FINRA should be permitted to look beyond the damages described in a statement of claim, and discuss the issues related to damages directly with investors, their representative and FINRA members and their counsel, in confidential sessions, prior to applying a presumptive CMA denial. UNLV recommended that the presumption apply to a CMA where there is a covered pending arbitration claim.

The existence of a specified regulatory history currently enumerated under Standard 3 that triggers the presumption to deny an application is intended to encourage compliance with unpaid arbitration awards, other unpaid adjudicated customer awards and unpaid arbitration settlements, and their existence raise the question of an applicant's capacity to comply with applicable securities laws and regulations, and with applicable

FINRA rules.⁵⁹ Standard 3, as proposed, would not diminish FINRA's ability to assess whether the applicant and its associated persons are able to meet this standard. FINRA would continue to consider an applicant's or its associated person's pending arbitration claims, among other regulatory history, in determining whether an applicant for continuing membership is "capable of complying with" the federal securities laws and FINRA rules. Accordingly, while FINRA appreciates the commenters' recommendations, FINRA has determined, at this time, not to apply the presumption of denial for pending arbitration claims to a CMA.

3. Evidence of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements, or Pending Arbitration Claims

A. Types of Evidence

Proposed IM-1014-1 would provide that an applicant may demonstrate, in a variety of ways, that it has the financial resources to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or a pending arbitration claim. Some examples include an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer.

With the exception of SIFMA, none of the commenters expressed views on the types of documentation an applicant may present to evidence the ability to satisfy an award, settlement or claim. SIFMA expressed concern about proposed IM-1014-1 requiring an applicant to show proof of insurance coverage, asserting that having

⁵⁹ See Rule 1014(a)(3)(C) (providing, in part, that a presumption of denial applies if the applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant's net capital, and any other member with respect to which these persons were a control person or a five percent lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements).

insurance coverage does not necessarily correspond to having the ability to pay the award, settlement or claim. FINRA notes that the supporting documentation listed in the proposed interpretive material are examples of what an applicant may produce to FINRA to evidence the ability to satisfy the award, settlement or claim, and is not intended to be an exhaustive list by which a member can show its financial resources.⁶⁰

B. Guarantee

In the Notice, FINRA requested comment on whether an applicant, if it designates a clearing deposit or the proceeds from an asset transfer for purposes of showing the ability to satisfy a pending arbitration claim, should be required to provide some form of guarantee that such funds will be used to satisfy the award, settlement or claim. Three commenters expressed their general support for a guarantee,⁶¹ with two of these commenters making additional recommendations.⁶²

Emphasizing the need to secure funds or to prevent them from being depleted for other purposes, PIABA recommended that applicants hold the funds in an escrow account with clear instructions to the third party escrow agent (unaffiliated with the member firm)

⁶⁰ FINRA notes that similar examples appear in other FINRA rules. See, e.g., Section 4(i)(3) of Schedule A to the FINRA By-Laws (describing the circumstances under which a CMA for an acquisition or transfer of 25 percent or more of the member's assets may qualify for a fee waiver where the applicant can demonstrate in the CMA the ability to satisfy in full any unpaid customer-related claim (e.g., sufficient capital or escrow funds, proof of adequate insurance for customer related claims)). Form CMA also includes various examples. See supra note 12.

⁶¹ See NASAA, PIABA, and UNLV.

⁶² See NASAA and PIABA.

to disburse the funds under specified circumstances.⁶³ PIABA also suggested strict penalties in the event of a breach of that guarantee, such as the immediate suspension of a member's broker-dealer license. NASAA noted that circumstances sometimes change during the pendency of a planned business transaction and that an applicant may need to reallocate the prior designated funds. To account for potentially changing business circumstances and given the fungibility of money, NASAA stated that an applicant should not be duty bound to satisfy an arbitration award or settlement from the funds they may have initially identified. Instead, FINRA's rules should allow an applicant the flexibility to amend its application and designate a different source of available funds to satisfy pending claims or unpaid arbitration awards or settlements if necessary.

In light of the comments received, FINRA has modified proposed IM-1014-1 to provide that to overcome the presumption to deny the application, the applicant must guarantee that any funds used to evidence the applicant's ability to satisfy any awards, settlements, or claims, will be used for that purpose. As proposed, IM-1014-1 would not preclude an applicant from designating a different source of funds to satisfy an award, settlement or claim, provided the source of funds is acceptable to FINRA. Moreover, Section 1(c) of Article IV of the FINRA By-Laws already requires an applicant to keep its application current by submitting supplementary amendments as necessary.⁶⁴ A change in source of available funds to satisfy pending arbitration claims or unpaid arbitration awards or settlements would require the application to be updated in accordance with the FINRA By-Laws.

⁶³ PIABA's other recommendation was to have the guarantee secured by a lien in favor of FINRA or the investor.

⁶⁴ See Section 1(c) of Article IV of the FINRA By-Laws.

C. Valuation of Claim Through Independent Legal Counsel

Proposed IM-1014-1 would also permit an applicant to provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable as to the value of the arbitration claim in an effort to lend support to the applicant's ability to demonstrate that it has the financial resources to satisfy the claim, award or settlement. Two commenters suggested that the proposed provision should not require that counsel be "independent."⁶⁵ FSI stated that a firm should be able to rely on the opinion of in-house counsel as such counsel would be more familiar with the firm and its risk profile, adding that obtaining an opinion from external legal counsel could be costly and would not increase the regulatory value of the opinion offered. NASAA stated that it did not believe that the expert opinion necessarily needed to be from an "independent" source and instead, FINRA should have the authority to assess the veracity and reasonableness of an offered expert opinion on a case-by-case basis and to require such qualifications and degree of independence from the applicant as FINRA reasonably believes warranted in each instance. In addition, NASAA recommended that proposed IM-1014-1 should compel an applicant to obtain a written opinion of a legal or financial expert to support the applicant's assertion that it can satisfy an unpaid award or settlement obligation it intends to assume, rather than giving the applicant the discretion to provide such opinion.

FINRA believes that it would be appropriate and consistent with current FINRA Rules to provide a member with the option to derive support for the valuation of an

⁶⁵ See FSI and NASAA.

arbitration claim through a legal opinion from an independent, reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claim.⁶⁶

4. Materiality Consultations

A. The Process

Proposed IM-1011-2 and proposed Rule 1017(a)(6) would require a member to seek a materiality consultation under specified circumstances. FSI, while not expressly opposed to the underlying concept of mandating materiality consultations, stated that the proposed rules do not set forth clear parameters around the process, such as the time in which FINRA must issue a decision and the remedy a member firm has if it does not agree with FINRA's decision on the materiality consultation. FINRA notes that the materiality consultation process is well established, and a description of the process and the information that should be included in a request for a materiality consultation, among other information, is detailed on FINRA.org.⁶⁷ In addition, FINRA notes that if this proposed rule change is approved by the Commission, FINRA will update the materiality consultation process as detailed on its website as necessary.

B. Mandatory Materiality Consultation for Business Expansion to Add One or More Associated Persons Involved in Sales with Covered Pending Arbitration Claims

As set forth in the Notice, proposed IM-1011-2 would require a member to seek a materiality consultation before effecting a business expansion that would involve adding

⁶⁶ See, e.g., FINRA Rule 2040 (Payments to Unregistered Persons) (providing in supplementary material that a member, if uncertain about whether an unregistered person may be required to be registered under SEA Section 15(a), can derive support from the member's determination by, among other things, a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area).

⁶⁷ See supra note 14 and accompanying text.

one or more associated persons involved in sales with a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration.⁶⁸ Thus, a member would not be permitted to effect the contemplated business expansion until FINRA determined whether or not a CMA would be required for such contemplated business expansion.

Four commenters expressed support for this proposed requirement,⁶⁹ with some commenters suggesting modifications. For example, NASAA recommended omitting the qualifying term “involved in sales” so that the proposed rule would apply to any associated person, irrespective of the nature of his or her employment at the member firm, who is subject to a claim, award or settlement, explaining that firms may assign an associated person with pending claims or unpaid awards to administrative, non-sales roles in order to circumvent a materiality consultation. GSU suggested that proposed IM-1011-2 should be expanded to apply to principals, control persons or officers as occasionally, associated persons from problematic firms may move on to become officers at larger firms.⁷⁰ If a materiality consultation results in the requirement to file a CMA,

⁶⁸ FINRA notes that the term, “associated person involved in sales” as used in proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) is derived from the safe harbor provision under IM-1011-1.

⁶⁹ See SIFMA, NASAA, GSU, and Cornell.

⁷⁰ FINRA notes that the proposed amendments relating to requiring a materiality consultation for asset acquisitions or transfers would apply to principals, control persons or officers with covered pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements moving between firms.

Cornell recommended that proposed IM-1011-2 should require the member to file the CMA within a specified timeframe (e.g., 30 days after FINRA's finding of materiality).⁷¹

FSI raised a concern that proposed IM-1011-2 could require a member to undergo a materiality consultation to add a single registered person with a pending arbitration claim. FSI recommended that proposed IM-1011-2 should exclude such a business expansion when adding associated persons involved in sales to a member's roster if done in connection with another corporate event such as a merger, acquisition, asset transfer or some other business expansion. FSI also recommended that the proposed rule exclude pending arbitration claims, explaining that a member should not be potentially compelled to undergo an application review process so that FINRA can assess the member's decision to hire one registered person with a pending arbitration claim, particularly when the claim is unsubstantiated. FSI noted that the proposed provision would have a negative impact on a member's recruiting efforts by overreaching into a member's routine hiring decisions.

As noted above, proposed IM-1011-2 is intended to address situations in which a member wants to hire an associated person who engages in sales with the public and has a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration and, therefore, may have a history of noncompliance. In the Notice, proposed IM-1011-2 also included a description of the possible outcomes of FINRA's determination on a materiality consultation; that is, either a member firm would

⁷¹ FINRA does not believe that it is necessary to require the applicant to file the CMA within a specified time period because if a CMA is required, the applicant would not be able to effect the transaction without FINRA's approval of the CMA and, therefore, FINRA believes the applicant would be incentivized to file the CMA for approval as soon as possible.

not be required to file a CMA in accordance with Rule 1017 and may effect the contemplated business expansion or the member must file a CMA in accordance with Rule 1017 and would not be permitted to effect the contemplated business expansion without FINRA's approval of the CMA.

For clarity, FINRA has modified the language in proposed IM-1011-2 in two ways. First, proposed IM-1011-2 expressly states that the safe harbor for business expansions in IM-1011-1 is not available if a member firm is seeking to add one or more associated persons involved in sales with a covered pending arbitration claim (as defined in proposed Rule 1011(c)(1)), unpaid arbitration award, or unpaid settlement related to an arbitration. Second, proposed IM-1011-2, as modified, directs member firms to proposed Rule 1017(a)(6)(B) under which the description of the possible outcomes of FINRA's determination on a materiality consultation now resides. Proposed IM-1011-2, as modified, and proposed Rule 1017(a)(6)(B) are intended to clarify that a member firm, before it considers hiring one or more associated persons involved in sales with a covered pending arbitration claim (as defined in proposed Rule 1011(c)(1)), unpaid arbitration award, or unpaid settlement related to an arbitration, must first seek a materiality consultation from FINRA.

Requiring a materiality consultation in this situation would give FINRA the opportunity to assess, among other things, the adequacy of any supervisory plan the member firm has in place for the individual, and to discuss with the member firm the potential impact on its finances if the member firm hires the individual and the individual engages in future potential misconduct while employed at the member firm that results in

an arbitration claim against the member firm. FINRA notes that, in general, materiality consultations are not lengthy processes, taking on average 12 days.

In addition, FINRA notes that with respect to pending arbitration claims, a materiality consultation would only be required if those claims individually or in the aggregate are substantial, i.e., exceed the hiring firm's excess net capital. As described above, mandating a materiality consultation where a member is seeking to increase the number of associated persons involved in sales with covered pending arbitration claims, unpaid arbitration awards or unpaid settlements is to provide FINRA the opportunity to assess the relevant facts and circumstances of hiring such individuals and the impact, if any, on the member's supervisory and compliance structure, among other considerations.

C. Mandatory Materiality Consultation for Any Acquisition or Transfer of Member's Assets (Proposed Rule 1017(a)(6)(A))

Proposed Rule 1017(a)(6)(A) would require a member to seek a materiality consultation before effecting any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration.⁷² The proposed rule would require a member to wait for FINRA's determination on whether or not a CMA would be required for the contemplated acquisition or transfer.

Several commenters supported proposed Rule 1017(a)(6)(A) either unequivocally or with a minor qualification.⁷³ GSU expressed its support for the proposed provision

⁷² In the Notice, this provision previously appeared as proposed paragraph (a)(4) in Rule 1017. The proposed rule change would renumber this provision as paragraph (a)(6)(A) in Rule 1017.

⁷³ See, e.g., Cornell, GSU, NASAA, and SIFMA.

insofar as it would prevent a member from acquiring or transferring a large amount of assets without first undergoing a materiality consultation in situations involving covered pending arbitration claims, unpaid arbitration awards or settlements, but recommended that smaller acquisitions or transfers involving such claims, awards or settlements should be permitted to proceed without a materiality consultation or CMA. Specifically, GSU recommended that FINRA should set a threshold of 10 percent, explaining that this threshold would allow the “occasional transfer” of customer accounts from one firm to another, but not allow an associated person to move a “meaningful percentage of his accounts to another firm.”

FSI stated that proposed Rule 1017(a)(6)(A) should exclude covered pending arbitration claims, noting that asset transfers that do not require a CMA under the current MAP rules should not be required to undergo a materiality consultation solely because the member or its associated person has a pending arbitration claim. FSI stated that proposed Rule 1017(a)(6)(A) could be interpreted as requiring a member that transfers any asset, no matter how immaterial, to undergo a materiality consultation and then potentially, a CMA, where the member or any of its associated persons may be subject to unsubstantiated, pending, investor arbitration claims.

While FINRA appreciates the commenters’ recommendation and concerns, FINRA has determined not to modify the proposal. As noted above, FINRA believes that the definition of a covered pending arbitration claim is sufficiently narrowly tailored to limit the extent to which a member would have to seek a materiality consultation, but would also capture those transactions that could result in investors not being paid should the claims go to award.

In the Notice, FINRA requested comment on whether proposed Rule 1017(a)(6)(A) should be limited to asset acquisitions or transfers involving a principal, control person or officer who has a covered pending arbitration claim, unpaid arbitration award, or unpaid arbitration settlement. Two commenters responded, opposing such limitation because it may provide an opportunity for circumvention.⁷⁴ NASAA stated that narrowing the scope of the proposed provision could allow a member to make staffing changes by temporarily shifting its principals, control persons or officers into administrative or other positions that fall outside the proposed provision. PIABA stated that a member's solvency may be jeopardized by an associated person who is not a principal, control person or officer, but who may be engaged in selling away activities or "running a large scheme" without the member's knowledge.

FINRA has determined not to limit proposed Rule 1017(a)(6)(A) to asset acquisitions or transfers involving principals, control persons or officers. FINRA believes that to help further address the issue of unpaid arbitration awards, the proposal should apply more broadly.

D. Definition of "Covered Pending Arbitration Claim"

The Notice defined the term "covered pending arbitration claim" for business expansions, and asset acquisitions and transfers as: (1) an investment-related, consumer-initiated claim filed against the associated person (for business expansions), or filed against the transferring member or its associated persons (for asset acquisitions and transfers) that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. Under

⁷⁴ See NASAA and PIABA.

both circumstances, the definition provided that such claim amount would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney's fees.

Two commenters discussed this definition.⁷⁵ FSI stated that the nexus between an associated person's pending arbitration claim and a firm's excess net capital is unclear as the firm at which the misconduct occurred would be the one to cover the claim, not the firm that is obligated to file the materiality consultation. NASAA recommended that the definition should expressly state that it includes all investment-related arbitration claims filed in any arbitration forum (e.g., FINRA arbitration forum, a private alternative dispute resolution forum) or judicial (state or federal) forum). In addition, NASAA stated that the "claim amount" was unclear as to its treatment of pending claims for which there may be joint liability between more than one person or for which an associated person reasonably expects to be indemnified, explaining that pending claims with joint liability should be assessed to each respondent maximally, as if no other person could be potentially liable.

In response to comments, FINRA has modified the definition to clarify that a covered pending arbitration claim would include those filed in any arbitration forum, and that a pending claim with joint liability would be assessed to each respondent, as if no other person could be potentially liable. In addition, FINRA emphasizes that the definition would be applied only for purposes of determining whether a materiality consultation would be required or not. The term is not intended to speak to whether the member would be responsible for satisfying the covered pending arbitration claim.

⁷⁵ See FSI and NASAA.

In the Notice, FINRA requested comment on whether the definition of “covered pending arbitration claim” should be limited to claims filed prior to a specified time period or event such as a public announcement of the contemplated transaction. Two commenters addressed this question.⁷⁶ SIFMA stated that the definition should include only those pending arbitration claims filed prior to public announcement of the contemplated transaction. PIABA stated that the definition should be broad and not be limited to claims filed prior to a specific date, but if a date is specified, then FINRA should require that any funds received in consideration for the transaction be frozen or subject to a lien in favor of the investor, pending the resolution of all pending arbitration claims filed within a certain period following the transaction closing.

FINRA has determined not to limit the proposed definition to only those claims filed prior to a specified date. At this time, FINRA believes that the definition of a covered pending arbitration claim is sufficiently narrowly tailored without adding a time limitation relating to when the arbitration claims are filed.

5. Written Notification of Any Pending Arbitration Claim that is Filed, Awarded, Settled or Becomes Unpaid Before Final Action is Served on Applicant

FINRA is proposing to add a new provision to the application review process to require an applicant to provide prompt notification, in writing, of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before a decision constituting final action of FINRA is served on the applicant. Two commenters expressed their views on proposed Rules 1013(c) and 1017(h).⁷⁷

⁷⁶ See PIABA and SIFMA.

⁷⁷ See Cornell and NASAA.

Cornell noted that the proposed provisions would enhance FINRA's ability to monitor when pending arbitration claims are filed or when awards become unpaid during the application review process. NASAA recommended moving the language from proposed Rule 1013(c) to Rule 1013(a)(1)(H), which currently provides that an NMA must include documentation of disciplinary history and certain regulatory, civil, and criminal actions, arbitrations, and customer complaints for the applicant and its associated persons, unless such history has been reported to the Central Registration Depository (CRD®). At this time, FINRA intends to retain the language as a standalone provision under proposed Rule 1013(c) to maintain clear parity with the language appearing under proposed Rule 1017(h). However, FINRA will consider NASAA's recommendation in connection with its separate proposal to substantially restructure the MAP rules.⁷⁸

6. Other Comments

UNLV recommended that FINRA consider proposing a rule to protect investors when FINRA members try to convert themselves into another area of the securities industry while facing covered pending arbitration claims or outstanding unpaid arbitration awards. IBN expressed the view that "[a]rbitration has nothing to do with the law it is about feelings[.]" suggesting that there needs to be two sets of rulebooks, one for small firms and the other for large firms. While FINRA acknowledges the commenters' concerns, their recommendations are beyond the scope of this proposed rulemaking and, therefore, FINRA has not addressed them here.

⁷⁸ See Notice 18-23.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2019-030 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2019-030. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The

Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2019-030 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁷⁹

Jill M. Peterson
Assistant Secretary

⁷⁹ 17 CFR 200.30-3(a)(12).

Regulatory Notice

18-06

Membership Application Program

FINRA Requests Comment on Proposed Amendments to its Membership Application Program to Incentivize Payment of Arbitration Awards

Comment Period Expires: April 9, 2018

Summary

FINRA is requesting comment on proposed amendments to its Membership Application Program (MAP) rules to create further incentives for the timely payment of arbitration awards by preventing an individual from switching firms, or a firm from using asset transfers or similar transactions, to avoid payment of arbitration awards while staying in business. The amendments would address situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

The text of the proposed amendments can be found at www.finra.org/notices/18-06.

Questions concerning this *Notice* should be directed to Victoria Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104.

February 8, 2018

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Registration
- ▶ Senior Management

Key Topics

- ▶ Arbitration
- ▶ Membership Application Program
- ▶ Supervision

Referenced Rules & Notices

- ▶ NASD IM-1011-1
- ▶ NASD Rule 1011
- ▶ NASD Rule 1013
- ▶ NASD Rule 1014
- ▶ NASD Rule 1017
- ▶ SEA Rule 15c3-1



Financial Industry Regulatory Authority

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 9, 2018.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:
 Jennifer Piorko Mitchell
 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 membership application rules are intended to promote investor protection by applying strong standards for admission to FINRA as a member firm and for material changes to a current member firm's ownership, control or business operations. These MAP rules require an applicant to demonstrate its ability to comply with the federal securities laws and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade applicable to its business.

FINRA's Department of Member Regulation, through the MAP Group (collectively, the Department), evaluates an applicant's financial, operational, supervisory and compliance systems to ensure that the applicant meets FINRA's standards for admission. In addition, the Department considers whether persons associated with an applicant have material disciplinary actions taken against them by other industry authorities, customer complaints, adverse arbitrations, pending arbitration claims, unpaid arbitration awards, pending or unadjudicated matters, civil actions, remedial actions imposed or other industry-related matters that could pose a threat to public investors.

FINRA is proposing to amend the MAP rules to allow FINRA to take a stronger approach to addressing the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms, in connection with the new membership application (NMA) or continuing membership application (CMA) processes.³ In addition, the proposed amendments would enable the Department to consider the supervision of individuals with pending arbitration claims and, therefore, who may have a history of non-compliance.

Among other things, the proposed amendments are intended to address concerns regarding situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

First, the proposed amendments would provide the Department with rule-based authority to presumptively deny an NMA if the applicant or its associated persons are subject to pending arbitration claims. Today, the Department considers if an applicant's or its associated person's record reflects a pending arbitration in determining if the applicant meets the standards for admission, but a record of a pending arbitration does not create a presumption of denial. Under the proposal, the applicant could overcome the presumption of denial if the applicant demonstrates its ability to satisfy the pending arbitration claims such as through an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms that the Department may determine to be acceptable.

This presumption of denial for pending arbitration claims would not apply to a CMA. Instead, consistent with today's practice, the Department would consider if an applicant's or its associated person's record reflects a pending arbitration in determining if the applicant meets the standards for admission.

Second, the proposed amendments would not permit a member to effect a business expansion that involves adding one or more associated persons with a "covered pending arbitration claim" (as discussed in further detail below), unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation for the contemplated expansion with the Department and the Department determines that the member may effect the contemplated business expansion without a CMA.

Third, the proposed amendments would not permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where the transferring member or one or more of its associated persons has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation for the contemplated acquisition or transfer and the Department has determined that the member is not required to file a CMA for approval of the acquisition or transfer.⁴

As further detailed below, "covered pending arbitration claims" for purposes of the proposed amendments are those whose amount (either individually or in the aggregate) exceed the member's excess net capital. In conducting its materiality consultation and determining whether a CMA is required, the Department would consider the risk that the proposed business expansion, acquisition or transfer would result in non-payment of an arbitration claim if it goes to award, or the continued non-payment of an arbitration award or settlement related to an arbitration, and would permit transactions to proceed where there is no material risk of non-payment.

Proposed Amendments

A. Standards for Admission

Rule 1014(a) sets forth 14 standards for admission applied by the Department in determining whether to approve an NMA or a CMA. Currently, Rule 1014(a)(3) specifies the factors that the Department considers to determine an applicant's ability to comply with the federal securities laws, the rules and regulations thereunder, and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. The standard enumerates factors that the Department will consider when making this assessment, some of which have a presumption of denial.

One such factor in Rule 1014(a)(3)(C) to be considered by the Department, and that creates a presumption of denial, is whether the applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant's net capital, and any other member with respect to which these persons were a control person or a five percent lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements.

The rebuttable presumption does not apply, however, to pending arbitration claims. As noted above, today, the Department considers if an applicant's or its associated person's record reflects a pending arbitration in determining if the applicant meets the standard for admission under Rule 1014(a)(3), but a record of a pending arbitration does not create a presumption of denial.

FINRA is concerned about new members onboarding principals and registered representatives with pending arbitration claims without the firm having to demonstrate how those claims would be paid if they go to award. In addition, FINRA is concerned about the new firm's supervision of such individuals who may have a history of non-compliance. Accordingly, FINRA is proposing to amend Rules 1014(a) and (b) to specify that a presumption of denial exists if the new member applicant or its associated persons are subject to pending arbitration claims. Creating a presumption of denial in connection with pending arbitration claims for NMAs would shift the burden to the new member to demonstrate how its claims would be paid should they go to award. In addition, it would shine a spotlight on the individuals with the pending arbitration claims and the firm's supervision of such individuals.

This presumption of denial for pending arbitration claims would not apply to a member firm filing a CMA. Instead, consistent with today's practice, the Department would consider if an applicant's or its associated person's record reflects a pending arbitration in determining if the applicant meets the standards for continued membership, but the record of a pending arbitration would not create a presumption of denial.⁵

In addition, to allow an applicant to demonstrate that it has the resources to satisfy such claims (with respect to a new member applicant), as well as unpaid arbitration awards and unpaid arbitration settlement agreements, FINRA is proposing to add new supplementary material to Rule 1014 to provide that an applicant can overcome the presumption of denial, if the applicant demonstrates its ability to satisfy the pending arbitration claims (with respect to a new member applicant), unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements. The applicant could demonstrate its ability to satisfy such obligations through an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms that the Department may determine to be acceptable.⁶ The applicant could provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable in the area as to the value of the arbitration claims (which might be zero). Any demonstration by an applicant of its ability to satisfy these outstanding obligations would be subject to a reasonableness assessment by the Department.

B. Materiality Consultation for Business Expansions and Asset Acquisitions and Transfers

1. Business Expansions

To help further incentivize payment of arbitration awards, FINRA is proposing not to permit a member to effect a business expansion that would involve adding one or more associated persons with a "covered pending arbitration claim," unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation for the contemplated expansion with the Department and the Department determines that the member may effect the contemplated business expansion without a CMA.

For purposes of a business expansion, FINRA is proposing to define a “covered pending arbitration claim” as: (1) an investment-related, consumer-initiated claim filed against the associated person that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member’s excess net capital. For purposes of this definition, the claim would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees.

Rule 1017(a) provides, among other things, that a member shall file a CMA for a material change in business operations. A “material change in business operations” includes: (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. IM-1011-1 creates a safe harbor for specified changes that are presumed not to be a “material change in business operations” and, therefore, do not require a member to file a CMA for approval of the change. One such change includes increases in the number of associated persons involved in sales within the parameters prescribed in the safe harbor.

Currently, the materiality consultation process is used when a member contemplates a change in business operations that may not squarely fall within one of the categories or definitions that would require a CMA under Rule 1017 and the member firm seeks guidance to determine how best to proceed with the proposed change by voluntarily seeking a materiality consultation from the Department. A request for a materiality consultation is a written request from a member firm for a determination from the Department of whether a proposed change is material. There is no fee associated with submitting this request to the Department. The characterization of a proposed change as material depends on an assessment of all the relevant facts and circumstances. The Department may communicate with the member firm to obtain further information regarding the proposed change and its anticipated impact on the member firm. Where the Department determines that a proposed change is material, the Department will instruct the member to file a CMA if it intends to proceed and will advise that effecting the change without approval would constitute a violation of NASD Rule 1017.

FINRA is concerned that the definition of a material change in business operations and the availability of the safe harbor for business expansions could allow a member to, for example, onboard principals and registered representatives with substantial pending arbitration claims without consideration as to the supervision of those individuals.

Accordingly, FINRA is proposing to add IM-1011-2 (Business Expansions and Covered Pending Arbitration Claims) to provide that if a member is seeking to add one or more associated persons involved in sales and one or more of those associated persons has a covered pending arbitration claim, an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, the member may not effect the contemplated business expansion unless the member has first

submitted a written letter to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated business expansion and the Department determines that the member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated business expansion. Thus, under such circumstances, a member would not be able to avail itself of the safe harbor for business expansions.

The materiality consultation would allow the Department to, among other things, assess the nature of the anticipated activities of the principals and registered representatives with the arbitration claims; the impact on the firm's supervisory and compliance structure, personnel and finances; and any other impact on investor protection raised by adding the principals and registered representatives.

The Department would consider the letter and other information or documents provided, and determine in the public interest and the protection of investors that either: (1) the member is not required to file a CMA in accordance with Rule 1017 and may effect the proposed business expansion; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the proposed business expansion unless the Department approves the CMA.

If the Department determines that a member must file a CMA, the member's application would be subject to the full membership application process, including a review of any record of a pending arbitration and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements.

2. Asset Acquisitions and Transfers

In addition, FINRA believes that member firms engaging in asset acquisitions or transfers that have covered pending arbitration claims, unpaid arbitration awards or unpaid settlement agreements related to an arbitration should be required to seek a materiality consultation for the contemplated acquisition or transfer. Under the current requirements for filing a CMA, a member must file an application for approval for direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the New York Stock Exchange (NYSE).⁷ FINRA is concerned that this 25 percent threshold permits firms with pending claims that ultimately produce awards to avoid satisfying those awards by transferring assets without encumbrance and then closing down.

Accordingly, FINRA is proposing not to permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member has submitted

a written letter to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated transfer and the Department has determined that the member is not required to file for approval of the transfer. As part of the materiality consultation, the Department would consider the letter and other information or documents provided by the member to determine if the acquisition or transfer could result in non-payment of an arbitration claim should it go to award, or the continued non-payment of an arbitration award or settlement related to an arbitration.

For purposes of this proposed amendment, FINRA is proposing to define a “covered pending arbitration claim” as: (1) an investment-related, consumer initiated claim filed against the transferring member or its associated persons that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member’s excess net capital. The claim amount would include claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney’s fees.

The proposed materiality consultation would allow the Department to consider whether the transferring member has documentation with regard to the pending arbitration claims and whether the member could pay the claims, or any unpaid arbitration awards or unpaid settlements related to an arbitration, if the member engages in the contemplated transaction. FINRA would make its determination through, for example, discussions with the firm and reviewing relevant documentation and any other information submitted by the firm in the materiality consultation process.

Following its review, the Department would determine in the public interest and the protection of investors that either: (1) the member is not required to file a CMA in accordance with Rule 1017 and may effect the proposed transaction; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the proposed transaction unless the Department approves the CMA.

If the Department determines that a member must file a CMA, the member’s application would be subject to the full membership application process, including a review of any record of a pending arbitration and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements.

3. Other Proposed Amendments

a. Notification of Changes

FINRA also proposes to amend Rules 1013⁸ and 1017 to add a new provision to require an applicant to provide prompt notification, in writing, of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before a decision constituting final action of FINRA is served on the applicant. Any such pending claim (for a new member applicant), unpaid arbitration award or unpaid arbitration settlement would result in the Department

being able to presumptively deny the application under the standards in Rule 1014(a)(3) and the ability of the applicant to overcome such presumption by demonstrating its ability to satisfy its obligation as discussed above.

b. Effecting Change and Imposition of Interim Restrictions

Rule 1017(c) sets forth the timing and conditions for effecting a change under Rule 1017. Under paragraph (1), an application for a change in ownership or control requires an application for approval to be filed at least 30 days prior to the proposed change. While a member may effect the change prior to the conclusion of the Department's review of the application, the Department may place interim restrictions on the member based upon the standards in Rule 1014 pending a final determination. Under paragraph (2), a member may file an application to remove or modify a membership agreement restriction at any time, but such existing restriction shall remain in effect during the pendency of the proceeding. Finally, paragraph (3) permits a member to file an application for approval of a material change in business operations at any time but the member may not effect such change until the conclusion of the proceeding, unless the Department and the member otherwise agree.

FINRA proposes to amend Rule 1017(c) by adding new paragraph (4) that would provide that notwithstanding the existing conditions under paragraphs (1) through (3), where a member or an associated person has an unpaid arbitration award or unpaid settlement agreement related to an arbitration at the time of filing an application under Rule 1017, the member may not effect such change until the member has demonstrated its ability to satisfy such obligation in accordance with Rule 1014 and the proposed supplementary material, as discussed above.

Economic Impact Assessment

A. Need for the Rule

The MAP rules are intended to promote investor protection by applying uniform standards for admission to FINRA as a member firm, and for the review of changes to a current member firm's ownership, control, or business operations. For new and continuing member applications, however, the MAP rules do not take as strong of an approach with respect to the issue of pending arbitrations as they do with respect to the issue of unpaid arbitration awards and unpaid settlements related to an arbitration. The MAP rules also include a safe harbor from having to file a CMA for changes presumed not to be material, and a 25 percent threshold above which member firms must file a CMA for asset acquisitions and transfers. These provisions reduce the Department's ability to oversee changes to the business of member firms. The proposed amendments would strengthen the MAP rules when claimants and investors may need additional protections.

B. Economic Baseline

The economic baseline for the proposal is the current set of MAP rules. The MAP rules include the non-presumption of denial for pending arbitration claims for NMAs and CMAs, the definition of a material change in business operations and the availability of the safe harbor for some business expansions, and the requirements for a member firm to file a CMA relating to asset acquisitions and transfers.

The proposed amendments would affect new member applicants (and their associated persons) if the applicant or an associated person is subject to a pending arbitration claim. In addition, the proposed amendments would affect member firms (and their associated persons) that, but for the proposed amendments, may not file a CMA because they believe the contemplated transaction is not a material change in business operations or avail themselves of the safe harbor for business expansions. The proposed amendments would also affect member firms (and their associated persons) that, but for the proposed amendments, would not be required to file a CMA due to reliance on the provision relating to asset acquisitions and transfers. Lastly, the proposed amendments would affect the claimants to arbitrations filed against the applicant or an associated person of the applicant, and other investors exposed to individuals or firms with a history of non-compliance.

Currently, claimants to arbitration claims or awards are at risk for non-payment when the individuals or firms responsible for those claims or awards actively maneuver to avoid payment. For instance, individuals may join a new firm without being required to demonstrate an ability to pay should the claim go to award. Further, member firms may transfer assets or engage in similar transactions, in an attempt to avoid payment of arbitration awards.

When deciding NMAs and CMAs, the Department considers pending arbitration claims and unpaid arbitration awards and unpaid settlements related to an arbitration. The Department, however, may not have the ability to ascertain how new member applicants would pay pending arbitration claims if they go to award. In addition, the Department may not receive notification from member firms of business expansions and asset acquisitions and transfers. In these instances, the Department is not able to review any related pending arbitration claims or unpaid arbitration awards or settlements related to an arbitration. Claimants to these arbitrations may therefore be at a greater risk for nonpayment of awards or settlements.

The Department received 246 NMAs from January 2015 to December 2016. Among these applications, FINRA staff identified few new member applicants or their associated persons as having a pending arbitration claim at the time of the NMA filing. Among the 246 NMAs, FINRA staff identified seven NMAs (or three percent) as having a pending arbitration claim at the time of the filing.⁹

The Department also received 786 CMAs from January 2015 to December 2016. The Department does not receive notice from member firms that do not file a CMA, including those member firms that do not file a CMA because they either believe the contemplated transaction is not a material change in business operations or they avail themselves of the safe harbor for business expansions or the provision relating to asset acquisitions and transfers. The number of these transactions, therefore, is not known to the staff.

The member firms identified above as not providing notice may be different from the member firms that currently file a CMA. Thus, the sample only provides a potential indication of the scope of the proposed amendments. Of the CMAs that member firms filed, 276 CMAs related to material changes in business operations. These CMAs could have related to an increase in one or more associated persons involved in sales, or could have related to other business expansions that required the filing of a CMA. Another 122 CMAs related to asset acquisitions (nine) and transfers (113). FINRA staff identified 35 (or 29 percent) as having pending arbitration claims or unpaid arbitration awards or settlements related to an arbitration at the time of the filing.¹⁰

C. Economic Impact

The proposed amendments are designed to enhance the review of membership applications by strengthening the MAP rules in relation to pending arbitration claims, as well as unpaid arbitration awards and unpaid settlements related to arbitrations.

The proposed amendments would shift the burden to the new member applicant to demonstrate how pending arbitration claims would be paid if they go to an award. The proposed amendments would also help to ensure that member firms are not engaging in business expansions or asset acquisitions and transfers to avoid the payment of arbitration claims should the claims go to award.

The proposed amendments would benefit claimants by decreasing the risk that firms are avoiding the payment of awards by shifting their assets, including capital and customer accounts, to another firm. A decrease in the ability of firms to avoid satisfying their arbitration awards in this manner could result in a higher likelihood that arbitration claims that eventually go to award are paid in full in accordance with their terms. The proposed amendments would also benefit investors by increasing the oversight of associated persons who may have a history of non-compliance.

The proposed amendments would impose both direct and indirect costs on new member applicants. New member applicants with pending arbitration claims would incur direct costs to demonstrate their ability to satisfy pending arbitration claims. These costs include the time and expense of firm staff and outside experts to demonstrate the ability to satisfy the claims. New member applicants could also incur the costs to notify FINRA of changes to pending arbitration claims.¹¹ In addition, they could incur the opportunity costs associated

with setting aside funds that could otherwise be used for new business. A new member applicant could incur more opportunity costs than is necessary if it sets aside more capital than the actual award amount.

New member applicants could also incur indirect costs if the rebuttal process delays the applicant's ability to begin earning revenues or otherwise negatively impacts the business. The magnitude of these costs is related to the ability of the new member applicant and FINRA to adequately gauge the likelihood of an award and the size of the award (conditional on its grant). However, as noted above, FINRA estimates that few associated persons related to new member applicants have pending arbitration claims at the time of the filing.¹² Most new member applicants are therefore unlikely to be affected by the proposed amendments.

Member firms that are seeking to add one or more associated persons involved in sales or an asset transfer or acquisition, and are not otherwise required to file a CMA, would incur the direct costs associated with seeking a materiality consultation. The direct costs of a materiality consultation include the expense to hire outside experts (where applicable), the time of firm staff, and the expense to submit documentation describing the covered pending arbitration claim as well as the ability of the firm to pay the claim should it go to award.

Member firms that seek a materiality consultation would also incur costs that are dependent on its outcome. If the member firm does not have to file a CMA, the only additional cost would be the delay in effecting the contemplated expansion or transaction. A delay could negatively impact the value of the expansion or transaction, and potentially lead to a loss of business opportunities. Given the experience of FINRA staff, this delay is anticipated to be small as the time for a materiality consultation averages approximately ten days; although this time period could be longer depending on the complexity of the contemplated expansion or transaction.

Alternatively, if the member firm must file a CMA, the costs to member firms would increase. The increase in costs relate to the fees associated with a CMA, time of firm staff, the submission of documentation, and the notification of changes to any pending arbitration claim.¹³ The filing of a CMA would also delay the effectuation of the contemplated expansion or transaction. In the event of a delay, member firms, associated persons and the customers of member firms could lose the benefits associated with lost business opportunities. A determination that a CMA must be filed, however, would indicate that the risks to claimants, and therefore the potential benefits of a closer examination, would be higher. If the actual risks to claimants are low (*e.g.*, the amount awarded is a small percentage of that claimed), then the higher costs to member firms would not correspond to a similar increase in benefits.

FINRA believes that the proposed definition of a covered pending arbitration claim would mitigate the risk that a member firm would be required to file a CMA when the risk to claimants is small. Only pending arbitration claims (individually or, if there is more than one claim, in the aggregate) that exceed the member's excess net capital would trigger a materiality consultation. Member firms, however, could become more constrained in their future business activities to the extent that those activities would require additional capital. Future business activities that require additional capital could increase the likelihood of a materiality consultation in the event of a business expansion or asset acquisition or transfer. As noted above, the evidence suggests that a number of member firms that engage in asset acquisitions or transfers could have covered pending arbitration claims and, therefore, would be required to seek a materiality consultation with the Department to determine if they must file a CMA.¹⁴

Lastly, member firms that file a CMA would not be able to effect the transaction if at the time of filing the application, the member firm or an associated person has an unpaid arbitration award or unpaid settlement related to an arbitration. Although this aspect of the proposed amendments would increase the likelihood of payment, it could also delay the effectuation of the transaction. A delay could cause member firms, associated persons, and the customers of member firms to lose the benefits associated with lost business opportunities.

D. Alternatives Considered

FINRA considered a range of suggestions in developing the proposal. The proposal reflects the changes that FINRA believes at this time to be the most appropriate for the reasons discussed herein.

An alternative that FINRA considered involved proposing a presumption of denial for pending arbitration claims for CMAs. This alternative would increase the costs to member firms associated with CMAs. Member firms would incur costs to demonstrate their ability to satisfy the claims, as well as the opportunity costs associated with setting aside funds that could otherwise be used for other business opportunities. A presumption of denial, however, would reduce concern with respect to how the pending arbitration claims would be paid if they go to award. FINRA requests comment below as to whether there are circumstances under which member firms that file a CMA should have a presumption of denial for pending arbitration claims.

Other alternatives that FINRA considered include the elimination of the safe harbor to file a CMA for changes presumed not to be material, and the elimination of the 25 percent threshold to file a CMA for asset acquisitions and transfers. These alternatives would increase the number of member firms that file a CMA. The member firms that would file a CMA under this alternative would incur additional costs. FINRA staff believes that the requirement under the proposed amendments for member firms to instead seek a materiality consultation would provide for additional investor protections while minimizing the costs to member firms.

Request for Comment

FINRA is interested in receiving comments on all aspects of the proposed amendments. In particular, FINRA requests comment on the following:

1. Should FINRA consider proposing to apply a presumption of denial in connection with pending arbitration claims and CMAs? If so, under what circumstances?
2. If an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, should FINRA require the applicant to provide some form of guarantee that the funds would be used for that purpose?
3. The proposed amendments would not permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where one or more of the transferring member's associated persons has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, unless the member first seeks a materiality consultation for the contemplated acquisition or transfer and the Department has determined that the member is not required to file a CMA for approval of the acquisition or transfer. Should the proposed amendment be limited to principals, control persons or officers? Please explain.
4. Are there any material economic impacts associated with the proposed definition of a "covered pending arbitration claim"? Should FINRA include in the definition only those pending arbitration claims filed prior to a specified time period or event? For example, should FINRA limit the definition of a covered pending arbitration claim to those claims filed prior to public announcement of the contemplated transaction? Please explain.
5. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposed amendments? If so: a) What are these economic impacts and what are their primary sources? b) To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models? c) What would be the magnitude of these impacts, including costs and benefits?
6. Are there any expected economic impacts associated with the proposed amendments not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) 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 take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. In addition, FINRA intends to transfer the NASD Rule 1010 Series (Membership Proceedings), which governs FINRA's membership application program to the FINRA Rule 1000 Series in the Consolidated FINRA Rulebook, either as part of this proposal or a separate rulemaking. For purposes of this *Notice*, all references to the MAP rules will be to the NASD Rule 1010 Series. The proposed amendments would also update cross-references and make other non-substantive, technical changes, and make corresponding changes to the Forms NMA and CMA. FINRA is separately developing changes to the MAP rules in connection with the retrospective review of this rule set. *See* Retrospective Rule Review Report—Membership Application Rules and Processes (March 2016) at <http://www.finra.org/sites/default/files/RetroRuleReview-03-2016.pdf>.
4. These changes would not prevent other slower ways of closing down potentially to avoid arbitration awards, such as the firm terminating while the registered representatives moved en masse to another firm. Note that in this case the new firm would need the customers' individual consent to transfer their accounts, rather than moving them as a group based on a negative consent notice as permitted when the terminating firm arranges for transfer of the accounts.
5. FINRA is continuing to consider under what circumstances a presumption of denial in connection with pending arbitration claims and CMAs may be appropriate.
6. FINRA is considering whether to provide that, if an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, the applicant would have to provide some form of guarantee that the funds would be used for that purpose.
7. *See* NASD Rule 1017(a). Other events that require a member to file a CMA for approval before effecting the proposed event include:
 - a merger of the member with another member, unless both members are members of the NYSE or the surviving entity will continue to be a member of the NYSE;
 - a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE;
 - a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or
 - a material change in business operations as defined in NASD Rule 1011(k).
8. Rule 1013 sets forth the requirements for the filing of an NMA, including how to file the documents that must be submitted with the application, the ability of the Department

to request additional documentation and to reject an application that is “not substantially complete,” and the process and information needed for conducting membership interviews.

9. The seven NMAs relate to four arbitration claims filed against associated persons. Of the four pending arbitration claims, three related to customer claims. One of the customer claims resulted in a settlement, and two were withdrawn. The total amount of compensatory damages sought by customers was over \$500,000 (including the claims that resulted in a settlement). The fourth claim was an industry claim that resulted in a \$4.5 million award. FINRA staff is not able to identify an NMA in the sample that relates to an unpaid award or an unpaid settlement related to an arbitration.
10. FINRA staff identified 211 pending customer arbitration claims relating to the 35 CMAs including claims made against both member firms and associated persons of member firms. Of the 211 pending arbitration claims, 16 claims resulted in an arbitration award in favor of customers, 37 claims resulted in no arbitration award (including cases withdrawn), 131 claims resulted in a settlement, and 27 claims were still pending. Customers requested a total of \$244 million in compensatory relief (including the claims that resulted in a settlement); and in the claims resulting in an arbitration award in favor of customers, customers were awarded approximately \$4 million in compensatory damages. Among these member firms, seven reported excess net capital greater than the total compensatory damages customers requested for relief. FINRA staff also identified one CMA in the sample relating to asset acquisitions and transfers where the member firm and an associated person had an unpaid arbitration award of approximately \$1.5 million. The member firm later withdrew the CMA and is no longer registered. The associated person was suspended for non-payment of the award. The suspension was later terminated based on evidence of a settlement agreement between the parties.
11. FINRA staff identified three NMAs as relating to a pending arbitration claim either filed or closed after the filing of the NMA but before the Department’s decision. Two of the three NMAs relate to a pending arbitration claim filed after the filing of the NMA. The third NMA relates to a pending arbitration claim that closed prior to the Department’s decision.
12. *See supra* note 9 and related text.
13. FINRA staff identified 115 of the 786 CMAs (or 15 percent) as relating to a pending arbitration claim either filed or closed after the filing of the CMA but before the Department’s decision. Eighty-six of the CMAs relate to pending arbitration claims filed after the filing of the CMA, and 73 of the CMAs relate to pending arbitration claims that closed prior to the Department’s decision. Forty-four of the 115 CMAs had both pending arbitration claims that were filed after the filing of the CMA and had pending arbitration claims that closed prior to the Department’s decision. The median number of changes to a pending arbitration claim for the 115 CMAs is two.
14. *See supra* note 10 and related text. Customers may have a new incentive to file an arbitration claim for the sole purpose of disrupting a contemplated transaction. This incentive could increase the number of member firms that would be required to seek a materiality consultation and potentially to file a CMA. This new incentive is not reflected in the numbers above. FINRA staff has no reasonable basis on which to predict the frequency of this occurring if the rule proposal is adopted.

EXHIBIT 2b

**Alphabetical List of Written Comments
Regulatory Notice 18-06**

1. Joseph Borg, North American Securities Administrators Association, Inc. (“NASAA”) (April 9, 2018)
2. Richard J. Carlesco, Jr., IBN Financial Services, Inc. (“IBN”) (August 31, 2018)
3. Kevin M. Carroll, Securities Industry and Financial Markets Association (“SIFMA”) (April 9, 2018)
4. Benjamin Dell’Orto, Esmat Hanano, Nicole G. Iannarone, and Alisa Radut, Georgia State University College of Law (“GSU”) (April 9, 2018)
5. Chester Hebert, Colorado Financial Service Corporation (“Colorado”) (April 4, 2018)
6. William A. Jacobson and Mercedes M. Taitt-Harmon, Cornell University Law School (“Cornell”) (April 9, 2018)
7. Kristopher J. Kalkowski, University of Nevada, Las Vegas, William S. Boyd School of Law (“UNLV”) (April 9, 2018).
8. Andrew Stoltmann, Public Investors Arbitration Bar Association (“PIABA”) (April 9, 2018)
9. Robin M. Traxler, Financial Services Institute (“FSI”) (April 9, 2018)

**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

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April 9, 2018

Submitted electronically to pubcom@finra.org.

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

RE: FINRA Regulatory Notice 18-06: Membership Application Program – Proposed Amendments to Incentivize Payment of Arbitration Awards

Dear Ms. Mitchell:

On behalf of the North American Securities Administrators Association, Inc. (“NASAA”),¹ I hereby submit the following comments in response to FINRA Regulatory Notice 18-06 (the “Proposal”).² NASAA members regulate FINRA-registered broker-dealers and agents, contributing to the longstanding and multifaceted collaborative regulatory relationship between NASAA and FINRA. NASAA and its members are committed to a well-regulated securities industry, including the implementation and availability of robust investor protection rules.

Unpaid arbitration awards remain an unresolved and well-documented investor protection concern. In failing to pay arbitration awards, broker-dealers fail to comply with their legal, regulatory and ethical obligations. NASAA has been a longstanding proponent of measures to redress this problem.³ While the Proposal is an improvement, it will not resolve the problem of unpaid arbitration awards. NASAA looks forward to working with FINRA and other stakeholders in finding a solution that will ensure that no investor awards or settlements go unpaid. Until such time, the Proposal is a well-considered step in the right direction and should help ensure more

¹ NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

² FINRA Regulatory Notice 18-06: *Membership Application Program – Proposed Amendments to FINRA Membership Application Program to Incentivize Payment of Arbitration Awards* (Feb. 8, 2018), available at <http://www.finra.org/industry/notices/18-06>.

³ See, e.g., Letter from NASAA President Joseph Borg to March E. Asquith regarding FINRA Regulatory Notice 17-33 (Dec. 20, 2017).

Jennifer Piorko Mitchell

April 9, 2018

Page 2 of 6

awards get paid. NASAA also appreciates FINRA's disclosure of arbitration information through the FINRA discussion paper that accompanied release of the Proposal.⁴

NASAA wholeheartedly supports the Proposal's goal of incentivizing timely payment of arbitration awards by individuals or firms in connection with FINRA's new membership application ("NMA") or continuing membership application ("CMA") processes. NASAA also supports the proposed rule amendments, though we offer below recommended revisions to the Proposal and responses to three of the Proposal's six specific requests for comment.

Recommended Revision to Rule 1011 as Proposed

The Proposal creates a new definition, "Covered Pending Arbitration Claim," as Rule 1011(c). NASAA recommends expressly stating that this definition includes all investment-related arbitration claims wherever filed – *i.e.*, FINRA arbitrations as well as any investment-related private arbitrations, such as JAMS or AAA proceedings. NASAA also suggests that this definition should be expanded to include any investment related claims pending in a judicial forum – *i.e.*, in a state or federal court. Without these important clarifications, the Proposal could be open to abuse. For example, absent these clarifications, an investment adviser representative subject to a pending private arbitration claim or a pending investment related civil action who subsequently sought to join the brokerage industry and become associated with a FINRA member firm might conclude that the private proceeding or pending court case need not be disclosed under the Proposal. This would be unfortunate; the Proposal should be clearly understood as applying to all pending investment-related claims, wherever filed.

In addition, NASAA recommends the term "claim amount" in Rule 1011(c) be defined more broadly. The term as currently proposed is open to abuse. For example, the Proposal is unclear as to its treatment of pending claims for which there may be joint liability between more than one person or for which an associated person reasonably expects to be indemnified. (In our opinion, pending claims with joint liability should be assessed to each respondent maximally, as if no other person could be potentially liable.)

With these considerations, NASAA respectfully recommends the following revisions to proposed Rule 1011(c)⁵:

(c) "Covered Pending ~~Arbitration~~ Claim"

The term "Covered Pending ~~Arbitration~~ Claim," means:

(1) For purposes of a business expansion as described in IM-1011-2:

⁴ Discussion Paper – FINRA Perspectives on Customer Recovery (Feb. 8, 2018), available at http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

⁵ If this change is adopted other portions of the Proposal would need to be revised to account for the addition of customer-initiated, investment-related claims pending in judicial forums.

Jennifer Piorko Mitchell

April 9, 2018

Page 3 of 6

(A) An investment-related, consumer initiated claim filed against the Associated Person in any arbitral or judicial forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital.

(2) For purposes of an event described in Rule 1017(a)(4):

(A) An investment-related, consumer initiated claim filed against the transferring member or its Associated Persons in any arbitral or judicial forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member's excess net capital.

For purposes of this definition, the claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees~~[-]~~, and shall be the maximum amount for which the Associated Person is potentially liable regardless of whether the claim was brought against additional persons or the Associated Person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for part or all of such maximum amount.

Recommended Revision to IM-1011-2 as Proposed

The Proposal creates new IM-1011-2, *Business Expansions and Covered Pending Arbitration Claims*, to provide additional guidance on business expansions and acquisitions involving unpaid arbitration awards. NASAA recommends deleting the phrase "involved in sales" from this interpretive material. The Proposal should be understood as applying to any associated person (defined in Rule 1011(b)) who is subject to a pending civil claim or unpaid arbitration award or settlement and who seeks to join a FINRA member firm. The nature of an associated person's employment at the firm should not matter. IM-1011-2 as drafted, however, suggests that the Proposal only applies to associated persons who are *involved in sales*. This would be a mistake. Were the Proposal seen as limited to sales professionals only, it would incentivize firms to evade the Proposal by simply assigning persons with unpaid pending claims or unpaid awards into administrative, non-sales roles.

Recommended Revision to Rule 1013 as Proposed

The Proposal would create a new subparagraph (c) in Rule 1013. NASAA recommends including this additional text within existing Rule 1013(a)(1)(H), rather than as new standalone subparagraph (c). Rule 1013(a)(1)(H) already identifies disciplinary events that must be disclosed in a new member application. The disclosure obligation outlined in proposed Rule 1013(c) could reasonably be inserted as new subparagraph (vi) within Rule 1013(a)(1)(H). FINRA could also

Jennifer Piorko Mitchell

April 9, 2018

Page 4 of 6

remind readers in the Proposal that all the disclosure obligations under Rule 1013(a)(1)(H) must be updated as necessary throughout the pendency of the membership application in accordance with Article IV, Section 1(c) of FINRA's Bylaws.⁶

NASAA accordingly recommends that, rather than the existing proposed amendments to Rule 1013, the following provision be inserted as new Rule 1013(a)(1)(H)(vi):

...

(vi) any arbitration claim that is filed, awarded or becomes unpaid before a decision constituting final action of FINRA is served on the Applicant;

....

Recommended Revision to Rule 1014 as Proposed

NASAA recommends FINRA expressly state in the Proposal that, in reviewing a new or continuing membership application with disclosures of unpaid arbitration awards or settlements, FINRA may in its discretion contact the claimants of such awards or settlements to confirm the accuracy of the information provided by the Applicant. The Proposal does not express this. We believe FINRA generally should verify this information with claimants and, accordingly, should provide notice to members that it may do so.

In addition, the Proposal should be revised to state that FINRA may require an expert's opinion to support an Applicant's assertion that it can satisfy an unpaid award or settlement obligation it intends to assume. The Proposal as drafted indicates an Applicant may provide such an opinion but does not expressly give FINRA authority to require it. This should be made explicit. On the other hand, we do not believe such an expert opinion necessarily needs to be from an "independent" source. The Proposal should give FINRA staff the authority to assess the veracity and reasonableness of an offered expert opinion on a case-by-case basis and to require such qualifications and degree of independence from the Applicant as the staff reasonably believes warranted in each instance. We therefore suggest the following revisions to proposed Supplementary Material .01 of Rule 1014.

. . . Such documentation may include an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund or the retention of proceeds from an asset transfer, or such other forms that the Department may determine to be acceptable. [The

⁶ Article IV, Section 1(c), states:

"(c) Each applicant and member shall ensure that its membership application with the Corporation is kept current at all times by supplementary amendments via electronic process or such other process as the Corporation may prescribe to the original application. Such amendments to the application shall be filed with the Corporation not later than 30 days after learning of the facts or circumstances giving rise to the amendment."

Jennifer Piorko Mitchell

April 9, 2018

Page 5 of 6

~~*Applicant may provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claims.]*~~ *The Department may require that the Applicant obtain a written opinion of a legal or financial expert satisfactory to the Department in support of the Applicant's claimed ability to satisfy such awards, settlements or claims.* Any demonstration by an Applicant of its ability to satisfy these outstanding obligations will be subject to a reasonableness assessment by the Department.

Response to Request for Comment #1 in the Proposal

NASAA believes it is appropriate for the Proposal to distinguish NMAs from CMAs with respect to whether a presumption of denial should apply to pending arbitration claims. Applying a presumption of denial to NMAs with pending awards is appropriate given that these firms will lack operating histories with FINRA. New applicants should be required to affirmatively demonstrate to the Department's satisfaction that they can meet any arbitration obligations they would be bringing with them as new FINRA members. In contrast, existing FINRA members have operating histories the Department can review and consider in any CMA request. FINRA rules should incentivize member firms to pay arbitration awards, including awards they assume in the process of acquiring other members or lines of business. But presumptively denying CMAs with pending claims would be unnecessarily disruptive to existing members and would raise the costs of the CMA process for FINRA members while providing no informational benefit to the Department. This would disincentivize FINRA members from taking-on potential liabilities through business acquisitions and, consequently, could result in more, not fewer, arbitration awards ultimately going unpaid. This would be counterproductive. The materiality consultation process for asset acquisitions and transfers as currently described in the Proposal appears entirely appropriate.

Response to Request for Comment #2 in the Proposal

When an applicant designates the funds to be used for payment of a pending arbitration, unpaid award, or unpaid settlement, the applicant should be required to guarantee that those funds will remain available for such payment. However, NASAA recognizes that circumstances sometimes change during the pendency of a planned business transaction and that applicants may need to reallocate the prior designated funds. To account for potentially changing business circumstances and given the fungibility of money, applicants should not be duty bound necessarily to satisfy an arbitration award or settlement from the funds they may have initially identified. Instead, FINRA's rules should allow an applicant the flexibility to amend its application and designate a different source of available funds to satisfy pending claims or unpaid arbitration awards or settlements if necessary.

Jennifer Piorko Mitchell

April 9, 2018

Page 6 of 6

Response to Request for Comment #3 in the Proposal

We interpret the Proposal as applicable to any person who seeks to become associated with a FINRA member. The proposal thus incorporates by reference the definition of “associated person” in Rule 1011(b). This broad scope is appropriate. The Proposal should not be structured more narrowly, such as by making it applicable only to principals, control persons or officers. A narrower scope such as this would undermine the goals of the Proposal and open it up to potential abuse. For example, if the Proposal were limited to only certain categories of associated persons, members could avoid the Proposal by simply staffing such individuals temporarily in administrative or other positions that fell outside the scope of the Proposal. Keeping the Proposal applicable to all “associated persons” will minimize the risks of such gamesmanship by member firms.

In summary, NASAA supports the Proposal but believes certain revisions discussed above are warranted. NASAA also offers the preceding comments in response to three of the Proposal’s six requests for comment. NASAA welcomes an opportunity to discuss this letter and confer with FINRA staff on further steps that can be taken to resolve the problem of unpaid arbitration awards. If you have any questions about this letter please contact me or NASAA General Counsel A. Valerie Mirko, at vm@nasaa.org or (202) 737-0900.

Sincerely,

A handwritten signature in dark ink, appearing to read "J. Borg", with a stylized flourish underneath.

Joseph Borg
NASAA President
Alabama Securities Commissioner

I am writing to you about Regulatory Notice 18-06;

Here is what a small broker dealer must deal with in the real world. You work seventy hours per week to build a company. You don't make a bunch of money, in my case about 150k per year. You keep a close relationship with FINRA and your coordinators.

Lawyers monitor companies that fail and solicit clients to sue if they lost money. The client agrees and files an arbitration. Cost to the B/D is 3k to 10k. By the time you reach discovery you have another 5 to 10k in legal costs. In many occasions the client made money while at your firm. However, the reality is that the lawyers who solicited the claim know that you will settle because even if your right, it does not matter, it is a cost issue. Arbitration has nothing to do with the law it is about feelings.

The position I am in is that I spend money on FINRA and Lawyers until it no longer makes sense. Who are we helping here FINRA and Lawyers or clients. If you don't want small broker dealers then just shut us down and be done with it. Instead you drag out the process and bleed us dry and we wind up with nothing, except we had a dream of building a business and helping people and lose everything we worked for.

You have the control to change the industry. However, you don't. As an introducing BD we must follow the same rules as Merrill Lynch without the resources. I truly believe that we need two FINRA's one for small introducing BDs and one for larger firms. I would love to have a conversation. I will survive however I am sure I will spend everything I own to survive all these bogus claims and wind up having to sell out anyway. Screwing all the good reps that have been with me for years. All this work to do nothing but benefit all the mega firms that do more to harm clients than small firms than all ever thought of doing.

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April 9, 2018

Via E-Mail to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-06 (proposed amendments to Membership Application
Program to incentivize payment of arbitration awards)

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates the opportunity to comment on Notice 18-06 (the “Notice” or the “Proposal”).² We applaud FINRA’s efforts to amend its Membership Application Program rules to help ensure that arbitration claims, awards, and settlements are paid in full.

We have long held that the issue of unpaid awards originates with the integrity and quality control standards that FINRA establishes for membership. That is the most appropriate juncture and means to address the issue, rather than viewing the issue as requiring some form of post-award collection pool, insurance, or guaranty. We offer the following comments and recommendations for your consideration.

1. Membership applications are presumptively denied if there are pending arbitration claims.

NMA. SIFMA supports the presumption of denial for a new membership application (“NMA”) if the applicant or its associated persons are subject to pending arbitration claims. We likewise support

¹ SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

² Notice 18-06, available at <http://www.finra.org/industry/notices/18-06>.

the applicant's ability to overcome the presumption of denial upon showing its ability to satisfy the pending arbitration claims through an escrow agreement, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer.

If the applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award, or unpaid settlement, then it would be appropriate for FINRA to require the applicant to provide some sort of written guaranty that the funds would be applied for that purpose.

We do not support overcoming the presumption of denial upon a showing of insurance coverage. It is erroneous to conflate insurance coverage with a respondent's ability to pay an award. Most insurance policies do not in fact provide coverage for FINRA arbitration claims.

Most relevant insurance coverages generally exclude, for example, fraud claims and conduct outside the scope of employment (e.g., selling away). In addition, determining whether an insurance policy "may" apply to a claim (in terms of subject matter, policy limits, and coverage determinations) is often difficult based on the Statement of Claim and other information available during the pendency of a case. Thus, in many cases, it would be unclear whether the policy may cover the claim.

Moreover, even if the claim may be covered, it is uncertain whether the insurance company would make an affirmative coverage determination, much less one that would cover the full prospective arbitration award. In many cases, even at the time an award is made, many insurers have not yet provided an opinion on whether their policy would apply. For all the foregoing reasons, insurance policies should not be allowed to demonstrate an applicant's ability to satisfy pending arbitration claims.

CMA. SIFMA agrees that the presumption of denial for pending arbitration claims should not apply to a continuing membership application ("CMA"). Instead, consistent with current practice, FINRA should consider pending arbitrations in determining if the applicant meets the standards for admission.

2. Business expansions require a materiality consultation for unpaid arbitration claims.

SIFMA supports the Proposal to not permit a member to effect a business expansion that involves adding one or more associated persons with a "covered pending arbitration claim,"³ unpaid arbitration award, or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation with FINRA and FINRA determines that the member may effect the contemplated business expansion without a CMA.

The definition of "covered pending arbitration claim" should include only those pending arbitration claims filed prior to public announcement of the contemplated transaction.

³ "Covered pending arbitration claims" means: (1) an investment-related, consumer-initiated claim filed against the associated person that is unresolved; and (2) whose claim amount (either individually or in the aggregate) exceed the member's excess net capital. The claim would include only claimed compensatory loss, not requests for pain and suffering, punitive damages, or attorneys' fees.


3. **Direct or indirect acquisitions or transfers of assets require a materiality consultation for unpaid arbitration claims.**

SIFMA supports the Proposal to not permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where the transferring member or one or more of its associated persons has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation and FINRA determines that the member is not required to file a CMA for approval of the acquisition or transfer.

* * *

If you have any questions or would like to further discuss these issues, please contact the undersigned.

Sincerely,



Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: ***via e-mail to:***

Robert L.D. Colby, Chief Legal Officer, FINRA

Richard W. Berry, Executive Vice President and Director, FINRA-DR

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April 9, 2018

VIA EMAIL to pubcom@finra.org

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Comments Concerning FINRA Regulatory Notice 18-06
Membership Application Program

To whom it may concern:

Thank you for the opportunity to comment on Regulatory Notice 18-06 and its proposed changes to the Membership Application Process. We work in the Georgia State College of Law's Investor Advocacy Clinic where we represent small investors who cannot afford legal representation. Because we work closely with investors, we understand the hard work it takes to reach a settlement or award and the value of funds to those investors. For these reasons, we support changes that improve the likelihood that settlements or awards are paid. We support stringent guidelines for new and continuing membership applications from firms with pending or unpaid awards. We also support the proposals to incentivize payments because investors need additional protections from those who have wronged them. Claimants in arbitration with new member applicants may be at a greater risk for nonpayment of awards or settlements and are therefore in need of greater protection.

Thus, we believe that firms should show that they can pay a pending arbitration claim before being approved as a new member. FINRA should have the final decision in approving a member's decision to hire problematic brokers with pending or unpaid awards or settlement. A firm should not be able to actively avoid its obligations to investors by shifting assets and resurfacing under a new entity identity. We also recommend carrying out the alternative suggestion in the notice by reducing the 25% threshold to file a Continuing Membership Application (CMA) for asset acquisitions and transfers to 10%. We also support including the presumption of denial for CMAs as well as new members.

A. A Firm Should Show Its Ability to Pay a Pending Arbitration Claim Before Being Approved as a New Member.

FINRA should deny new applications for applicants or their associated persons who have pending arbitration claims until the applicant shows how those claims would be paid should they go to award.¹ Showing an ability and intent to pay pending claims is an important factor to the public. If the claims go to award, the firms or associated persons will need to pay them. Requiring members to show their ability to do so engenders trust. As the notice itself states, this new requirement would “shine a spotlight on the individuals with the pending arbitration claims and the firm’s supervision of such individuals.”²

Additionally, we recommend that this presumptive denial also apply to CMAs for members who have pending arbitration or unpaid settlement claims for amounts greater than \$15,000. Investors with existing brokers should have at least the same amount of protection as those with new brokers. Limiting the required showing to claims over \$15,000 will provide some balance to this rule, only requiring a presumption of denial for claims that would be reported.

B. FINRA Should Have the Final Decision, Using A Materiality Consultation, to Approve a Member’s Decision to Hire Problematic Brokers With Pending or Unpaid Awards or Settlements.

We support the second proposed amendment that would require members, who do not otherwise have to file a CMA, to apply for a materiality consultation to approve or deny a business expansion when taking on new associated members with pending or unpaid arbitration claims or settlements.³ Currently, hiring brokers with pending or unpaid arbitration claims is not considered a material change. However, this is a material business change since these persons could affect future claims and liability owed by the member firm. In accordance with the proposed requirement, firms would have to abide by FINRA’s determination in the materiality consultation and file a CMA if they intend to proceed with the hiring of problematic brokers. This change prevents firms from taking advantage of the business expansion safe harbor when adding new members. Not only would FINRA be able to assess the impact these persons would have on firms, it would also incentivize firms’ scrutiny of brokers with a bad record of paying claims, adding an additional layer of supervision. Additionally, brokers would know that having claims against them would be problematic when trying to move to a different firm, which would

¹ See FINRA, REGULATORY NOTICE 18-06, MEMBERSHIP APPLICATION PROGRAM 4–5 (2018) (“One factor [already] considered in [existing] Rule 1014(a)(3)(C) to be considered by [FINRA’s Department of Member Regulation], and that creates a presumption of denial, is whether the applicant . . . is subject to unpaid arbitration awards . . . or unpaid arbitration settlements. The rebuttable presumption does not apply, however, to pending arbitration claims.” Therefore, “FINRA is proposing to amend Rules 1014(a) and (b) to specify that a presumption of denial exists if the new member applicant or its associated persons are subject to pending arbitration claims.”)

² *Id.* at 4.

³ See *id.* at 5 (“FINRA is proposing not to permit a member to effect a business expansion that would involve adding one or more associated persons with a ‘covered pending arbitration claim,’ unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation for the contemplated expansion with the Department and the Department determines that the member may effect the contemplated business expansion without a CMA.”)

hopefully deter bad actions. If such claims exist, this proposal incentivizes brokers to resolve and pay them.

We recommend that the proposed amendment be applicable to the hiring of anyone who is involved in direct customer sales, and also to principals, control persons, or officers. Occasionally, associated persons from problematic firms go on to become officers at larger firms, taking their poor business practices with them. FINRA should use these amendments as an opportunity to prevent these individuals from moving to firms where they can create a culture of misconduct.

Additionally, we believe that the applicability of a presumptive denial in a CMA for those with pending or unpaid arbitration awards or settlements is crucial. A firm should be aware that taking on a problematic broker would impose stricter membership approval standards. If they take on such a risk, they should take steps to ensure the public is protected.

C. A Firm Should Not Be Able to Actively Avoid Its Obligations to Investors by Shifting Assets.

We support preventing acquisitions or transfers without a materiality consultation where the member or any of its associated persons have pending or unpaid awards.⁴ Large transfers should be prevented until the firm files a CMA while some smaller transfers could still be permitted. A 10% safe harbor would still be small enough to allow the occasional transfer of customer accounts from one firm to another. However, it would not allow an associated person to move a meaningful percentage of his accounts to another firm. While we understand that this would overall result in more CMAs, adding costs to member firms, the added rigor of CMAs will help prevent problematic transfers.

We agree with this change because it would allow FINRA's Department of Member Regulation to determine how the claims will be paid before approving the transfer or acquisition. This will prevent firms with unpaid or pending claims from closing down and opening back up under a different name, or shifting their assets to other firms. This change would protect investors by preventing firms from actively avoiding their obligation to pay settlements or claims. By ensuring that firms are not engaging in business expansions or asset acquisitions as a means of avoiding payment of claims, investors would be better protected against these practices.

CONCLUSION

In conclusion, new members or brokers with pending or unpaid arbitration claims should bear the burden of showing how they will resolve these issues before having their application accepted. These changes would help contribute to FINRA's integrity, and hopefully ensure that more claims are paid. The costs incurred by firms are outweighed by the benefits of protecting

⁴ See *id.* at 7 ("FINRA believes that member firms engaging in asset acquisitions or transfers that have covered pending arbitration claims, unpaid arbitration awards or unpaid settlement agreements related to an arbitration should be required to seek a materiality consultation for the contemplated acquisition or transfer.")

April 9, 2018

Page 4 of 4

investors and maintaining industry integrity. The changes would serve as an incentive to treat investors fairly.

Thank you for this opportunity to share our comments.

Best regards,

/s/ Benjamin Dell'Orto

Benjamin Dell'Orto

Student Intern

Student Reg. No. SP001565*

/s/ Esmat Hanano

Esmat Hanano

Student Intern

Student Reg. No. SP001567*

/s/ Alisa Radut

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Student Reg. No. SP001351*

/s/ Nicole G. Iannarone

Nicole G. Iannarone

Assistant Clinical Professor

* All student interns in the Investor Advocacy Clinic, including this signatory, perform all work under the Georgia Student Practice Rule contained in Rules 91-95 of the Rules of the Supreme Court of Georgia as registered law students under the supervision of a licensed Georgia attorney.



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APRIL 4, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

RE: Proposed Rule Amending Membership Application Program

Thank you for the opportunity to comment on the referenced issue.

I support the intent of the proposed changes.

The proposed changes, I believe, would go a long way towards cleaning up the industry and memorializing a best practice. However, I would caution that the proposed regulation take into consideration due process and assumption of innocence for the representative who may be affected by such a rule.

A rule that requires all Broker-Dealers to operate on the same page would not allow a broker-dealer to be pressured, for whatever reason, to take-on a representative who perhaps should not be in the industry. More importantly if a representative or Firm skips on an arbitration award, that should be grounds enough for FINRA to deny registration until such time as the Firm and the representative, if jointly liable, cure the award. This a case of rules based regulation being necessary.

Thanks again for the opportunity to comment.

With kind regards,

A handwritten signature in black ink, appearing to read "Chester Hebert", is written over the printed name.

Chester Hebert

CEO



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April 9, 2018

Via E-Mail (pubcom@finra.org)

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-06 (Proposed Amendments to Membership Application Program to Incentivize Payment of Arbitration Awards)

Dear Ms. Mitchell,

The Cornell Securities Law Clinic (the "Clinic") submits this comment to support the proposed amendments ("Proposed Amendments") to the Financial Industry Regulatory Authority ("FINRA") Membership Application Program ("MAP") Rules. The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see: <http://securities.lawschool.cornell.edu>.

The Clinic supports the Proposed Amendments as an important part of an overall scheme to curb the problem of unpaid investor arbitration awards.

The Proposed Amendments create incentives for the timely payment of arbitration awards. Creating incentives to pay arbitration awards is important because investors typically are compelled to arbitrate by FINRA member firms. Data collected by FINRA between 2012 and 2016 shows that approximately 30% of cases in which the investor was awarded damages went unpaid.¹ Over the five-year period the aggregate unpaid amount was \$199 million with an additional \$1.4 million in dispute at the time of publishing.²

If adopted, the Proposed Amendments would impose supervisory review obligations on firms with regard to representatives with pending investment-related arbitration claims ("Covered Pending Arbitration Claim") and prevent FINRA member firms with Covered Pending Arbitration Claims from shifting assets in customer accounts, managers or owners to

¹ FINRA, Statistics on Unpaid Customer Awards in FINRA Arbitration, (Feb. 2018), <https://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration>.

² *Id.*

Jennifer Piorko Mitchell
 April 9, 2018
 Page 2

another firm then closing down. As such, the Proposed Amendments advance investor protection.

I. We Support the Proposed Amendment to Rules 1014(a) and (b)

The proposed amendments to Rules 1014(a) and (b) will create a rebuttable presumption of denial of a New Member Application (“NMA”) if there is an unpaid arbitration award, unpaid arbitration settlement, pending arbitration claims³ or other unpaid customer settlement on the part of the applicant, its control persons, principals, registered representatives, other associated persons (“Associated Persons”), any lender of five percent or more of the applicant’s net capital and any other member with respect to which these persons were a control person or a five percent lender of net capital for an NMA. This is a welcome addition to the rules because it will likely incentivize potential members and Associated Persons to pay off these obligations knowing that failure to do so will result in presumptive denial of the NMA.

This proposed amendment is also efficient because the presumption of denial does not apply to member firms which are required to file a Continuing Membership Application (“CMA”), since the CMA collects all of the information necessary for FINRA to determine whether the member firm or its Associated Persons are likely to pay their covered pending arbitration claims.⁴ This will likely have a balancing effect of not in itself chilling business expansion activity for member firms with an obligation to report.

Finally, this proposed amendment will allow new member applicants to overcome the presumption by demonstrating that they can pay covered pending arbitration claims via insurance coverage, an escrow account, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms that FINRA’s Department of Member Regulation (“the Department”) may determine to be acceptable. These provisions balance any negative effects by not punishing new member applicants with legitimate plans of paying the claims against them should such claims result in arbitration awards.

II. We Support the Proposed Addition of the Business Expansion for Members Rule

This proposed amendment imposes an extra level of review when a member firm that is not required to file a CMA tries to effect a business expansion that involves adding one or more associated persons with a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, by making the member first seek a materiality consultation

³ The Regulatory Notice uses the term “pending arbitration claim” instead of “covered pending arbitration claim” to describe what is prohibited in this section. The Clinic assumes that “pending arbitration claim” is used to refer to the same concept as “covered pending arbitration claim” elsewhere. If FINRA aims to have “pending arbitration claim” refer to a broader concept than “covered pending arbitration claim” it should make that clear.

⁴ See FINRA, Continuing Membership Guide – CMA Requirements, <http://www.finra.org/industry/continuing-membership-guide-cma-requirements-0315>.



Jennifer Piorko Mitchell

April 9, 2018

Page 3

with the Department and requiring the Department to find that the member may effect the contemplated business expansion without a CMA (“Business Expansion for Members”).

The proposed addition of the Business Expansion for Members Rule will likely incentivize members to investigate the covered pending arbitration claims and unpaid awards of new hires, since the proposed amendment will require that the Member have a net capital large enough to cover the individual’s covered pending arbitration awards, unpaid arbitration awards and unpaid settlement amounts. The proposed amendment will assess whether the member firm’s net capital can cover that individual’s covered pending arbitration claims. Thus, it is foreseeable that individuals with large aggregate covered pending claim amounts and unpaid arbitration awards will, at a minimum, be subject to increased supervision and review.

One possible negative effect of this addition may be that individuals with large aggregate unpaid awards and covered pending arbitration claims will be attracted to brokerage firms with large net capitals and those individuals may be attractive to brokerage firms with large net capitals. This may create a situation where some well-capitalized firms have a concentration of individuals with substantial unpaid awards or covered pending arbitration claims.

Another downside is that the proposed addition does not directly prohibit the member firm from conducting a Business Expansion while having covered pending arbitration claims — it merely imposes an extra level of review. While it is certainly helpful to have a Department determination of whether a firm’s proposed Business Expansion is material and a pronouncement that the firm must file a CMA to remain in non-violation of the FINRA Rules, FINRA should consider including a more affirmative prohibitive mechanism in the rule’s language. For example, appropriate language to the effect that failure to file a CMA within 30 days upon a finding of materiality will result in an imposition of fines or suspension.

III. We Support the Proposed Amendments to the Business Expansion for Asset Transfer Rule

This proposed amendment will prevent member firms who are not already required to submit a CMA from effectuating the direct or indirect transfer or acquisition of assets, businesses or lines of operation without seeking a materiality consultation. This proposed amendment will likely effectively address the problem of member firms attempting to dodge liability for covered pending arbitration claims or unpaid arbitration awards by forcing member firms to alert FINRA on both the acquisition and transfer front.

IV. We Support the Proposed Amendments to the New Member Notification Rule and Business Expansion Notification Rule.

This proposed amendment will likely make it easier for FINRA to effectively monitor when pending arbitration claims⁵ are filed, or awards become unpaid during the time that FINRA

⁵ See Footnote 3, above.



Jennifer Piorko Mitchell
April 9, 2018
Page 4

is deciding on the new member's application or the member firm's proposed business expansion activities.

Conclusion

For the foregoing reasons the Clinic supports the Proposed Amendments.

Respectfully submitted,

/William A. Jacobson/

William A. Jacobson, Esq.
Clinical Professor of Law
Director, Securities Law Clinic

/Mercedes M. Taitt-Harmon/

Mercedes M. Taitt-Harmon
Cornell Law School, Class of 2019

April 9, 2018

By email to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-06
Membership Application Program

Dear Ms. Mitchell:

On behalf of the Investor Protection Clinic ("Clinic") at the William S. Boyd School of Law at the University of Nevada, Las Vegas, I write to comment on FINRA Regulatory Notice 18-06. Our Clinic represents investors who suffered losses because of unsuitable financial advice, and provides pro bono assistance to investors who cannot secure private legal representation because of the size of their claims. Our Clinic's clients have a direct interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA").

Thank you for the chance to comment on proposed changes to FINRA's rules governing its Membership Application Program. Below are our Clinic's comments on two of the questions.

Request for Comment No. 1. *Should FINRA consider proposing to apply a presumption of denial in connection with pending arbitration claims and CMAs? If so, under what circumstances?*

FINRA should presumptively deny Continuing Membership Applications (CMAs) from member firms that face pending arbitration claims.¹ This

¹ Under FINRA's rules, the member firm that must file a CMA after a merger or acquisition depends on the specific transaction. For example, if one firm faces an acquisition or merger with another firm, both firms may have to file a CMA because FINRA Rule 1017(a)(3) requires any member firm to file a CMA application for "direct or indirect acquisitions or transfers of 25% or more in the aggregate of the member's assets or any asset." By contrast, if one large firm transfers a relatively small portion of its assets, but those assets go to a much smaller firm, then under FINRA Rule 1011(k) it is likely

presumption should only apply, however, in the limited circumstance of a “covered pending arbitration claim” as defined in Regulatory Notice 18-06—meaning, where there is: “(1) an investment-related, consumer-initiated claim filed against the associated person that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member’s excess net capital.”²

A presumption of denial in that specific circumstance would limit member firms’ ability to dissipate their assets to escape liability. By some reports, this happens quite often. For example, one experienced securities lawyer recently explained that “[t]here’s literally a playbook that owners of brokerage firms follow to shield their assets when things go wrong.”³

Additionally, FINRA should consider proposing a rule to protect investors when FINRA members try to convert themselves into another area of the securities industry while facing covered pending arbitration claims or outstanding unpaid arbitration awards. Section 2 of this Response to Request for Comment No. 1 discusses the need for FINRA to propose this rule.

1. FINRA SHOULD CREATE A PRESUMPTION OF DENIAL FOR CMAS WITH COVERED PENDING ARBITRATION CLAIMS.

From January 2015 to December 2016, FINRA staff received 35 CMAs that involved a pending arbitration claim or unpaid arbitration award.⁴ Of those 35 CMAs, only “*seven member firms* reported excess net capital greater than the total compensatory damages that customers requested.”⁵ In other words, twenty-eight of the thirty-five member firms did not have enough assets to satisfy the arbitration claims that they faced, yet these firms still sought to reorganize or transfer their firms’ assets.

This statistic seems puzzling. Why do so many firms frequently reorganize or transfer their assets when they face crushing liability? The answer is likely simple: current legal principles of successor-in-interest liability favor firm

that only the smaller firm would have to file a CMA, because only that smaller firm underwent a “material change” in business operations by receiving those assets.

² See FINRA Regulatory Notice 18-06, *Membership Application Program* 13, www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-06.pdf (last visited Feb. 22, 2018) (defining a “covered pending arbitration”).

³ Andrew Osterland, *Wronged Investors Win Cases over Brokers but Never Collect*, CNBC (Mar. 7, 2016, 7:59 AM), <https://www.cnbc.com/2016/03/07/wronged-investors-win-cases-over-brokers-but-never-collect.html> (quoting Andrew Stoltmann, a Chicago-based securities lawyer).

⁴ FINRA Regulatory Notice 18-06, *supra* note 1, at 11.

⁵ *Id.* at 11 n.10 (emphasis added).

reorganization when there are pending claims or awards.⁶ Put differently, when one member firm transfers or sells its assets to another firm, the firm that receives those assets can potentially disclaim the other firm's liability from pending arbitrations.⁷ These successor-in-interest principles exist because the firm that receives another firm's assets generally does not gain the previous member firm's "customers" in the legal liability sense. Instead, the liability from customers of the selling/transferring firm likely remains legally with that original member firm.⁸ Further, when those sales/transfers occur, *courts* generally control an arbitrator's power to award damages for pre-transfer liabilities, not FINRA arbitrators.⁹ So, investors with the initial member firm are often left without a full remedy in FINRA's arbitration process due to that initial firm's insolvency or a discharge of owed funds through, for example, bankruptcy.¹⁰

Unfortunately, FINRA rules have not eliminated its members' ability to dissipate assets. In fact, the central FINRA rule on CMA requirements, Rule 1014(a), now only looks at pending arbitration claims as one factor in many to grant or deny an application.¹¹ Further, no single factor presumptively controls FINRA's decision; nor does any factor weigh heavier than others. This means that if one firm has a covered pending arbitration claim, yet still applied for a CMA, FINRA could nonetheless grant that firm's CMA. FINRA would do so by

⁶ Courts generally impose successor-in-interest liability only if: (1) the purchaser agreed to assume the debt, (2) there was a de facto merger of the two corporations, (3) the purchaser was a mere continuation of the seller, or (4) the transaction was fraudulent. *See Wheat, First Sec., Inc. v. Green*, 993 F.2d 814, 821 (11th Cir. 1993); Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 425 n. 56 (2003).

⁷ *See Black, supra* note 6, at 426 (discussing a prominent federal court case, which found that, in some circumstances, "it would be unfair to require the purchaser to arbitrate claims against someone who was never its customer").

⁸ The previous court decisions that created this legal "customer" distinction relied on the NASD Rule 10301 definition of "customer," which is now superseded by FINRA rules. These cases are still relevant to this discussion, however, because the same definition of "customer" exists under current FINRA rules. *See* FINRA Rule 12100 ("A customer shall not include a broker or dealer."). Likewise, court rulings differ over whether "customer" includes investors who were part of a firm that existed prior to a merger or asset sale. *See Who is a "Customer,"* THE GUILIANO LAW FIRM, P.C., <https://securitiesarbitrations.com/who-is-a-customer/> (last visited Feb. 21, 2018) (discussing the several federal circuit court cases on this topic).

⁹ *See Wheat, First Sec., Inc.*, 993 F.2d at 820 (enjoining the arbitrator from hearing claims prior to the transfer of the account, but allowing arbitration of the post-transfer claims).

¹⁰ *See* Hugh D. Berkson, *Unpaid Arbitration Awards: A Problem the Industry Creates—A Problem the Industry Must Fix*, PUB. INV. ARB. B. ASS'N 4 (Feb. 25, 2016), <https://piaba.org/piaba-newsroom/report-unpaid-arbitration-awards-problem-industry-created-problem-industry-must-fix> (discussing generally the outcomes of bankruptcy with member firms).

¹¹ *See* FINRA Rule 1014(a) (stating that FINRA can consider a request for CMA by looking to several factors alongside pending arbitration claims including, but not limited to: whether the application and all supporting documents are complete and accurate; whether the applicant can comply with federal securities laws; and if the applicant poses a threat to public investors).

finding that other factors outweighed the covered pending arbitration claims' potential for harm to investors.

FINRA can solve this issue, however, by implementing a presumption of denial for CMAs involving covered pending arbitration claims. This presumption could eliminate the potential for member firms to escape liability because it would condition FINRA's grant of a CMA on firms' ability to satisfy any pending arbitration claim. That is, firms could only overcome this presumption by executing an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, the retention of proceeds from an asset transfer, or such other methods that FINRA may determine to be acceptable—the same circumstances that FINRA currently wishes to use based on its proposal in Regulatory Notice 18-06 for New Membership Applications. Consequently, the successor-in-interest scheme would be impractical, because a firm would need to prove that it would pay any arbitration award before its firm underwent any transfers or sales of assets to escape paying damages.

Additionally, a presumption of denial for CMAs from firms facing covered pending arbitrations would align with FINRA's current rules, and, at the same time, improve the accountability of the securities industry. FINRA already uses a presumption of denial for CMAs when the “applicant, its control persons, principals, registered representatives . . . [are] subject to unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements.”¹² By expanding these current principles to covered pending arbitration claims, FINRA would only marginally extend its current presumption-of-denial procedures. Likewise, investors who know that they are more likely to be paid in the event of wrongdoing have an added incentive to participate in the industry.¹³

A. Responses to FINRA's Concerns in Regulatory Notice 18-06

This Comment's proposed solution satisfies FINRA's central concerns about a presumption of denial in CMAs for firms that face covered pending arbitration claims. Specifically, FINRA's central concerns are: (1) member firms would incur costs to demonstrate their ability to satisfy the claims, as well as the opportunity costs associated with setting aside funds that could otherwise be used for other business opportunities; and (2) customers may have a new incentive to file an arbitration claim for the sole purpose of disrupting a contemplated transaction,

¹² FINRA Rule 1014(a)(3)(C).

¹³ See Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 YALE L. REV. 963, 971 (2012) (discussing FINRA duties to “protect investors and the integrity of the market”).

which would increase the number of member firms required to seek a materiality consultation to file a CMA.¹⁴

Though the first worry may still exist under this Comment's solution, the costs to member firms would be minimal because only member firms that have *covered pending arbitration claims* are affected. All other pending arbitration claims would not suffer any additional costs from a more burdensome procedure. Also, as to FINRA's second concern, customers that are represented by counsel may not file an arbitration claim without any basis for their damages allegations.¹⁵ So, they could not know with certainty that their claim would be a "covered" claim.

Naturally, this Comment's proposed solution may have some adverse industry impact. For instance, a presumption of denial in the CMA context could slow the growth and expansion of member firms in the broker-dealer industry. That is, if the presumption of denial reduces the number of CMAs that FINRA grants, then other firms could not buy or receive the denied firm's assets; nor could other firms merge with the denied firm to expand their practice. But FINRA should not consider this slowed-growth effect as undesirable. Instead, as further explained below, this outcome benefits the industry because it prevents brokers with a record for misconduct from joining and concentrating within other firms with a record for misconduct.

B. Advantages of this Comment's Proposed Solution

A recent study by Mark Egan, Gregor Matvos, and Amit Seru found that "[associated persons] with misconduct switch to firms that employ more [associated persons] with past misconduct records."¹⁶ The explanation for this phenomenon is that firms with already poor misconduct records have a higher tolerance for misconduct, and are less likely to discipline their associated persons through termination or strong action—thus attracting other associated persons who are more likely to engage in future wrongdoing.¹⁷

This dynamic creates member firms with higher-than-normal misconduct records. As an example of this current concentration, consider Oppenheimer & Co., Wells Fargo Advisors Financial Network, and First Allied Securities—

¹⁴ FINRA Regulatory Notice 18-06, *supra* note 1, at n.14.

¹⁵ See Am. B. Assoc. Rule 3.1.

¹⁶ Mark Egan, Gregor Matvos, and Amit Seru, *The Market for Financial Adviser Misconduct*, J. POL. ECON. 1–2 (forthcoming) (referring to "advisors" as "registered representatives" with FINRA).

¹⁷ *Id.* at 4.

where more than one in seven associated persons have a record of misconduct.¹⁸ By contrast, in most other firms the ratio is less than one in thirty-six.¹⁹ This means that the concentration of brokers with records of misconduct is not a statistical anomaly; it instead may be a product of the current market conditions, where there is a specific market for broker misconduct.²⁰

FINRA can inhibit this activity by implementing a presumption of denial in the CMA process for firms facing covered pending arbitration claims, which would limit the rate at which member firms dissipate their firms' assets. To illustrate, say FINRA were to implement the presumption of denial that this Comment advocates. This would likely reduce the number of CMAs that FINRA grants, because firms facing covered pending arbitration claims could not reorganize through this revised CMA process. Those firms would then be removed from the acquisition market.²¹ And by removing those firms from the market, FINRA would check the expansion of firms "specializing" in misconduct "and catering to unsophisticated consumers."²²

Altogether, if FINRA were to propose a rule that would create a presumption of denial for "covered pending arbitration claims," that rule would help ensure that no member firm can sidestep liability. Similarly, that rule would likely have the added benefit of reducing concentrations of associated persons with prior misconduct at particular firms.

2. FINRA SHOULD PROPOSE A RULE THAT WOULD ALLOW IT TO COLLECT UNPAID ARBITRATION AWARDS FROM MEMBER FIRMS THAT CONVERT THEMSELVES INTO ANOTHER AREA OF THE FINANCIAL SERVICES INDUSTRY WHILE CONCURRENTLY FACING PENDING ARBITRATION CLAIMS OR HAVE UNPAID ARBITRATION AWARDS.

Unpaid awards and pending arbitration claims may also be a large problem when broker-dealer firms restructure themselves into a different part of the

¹⁸ *Id.* at 3, 42 (showing that 19.60% of associated persons with Oppenheimer & Co. had a history of misconduct, 17.72% First Allied Securities, and 15.30% at Wells Fargo Advisors Financial Network).

¹⁹ *Id.*

²⁰ *Id.* ("If firms had identical tolerance toward misconduct, such rehiring [of advisors with a history of misconduct] would not take place. We find that advisers with misconduct switch to firms that employ more advisers with past misconduct records. . . . Thus the matching between firms and advisers on misconduct partially undermines the disciplining mechanism in the industry, lessening the punishment for misconduct in the market for financial advisers.").

²¹ *Id.* at 3–4.

²² *Id.* at 1 (stating how firms with a "clean reputation" would already steer clear of firms facing misconduct claims. So, only firms with a higher tolerance for misconduct would be in the market for additional assets with misconduct).

financial industry.²³ FINRA recognized in a 2018 Discussion Paper that “if an associated person of a FINRA member is suspended due to the failure to pay a FINRA arbitration award, FINRA is not aware of any federal provisions that would prevent that individual from entering or continuing in another area of the financial services industry, including acting as an investment adviser.”²⁴ Accordingly, a broker-dealer firm with a pending arbitration claim could convert itself into an advisory firm, continue to profit in another business, and potentially avoid any future arbitration award. This outcome challenges the integrity of the securities industry.

FINRA should consider preventing this problem by proposing a rule along these lines:

If a member firm seeks to restructure itself into another area of the financial services industry not regulated by FINRA while concurrently facing a pending arbitration claim, FINRA will, under appropriate circumstances, require the member firm to create an escrow account that will secure the potential damages that the member firm may have to pay if the member firm were to be found liable.

If a member firm does not escrow assets, FINRA may immediately seek a court order that freezes the firm’s assets prior to that firm’s transfer into a different area of the financial sector.

This proposed rule essentially allows FINRA to do two things: (1) preemptively require that a member firm set aside funds for a pending arbitration claim; and (2) act to freeze assets if the member firm does not comply with the request to create an escrow account.

Additionally, this proposed rule should apply to member firms that restructure themselves into *all areas of the financial services industry* that are not regulated by FINRA—including when a member firm restructures itself into an insurance-focused firm selling insurance products. This rule would then ensure that

²³ FINRA oversees this type of a change in business under FINRA Rule 1017, which requires that member firms file a CMA for “material changes” in the operations of a firm. Whether a change is “material” depends on many factors, such as: “the nature of the proposed expansion; the relationship, if any, between the proposed new business activity or expansion and the firm’s existing business . . . adding business activities that require a higher minimum net capital under SEC Rule 15c3-1.”

²⁴ *Discussion Paper—FINRA Perspectives on Customer Recovery*, FINRA 12 n.36 (Feb. 8, 2018), http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf (“Some associated persons who failed to pay arbitration awards in 2015 and 2016, for example, were suspended from being associated with a FINRA member, but continue to be registered as investment advisers.”).

FINRA could, whenever possible, collect arbitration awards from able firms, and that member firms could not unjustly escape liability—even when FINRA would not have direct regulatory jurisdiction.²⁵

This change would not overly expand FINRA’s role. FINRA already has rules that allow the self-regulatory organization to oversee firms when it would not normally have jurisdiction. FINRA Rule 8210, for example, allows FINRA to require any member firm to provide information, documentation, or to testify on the record during an investigative process.²⁶ And FINRA’s ability to compel a firm’s compliance extends for at least two years *after a firm has left the securities industry*.²⁷ During that extended time-frame of two years, FINRA can impose disciplinary actions against a firm that fails to comply, or even bar a non-complying firm entirely from the brokerage industry.²⁸ So, FINRA can simply mirror this approach by requiring a firm to set aside assets, and then monitoring that firm’s compliance with that action throughout the pending arbitration claim—regardless of whether the firm reorganizes to another part of the financial services industry.

In total, this Comment’s proposed rule would advance FINRA’s investor protection mission and ensure that no firm could escape liability.

Request for Comment No. 2. *If an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, should FINRA require the applicant to provide some form of guarantee that the funds would be used for that purpose?*

FINRA should require an applicant to provide some form of guarantee that it will use a clearing deposit or the proceeds from an asset transfer to satisfy a

²⁵ See Article III, Section 1(a), FINRA Manual, By-Laws of the Corporation (stating that FINRA has jurisdiction over “any registered broker, dealer, municipal securities broker or dealer . . . and whose regular course of business consists in actually transacting, any branch of the investment banking or securities business in the United States”).

²⁶ FINRA Rule 8210 (stating that FINRA can “require a member, person associated with a member, or any other person subject to FINRA’s jurisdiction to provide information orally, in writing, or electronically (if the requested information is, or is required to be, maintained in electronic form) and to testify at a location specified by FINRA staff, under oath or affirmation administered by a court reporter or a notary public if requested, with respect to any matter involved in the investigation, complaint, examination, or proceeding).

²⁷ See Michael Gross, *Frequently Asked Questions About FINRA Rule 8210*, BROKER-DEALER LAW CORNER (Oct. 3, 2016), <https://www.bdlawcorner.com/2016/10/frequently-asked-questions-about-finra-rule-8210/> (“If you are subject to FINRA’s retained jurisdiction (which typically extends for a period of two years after you have left the industry), FINRA likely will bring a disciplinary action against you and have you barred.”)

²⁸ See *id.*

pending arbitration claim, unpaid award, or unpaid arbitration settlement. This guarantee may be essential to the actual payment of arbitration awards.

Without any guarantee that member firms will use certain funds to pay for pending or unpaid arbitration claims, firms are free to negotiate their eventual losses and damages—even when firms face an imminent award. The Public Investors Arbitration Bar Association’s recent report explains this exact problem by discussing an incident with Securities America in 2010. Securities America was the “fifth largest independent brokerage firm in the country,” and it held a net capital of \$1,991,058 in the event of any firm liability.²⁹ Even so, when it faced an impending arbitration award in March of 2011, the firm’s CFO testified that if a limited fund class action settlement was not approved, the firm “might have to close.”³⁰ Securities America later asked investors to essentially take a certain amount of money or the firm would file for bankruptcy.³¹ Investors then had to decide between accepting the partial remedy or receiving nothing at all.

Luckily, Securities America received help from Ameriprise to pay investors.³² But what would have happened had Ameriprise not stepped in, or if Securities America decided to transfer assets before or after an award? Would Securities America have simply given an ultimatum to investors, even if they could have paid out more? FINRA should take that ability to manufacture an insolvency constraint out of member firms’ hands. One effective way to remove that possibility is to require member firms to set aside certain funds to satisfy pending arbitration claims, unpaid awards, or unpaid arbitration claims. Not only would this improve investors’ willingness to use member firms, but it would also improve investors’ trust in FINRA’s arbitration system.³³

There is a tradeoff if FINRA were to promulgate this proposed guarantee requirement. By requiring member firms to set aside funding for liability, firms would then have less capital to invest in innovative technologies or seize opportunities to grow their business. That inability to grow or seize an opportunity could be detrimental to an already struggling broker-dealer market—a market facing significant technological change and shifting consumer

²⁹ Berkson, *supra* note 10, at 3.

³⁰ *Id.* (quoting the CFO).

³¹ *Id.*

³² *Id.* (“While there are conflicting reports regarding the actual extent of Ameriprise’s participation in the settlement of the claims against Securities America, there is no doubt that Ameriprise did provide some financial means for the settlement . . .”).

³³ Jebesen, *supra* note 10, at 238 (“a system of investor justice refined to guarantee payment of legitimate claims would highlight the outstanding quality of the U.S. capital markets.”).


expectations.³⁴ Customers of broker-dealer firms might then suffer both direct and indirect costs.

FINRA should be confident, however, that advancing investor protection and market integrity outweighs member firms' need for free capital to keep up with innovation and opportunity. FINRA should stick to its purpose: "to safeguard the investing public against fraud and bad practices."³⁵ In other words, uncontrolled industry growth with the goal of speculative profits undermines FINRA's values. The public deserves the right to take their own risks in a fair market with full notice of the potential outcomes—outcomes that should not include the possibility of a member firm choosing potential profit over paying for its misconduct.

Altogether, the circumstances involving Securities America illustrate how member firms are generally unprepared to shoulder arbitration awards. And just as bankruptcy deprives an investor of hope for a practical remedy and trust in the securities industry, "so too does a failure to pay investors their adjudicated awards."³⁶ Thus, FINRA should require member firms to provide some sort of a guarantee that a clearing deposit or the proceeds from an asset transfer will satisfy a pending arbitration claim, unpaid award, or unpaid arbitration settlement.

Respectfully Submitted,

INVESTOR PROTECTION CLINIC
THOMAS & MACK LEGAL CLINIC
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³⁴ See Hester Peirce, *Dwindling Numbers in the Financial Industry*, BROOKINGS INST. (May 15, 2017), <https://www.brookings.edu/research/dwindling-numbers-in-the-financial-industry/> ("Technology has given rise to new forms of competition for traditional retail" brokerages).

³⁵ See *What We Do*, FINRA, <https://www.finra.org/about/what-we-do>.

³⁶ Jebson, *supra* note 11, at 216 ("Generally, a failure to pay investors their adjudicated awards undermine[s] general confidence in entrusting broker-dealers with capital.").



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April 9, 2018

Via email to pubcom@finra.org

Jennifer Piorko Mitchell

Office of the Corporate Secretary FINRA

1735 K Street, NW

Washington, DC 20006-1506

Re: **FINRA Regulatory Notice 18-06**
Program to Incentivize Payment of Arbitration Awards

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international, not-for-profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA’s mission has been to promote the interests of the public investor in arbitration proceedings by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) that relate to investor protection.

We are writing in response to Regulatory Notice 18-06 and welcome the opportunity to comment on the FINRA’s proposals to incentivize payment of arbitration awards. To characterize unpaid arbitration awards as a *problem* would be a massive understatement. As discussed in more detail herein, at this time, nearly one in three arbitration awards are never paid in full. These numbers are staggering and are demonstrative of the fact that unpaid awards are not just a *problem*, they are an epidemic wreaking havoc on investors, while eroding public confidence in FINRA, its members, and the dispute resolution system, at the same time. PIABA continues to support FINRA’s efforts to incentivize the payment of arbitration awards; however, we continue to maintain that more can be done to assure that all awards are paid.

The unpaid award problem is very real and continues to grow worse. Two years ago, PIABA determined that the then-most recent data demonstrated that 33.3% of all awards in favor of investors went unpaid, and more than 24% of the dollars awarded to investors went unpaid. PIABA updated its analysis two months ago and found the most recent data, for 2017, showed that 36% of all awards in favor of investors went unpaid, with 28.18% of the dollars awarded to investors went unpaid. Clearly, the crisis is not resolving itself and something must be done to stop it.

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Ms. Jennifer Piorko Mitchell
 April 9, 2018
 Page 2

Unpaid awards often follow a troubled firm closing its doors, at a time when it is without assets or insurance to satisfy the award(s). This practice is permitted under the FINRA Rules and can result in firm leadership either starting a new firm, or moving on to another firm, with impunity and without ever making any contribution to the corresponding award. Further, unpaid awards frequently arise in situations where an award is entered against an individual, such as a registered representative, an officer, or a control person. However, under the current system, troubled brokers are free to jump from one troubled firm to another, prior to the resolution of their claim and prior to satisfaction of the award. These practices need to be stopped; FINRA needs to institute stronger policies to ensure that the awards entered in its dispute resolution system have strong ramifications.

Regulatory Notice 18-06 requests comments on a series of specific topics, each of which is addressed in detail below.

1. Should FINRA consider proposing to apply a presumption of denial in connection with pending arbitration claims and CMAs? If so, under what circumstances?

PIABA supports a presumptive denial of continuing member applications (CMAs) when associated persons or members are subject to numerous pending arbitrations claims. PIABA understands that not all arbitration claims jeopardize the financial stability of a member firm or a registered representative of that firm, and further, that not all arbitration claims are in fact meritorious. However, PIABA members frequently encounter situations where the conduct of control persons, principals, registered representatives, and firms affects a large class of investors. In these situations, investor claims often involve similar products, individuals, and types of misconduct, which often arise during similar periods of time. These are the situations when the presumptive denial should come into play.

PIABA believes that the presumptive denial should be triggered when more than five claims are pending against any control person, principal, registered representative, or other associated person of the firm. If any of these parties are subject to five or more claims, it is clearly indicative of a problem within the firm, or with the corresponding individual, that warrants additional scrutiny by FINRA. After all, only .0055% of all registered representatives have 5 to 9 disclosable events on the CRD report.¹ Further, unresolved arbitration claims are strong indicators of the potential for future investor harm.²

Given these statistics, it is highly unlikely that an individual with five or more claims could argue that the claims pending against them are isolated or non-meritorious claims. When any control person, principal, registered representative, other associated person is subject to five or more claims, the presumptive denial of the CMA should apply, requiring the applicant to rebut presumption with evidence of their ability to satisfy the claims, if the claims were in fact successful.

With respect to member firms, a presumptive denial based upon a fixed number of pending arbitration claims is likely not the answer. The presumptive denial needs to apply when the pending claims are posing a realistic threat to the continuing viability of the member firm. Accordingly, PIABA feels that the presumptive denial, as it relates to

¹ See Wall Street Journal, *FINRA is Cracking Down on 'High Risk Brokers'*, November 21, 2013.

² "The improved performance of the model with all customer disputes suggests that not only the brokers disputes leading to award or settlement above a threshold amount, but also those pending, denied, or closed without action are useful in determining the likelihood of future investor harm." See *How Widespread and Predictable is Stock Broker Misconduct*, Securities Litigation and Consulting Group, April 21, 2016, Page 18.

Ms. Jennifer Piorko Mitchell

April 9, 2018

Page 3

pending arbitration claims against a member firm, should be applied based upon the aggregate amount of damages pleaded in all pending arbitration claims, taking the nature and quality of those claim into account, compared to the value of cash assets and insurance held by the member. If this ratio tends to suggest a substantial risk of insolvency or simply a present inability to pay all pending legitimate claims in full, then the presumption should apply.

PIABA is mindful of the fact that damages are not always easy to ascertain and *pro se* parties often lack the sophistication necessary to properly compute their potential losses. To this end, FINRA should be permitted to look beyond damages stated in a statement of claim, and discuss the issues related to damages directly with investors, their representatives, and the FINRA members and their counsel, in confidential sessions, prior to applying a presumptive CMA denial. PIABA feels that FINRA should weight the claimant's information more heavily than the member's, but FINRA should be free to develop its opinion based on all available information. Obviously, FINRA should keep in mind that the investor will present one biased view and the member, cognizant of its fight against both the claim and the possible loss of its membership status, will present a different and likely more vigorous biased view.

If a firm can overcome the presumptive denial of a CMA, and it still desires to onboard or continue the employment of individuals with five or more pending arbitration claims, those individuals with such claims pending against them should be subject to heightened supervision immediately and not be permitted to serve in a supervisory capacity until all pending arbitration claims against them have in fact been resolved, and the corresponding awards or settlements, if any, have been paid in full. Following the conclusion of such proceedings, the decisions related to an individual's supervision or supervisory capacity, should rest with the firm. Again, as statistics show, individuals with five or more pending arbitration claims represent some of the most problematic brokers in the country and pose a significant threat to the public investor. FINRA's Rules should be modified to ensure that these individuals are not permitted to move from one firm to another without regard to problems that occurred at their former firms.

2. *If an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, should FINRA require the applicant to provide some form of guarantee that the funds would be used for that purpose?*

PIABA believes that it is of the utmost importance to assure that assets used to demonstrate a firm's ability to satisfy pending arbitration claims should be earmarked for payment of the corresponding claims. To this end, PIABA feels that a written guarantee that the funds would be for that purpose is important, but it might not be enough to truly protect the arbitration claimants in question. If a guarantee is put into place to use the funds for a particular purpose, there needs to be strict penalties in the event of a breach of that guarantee. An appropriate penalty would likely be the immediate suspension of a member's broker-dealer license.

Special care must be taken when the member firm in the process of closing and winding up its affairs. A firm knowing its membership is already ending must still be incentivized to ensure the funds supposedly earmarked to satisfy awards are not directed elsewhere. The guarantee under those circumstances must be secured by a lien in favor of FINRA or the investor and be enforceable against other FINRA members. For example, if a clearing deposit was being used to demonstrate ability to pay, that deposit could be secured by statutory lien and notice could be provided to the clearing firm. If the clearing firm knew that it could be liable to FINRA or an investor for disbursing the funds to a member firm, it is highly unlikely that the funds would ever be used for any purpose other than satisfying the corresponding claim. And, if the funds were diverted elsewhere, the investor and/or FINRA would then have a right of recovery against the clearing firm. The same logic would work in the event of an asset sale: if

Ms. Jennifer Piorko Mitchell

April 9, 2018

Page 4

the purchaser knew of the lien, they would likely hold the funds pending resolution of the lien, to avoid further liability. While a guarantee that funds would be used to pay pending claims is important, there needs to be a way to secure the funds, to prevent them from being depleted for other purposes.

A better solution would be to hold funds in an escrow account, with clear instructions to the third-party escrow agent (who would be unaffiliated with the closing member firm) to disburse the funds only under very particular circumstances.

3. *The proposed amendments would not permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where one or more of the transferring member's associated persons has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, unless the member first seeks a materiality consultation for the contemplated acquisition or transfer and the Department has determined that the member is not required to file a CMA for approval of the acquisition or transfer. Should the proposed amendment be limited to principals, control persons or officers? Please explain.*

PIABA believes that limitations on transfers of member's assets, business assets or lines of operation should not be limited to instances where principals, control persons or officers have a covered pending arbitration claim, but rather, the restriction should include scenarios where an associated person also has a covered pending arbitration claim. PIABA's members often experience situations where a firm's solvency can be jeopardized by one broker, who is not necessarily a control person, a principal, or an officer. This is particularly common in cases involving a broker who is selling away from his or her firm. In these cases, a particular broker could be running a large scheme, without the knowledge of the control persons, principals, or officers.

In cases of smaller or mid-size broker-dealers, a scheme run by a representative could be large enough to threaten the viability of the firm and its ability pay the corresponding awards. Control persons, principals, or officers are often not added to proceedings like this, particularly at the onset of the arbitration case. To permit an asset transfer under circumstances like these, simply because the control persons, principals, or officers were not named in the proceeding, would result in a manifest injustice to investors and potentially foreclose on their right to a meaningful recovery.

4. *Are there any material economic impacts associated with the proposed definition of a "covered pending arbitration claim"? Should FINRA include in the definition only those pending arbitration claims filed prior to a specified time period or event? For example, should FINRA limit the definition of a covered pending arbitration claim to those claims filed prior to public announcement of the contemplated transaction? Please explain.*

PIABA feels that the definition of "covered pending arbitration claims" should be drafted in a broad manner, and should not include a limitation related to claims filed prior to a specific date. If the limitation is added, related to claims filed prior to a specific date, it would again, unjustly enrich a firm who was in the process of shifting assets prior to a claim being filed. Firms would therefore be incentivized to announce a transaction upon the learning of bad conduct by a broker that could lead to potential arbitration hearings. In adopting such an amendment, FINRA would be, possibly inadvertently, establishing a troubling policy that promotes its members' depletion of their assets rather than preserving them to pay investors who have fallen victim to the firm's and its associated persons' wrongdoing.

Ms. Jennifer Piorko Mitchell
April 9, 2018
Page 5

If FINRA does choose to include a limitation related to claims filed prior to a specific date, FINRA should also require that any funds received in consideration for the transaction assets be frozen or subject to a lien in favor of the investor, pending the resolution of all pending arbitration claims filed within a certain period following the transaction closing. This way, the hasty transaction can close, but assets would still be available to satisfy claims of aggrieved investors. While the assets should not be held indefinitely, a set time should be established to bring a claim against the firm – perhaps a year after the transaction closes.

5. *Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposed amendments? If so: a) What are these economic impacts and what are their primary sources? b) To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models? c) What would be the magnitude of these impacts, including costs and benefits?*

Paragraphs 5 and 6 will be addressed together below.

6. *Are there any expected economic impacts associated with the proposed amendments not discussed in this Notice? What are they and what are the estimates of those impacts?*

PIABA feels that the greatest economic impact associated with not adopting the above rules or other policies to ensure payment of arbitration awards will be borne by aggrieved investors. Unpaid arbitration awards leave investors penniless every day, and as written, the FINRA rules enable firms to onboard troubled brokers and shift assets when it is clear that pending claims may be larger than what the firm can afford to bear. Adding the above said restrictions to onboarding and asset transfers is a step in the right direction to protecting investors, and will likely help address the pervasive cockroaching problem, but FINRA needs to do more.

The time has come for FINRA to create an unpaid arbitration award pool, paid for by the financial industry. The unpaid awards pool is the only way to ensure that aggrieved investors are compensated for losses when a firm or registered representative fails to pay an award entered in favor of an investor.

Respectfully submitted,



Andrew Stoltmann
PIABA President



**FINANCIAL
SERVICES
INSTITUTE**

VOICE OF INDEPENDENT
FINANCIAL SERVICES
FIRMS AND INDEPENDENT
FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

April 9, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-06 | FINRA Requests Comment on Proposed Amendments to its Membership Application Program to Incentivize Payment of Arbitration Awards (Notice)

Dear Ms. Mitchell:

On February 8, 2018, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on its proposed amendments (Proposed Amendments) to FINRA's membership application program (MAP) rules.¹ The Proposed Amendments seek to incentivize FINRA members to pay arbitration awards, and settlements related to arbitrations by, among other things, requiring firms to file materiality consultations (MatCons) prior to adding associated persons with "covered pending arbitration claims" (as defined in the Proposed Amendments). The Proposed Amendments also require firms that are transferring their assets, to file a MatCon if: i) the firm, or its associated persons, is the subject of a covered pending arbitration claim; and ii) a continued membership application would not, otherwise, be required. Further, in certain enumerated circumstances, the Proposed Amendments, if adopted, would require firms to evidence an ability to pay pending arbitration claims prior to consummating specified transactions and allowing firms to demonstrate the value of pending claims *vis a vis* an opinion of outside counsel.²

The Financial Services Institute³ (FSI) appreciates the opportunity to comment on the Proposed Amendments. FSI applauds FINRA for dedicating organizational resources, and devoting rulemaking efforts, to finding a solution to unpaid investor arbitration awards. FINRA's February 8, 2018, discussion paper – FINRA Perspectives on Customer Recovery (Paper) – provided the industry with important contextual data and transparency into FINRA's efforts in this space.⁴ The Paper was a promising first-step in starting a productive discussion among industry stakeholders.

¹ See, generally, FINRA Regulatory Notice 18-06 (Feb. 8, 2018) (Notice).

² *Id.*

³ The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

⁴ See Discussion Paper – FINRA Perspectives on Customer Recovery, (Feb. 8, 2018), available at http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

Moreover, FSI supports the intent of the Proposed Amendments. FSI also supports certain aspects of the current proposal, such as requiring firms filing new member applications to report any arbitration claims that are filed, awarded or that become unpaid while the application is pending. Nonetheless, FSI is concerned that, other aspects of the Proposed Amendments, may have the unintended consequences of giving undue consideration to pending, but not yet substantiated, arbitration claims. Since these are merely claims, it is important to keep in mind that the underlying allegations have not been proven and, thus, are not an indication of any wrongdoing on the part of a firm or an advisor.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.⁵ These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).⁶

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate \$48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly \$6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.⁷

Discussion

FSI appreciates the opportunity to comment on the Proposed Amendments to FINRA's membership rules. Again, while FSI commends FINRA's efforts in addressing unpaid investor arbitration awards, FSI is concerned that certain aspects of the Proposed Amendments have the unintended consequences of giving undue consideration to pending, yet unsubstantiated, arbitration claims.

⁵ Cerulli Associates, Advisor Headcount 2016, on file with author.

⁶ The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

⁷ Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

In particular, the Proposed Amendments appear to require firms to file a MatCon seeking permission to hire a single advisor who has a pending investor arbitration claim. Thus, FSI is concerned about this MatCon requirement, and the additional weight the Proposed Amendments, in general, give to unsubstantiated claims. These concerns are discussed in greater detail below.

Background

FINRA's MAP group assesses both new member applications (NMAs) and continuing member applications (CMA) to ensure that applicants meet FINRA's admission standards.⁸ As part of this process, MAP evaluates applicants' financial vitality, as well as their operational and supervisory structures.⁹ Currently, the NMA and CMA processes can be long and, at times, arduous for applicants. Thus, FSI members are pleased that FINRA's Board of Governors has approved further proposed amendments to the membership application rules that would, reportedly, "restructure and streamline the rules, strengthen investor protections with respect to changes of control, and codify current practices to reduce the application review period, among other changes."¹⁰ FSI is concerned, however, that the Proposed Amendments promulgated in this Notice would not streamline the membership application process but, instead, in certain respects, would add complexities to the process. Moreover, these complexities appear to do little to facilitate the investor protection interests they are designed to assist, e.g., diminishing the number of unpaid investor arbitration awards.

a. Existing Rule

NASD Rule 1013 sets forth the membership application requirements to become a new FINRA member firm. NASD Rule 1017 sets forth certain events that would require existing FINRA members to file membership applications, including certain ownership changes, changes in control or in the firm's business operations. In particular, NASD Rule 1017 requires existing FINRA member firms to file membership applications for certain mergers, acquisitions, asset transfers, changes in their equity ownership and control, and other material changes to the member's business.¹¹

NASD Rule 1014 sets forth the standards for denying or approving CMAs and NMAs. Pursuant to NASD Rule 1014 (b)(1), a firm's failure to meet certain standards creates a presumption that a membership application should be denied. For instance, the presumption of denial exists if the firm, its control persons, principals, registered representatives or associated persons are the subject of unpaid arbitration awards, other adjudicated customer awards, or unpaid, settled arbitration awards.¹² That presumption is, however, rebuttable. Meaning, firms may offer evidence that, despite the existence of one or more of these events, the firm is still able to meet FINRA's admission standards.¹³

⁸ See Notice at p. 2.

⁹ *Id.*

¹⁰ See FINRA News Release, Report from FINRA Board of Governors Meeting – March 2018 (March 14, 2018), available at <http://www.finra.org/newsroom/2018/report-finra-board-governors-meeting-march-2018>.

¹¹ See NASD Rule 1017 (a)(1) – (5); see also, NASD Rule 1011 (k) defining "material change in business operations".

¹² See NASD Rule 1014(b)(1); see also NASD Rule 1014 (a)(3)(C); see also, Notice at p. 4.

¹³ See NASD 1014(b)(1).

b. Summary of the Proposed Changes of Concern to FSI Members

i. Proposed Requirement to File Materiality Consultations

As an initial matter, the Proposed Amendments would convert the MatCon process from a voluntary process, to one that, under certain circumstances, would be mandatory. Currently, the MatCon process is voluntary and is designed to assist firms in determining whether a contemplated change is material, such that a CMA should be required.¹⁴ The submission requirements for MatCons are largely embodied in FINRA guidance and allow FINRA to request additional documentation as it deems necessary to render a materiality decision.¹⁵

The Proposed Amendments, if adopted, would make MatCons mandatory in two circumstances. First, unless a CMA is independently required, members would have to file a MatCon prior to adding any associated persons, involved in sales, who are the subject of any of the following:

- “covered pending arbitration claims,”
- unpaid investor related arbitration awards, or
- unpaid, settled investor related arbitration claims.¹⁶

For the above purposes, the phrase “covered pending arbitration claim” (CPAC) would refer to an investor claim against the associated person that is unresolved and exceeds the member’s excess net capital.¹⁷ Upon filing the MatCon, FINRA would determine whether it is in the public’s interest that the firm file a CMA.¹⁸

Moreover, unless a CMA is required, firms transferring their assets, business or a line of operation, would also be required to file a MatCon, where the transferring member, or any of that member’s associated persons, have a CPAC, unpaid arbitration award, or unpaid settled arbitration claim.¹⁹ FINRA would, then, assess the MatCon and determine whether the firm is required to file a CMA.²⁰ For these purposes, CPAC would refer to an investor claim against either the firm, or its associated persons, that is unresolved and exceeds the member’s excess net capital.

Critically, absent from the proposal are clear and concise rule-based parameters around the MatCon process. In particular, the Proposed Amendments do not place limitations on FINRA’s time to issue a decision regarding a firm’s MatCon. They also do not place limitations on FINRA’s time to respond to firms’ communications during the MatCon process and do not state whether, now that MatCon’s would be mandatory, firms would be able to appeal MatCon decisions and, if so, the process for commencing that appeal.

¹⁴ See Overview of Materiality Consultation Process, available at <http://www.finra.org/industry/overview-materiality-consultation-process>.

¹⁵ *Id.*; see, also FINRA Notice to Members 00-73 (Oct. 2000).

¹⁶ See Proposed FINRA Rule IM-1011-2.

¹⁷ See Proposed FINRA Rule 1011(c)(1)(2).

¹⁸ *Id.* If the business expansion already independently requires an application, then a MatCon would not be required.

¹⁹ See Proposed FINRA Rule 1017 (a)(4).

²⁰ *Id.*

ii. *Allowing Firms to Overcome Rebuttable Presumption By Evidencing Their Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements or, for New Member Applications, Pending Arbitration Claims*

As discussed above, the current iteration of FINRA's membership rules set forth the circumstances that would create a rebuttable presumption that a membership application should be denied. NMAs will, for the first time, be subject to a rebuttable presumption of denial if the applicant, or any of its associated persons, are subject to a pending arbitration claim.²¹ Additionally, where the rebuttable presumption is triggered on the basis of a firm's or an associated person's "unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements or, for new member applications, pending arbitration claims," applicants may overcome the presumption by demonstrating their ability to satisfy the award or claim.²² Sufficient evidence of the firm's ability to pay would include escrow, insurance, or a guarantee.²³ Firms would be able to demonstrate the value of the claim by submitting an opinion of outside counsel.²⁴

FSI's Suggested Modifications to the Proposed Amendments

a. IM-1011-2 Should Be Clarified to Exclude Firms' Routine Hiring Decisions

IM-1011-2 should be clarified to indicate that, for this rule to apply, the addition of an associated person must, specifically, be in connection with a merger, acquisition, asset transfer or some other business expansion. Absent that clarification, the proposal may be interpreted to require a MatCon for the simple hiring of a single advisor. In particular, proposed rule IM-1011-2 states, in pertinent part, that:

"If a member is seeking to add one or more Associated Persons involved in sales and one or more of those Associated Persons has a Covered Pending Arbitration Claim..., and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, the member may not effect the contemplated business expansion unless the member has first submitted a written letter to [FINRA] ...seeking a materiality consultation for the contemplated business expansion.

While IM-1011-2 references business expansions, without the requested clarification, IM-1011-2 would appear to equate the act of "adding one of more associated persons involved in sales" and a business expansion. This would, seemingly, require a member to file a MatCon anytime it hires an advisor who has a CPAC.

b. IM-1011-2 and Proposed Rule 1017 (a)(4) Should Exclude Pending Arbitration Claims as a Basis For Requiring Firms to File a MatCon

To the extent that it is FINRA's intent that IM-1011-2 refer to the hiring of any advisor with a CPAC, regardless of the existence of a business expansion, firms should not be forced into participating in membership proceedings so that FINRA can review the firm's decision to hire a single advisor; particularly when this filing requirement is based on an unsubstantiated claim. In

²¹ See Proposed FINRA Rule 1014 (b)(1).

²² See Proposed FINRA Rule 1014 Supp. Mat. .01.

²³ *Id.*

²⁴ *Id.*

addition to this provision potentially causing FINRA to overreach into firms' routine hiring decisions, it may also have a negative impact on firms' recruiting efforts in a time where there is already a shortage of advisors.²⁵

Along these same lines, firms engaging in asset transfers that would not trigger a CMA under the current iteration of the MAP rules, should not be required to file a MatCon, solely because they, or their associated persons, have a CPAC. If adopted, proposed rule 1017(a)(4) may be interpreted to require firms transferring *any* asset, no matter how immaterial, to file a MatCon where the firm, or any of the firm's, potentially hundreds of associated persons, are the subject of unsubstantiated, pending, investor arbitration claims. This would, consequently, be unduly burdensome, particularly since, in most cases, these claims are subject to other FINRA rules that require disclosure.²⁶

Further exacerbating FSI's concerns, is the fact that filing the MatCon may, ultimately, result in the firm having to file a CMA. The CMA may, in turn, result in the firm being prohibited from consummating a minor asset transfer, because one of its associated persons has a pending, and unsubstantiated customer claim. This may have the unintended consequences of forcing firms to terminate associated persons so that the firm can consummate a non-material asset transfer; even though there is no demonstrable evidence that the associated person engaged in any actual wrongdoing.

c. The Proposed Amendments Should Provide Clarity Into the MatCon Process

As stated above, if the Proposed Amendments are adopted, they would convert MatCons from a voluntary process, to a mandatory one. Thus, notwithstanding the concerns set forth above, like the requirements attributable to CMAs and NMAs, the Proposed Amendments should impose clarity regarding, and parameters around, the MatCon process. These parameters may include remedies for firms should they not agree with the MatCon decision, timeframes around FINRA issuing a MatCon decision, limitations on FINRA's time to either issue a decision or ask additional questions, etc..²⁷ Absent these parameters, firm's may end up in the MatCon process, for indefinite periods of time, for changes that are, arguably, not material to their businesses.

d. The Nexus Between an Associated Person's Pending Claim and the Firm's Net Capital Is Unclear

For the purposes of IM-1011-2, CPAC is defined as follows:

"An investment-related, consumer initiated claim filed against the Associated Person that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital."

²⁵ See Investment News, *Shrinking talent pool puts strain on advisory firms*, (March 20, 2017), explaining that "[b]y 2022, the industry is expected to face a shortfall of at least 200,000 advisers", available at <http://www.investmentnews.com/article/20170520/FREE/170529995/shrinking-talent-pool-puts-strain-on-advisory-firms>.

²⁶ See e.g., FINRA Rule 4530; see also, Uniform Application for Securities Industry Registration or Transfer, question 14.

²⁷ FSI understands that FINRA has published guidance on the MatCon process. See, e.g., Overview of Materiality Consultation Process, available at <http://www.finra.org/industry/overview-materiality-consultation-process>. However, guidance and rules are different and if the MatCon process becomes a rule-based requirement; rather than a voluntary process, rules regarding the process are seemingly also appropriate.

(emphasis added).²⁸

This definition appears to interpose a nexus between the associated person's CPAC and the firm's net capital. While firm's may cover arbitration awards against their associated persons, they may elect not to. In that case, the associated person would be responsible for satisfying any award stemming from the claim.

Further, it also interposes a nexus between the individual and the firm hiring the individual. IM 1011-2 speaks to members "seeking to add one or more [a]ssociated [p]ersons". Meaning, these individuals were not formerly associated with the firm that is filing the CMA. Also, presumably meaning, that the acts or omissions giving rise to the customer claim mostly likely occurred while the individual was associated with another firm. Thus, it is likely that if any firm would cover the individual's claim, it would be the firm the individual was associated with at the time the misconduct occurred and not the firm that is obligated to file the MatCon. Consequently, the nexus between the individual's claim and the filing firm's excess net capital is unclear.

e. An Opinion of In-House Counsel Should Be Adequate Under the Supplemental Material to Rule 1014

Obtaining an opinion from external legal counsel can be costly and does not increase the regulatory value of the opinion offered. Firms should, therefore, be allowed to rely on opinions of in-house legal counsel. Regardless of whether the opinion is prepared by internal or external counsel, in both cases, the firm is the attorney's client and the attorney is being paid by the client for his or her services. In the case of external counsel, the fee is larger and is tendered for the specific purposes of drafting an opinion acceptable to the client. Arguably, external counsel has a greater impetus to not act independently. Additionally, in-house counsel is more familiar with the firm and its risk profile. Thus, in-house counsel may be able to provide an opinion that is more informed than an opinion provided by external counsel. This would provide FINRA staff with better intelligence for assessing the membership application and the investor protection issue stemming from the claim. Further, any concerns FINRA would have regarding the attorney's partiality should be satiated by the fact that, both internal and external counsel are bound by rules of professional ethics requiring them to issue an opinion that is truthful and based on the law.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with the Department on this and other important regulatory efforts.

²⁸ See Proposed Rule 1011 (c)(1)(A).

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

Respectfully submitted,

A handwritten signature in blue ink that reads "Robin Traxler". The signature is fluid and cursive, with a large initial "R" and a long horizontal stroke at the end.

Robin M. Traxler
Vice President, Regulatory Affairs & Associate General Counsel

EXHIBIT 5

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

FINRA Rules

* * * * *

1000. MEMBERSHIP APPLICATION AND ASSOCIATED PERSON REGISTRATION

* * * * *

1011. Definitions

Unless otherwise provided, terms used in the Rule 1000 Series shall have the meaning as defined in Rule 0160.

(a) through (b) No Change.

(c) "Covered Pending Arbitration Claim"

The term "Covered Pending Arbitration Claim" means:

(1) For purposes of a business expansion as described in IM-1011-2 and

Rule 1017(a)(6)(B):

(A) An investment-related, consumer initiated claim filed against the Associated Person in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the hiring member's excess net capital.

(2) For purposes of an event described in Rule 1017(a)(6)(A):

(A) An investment-related, consumer initiated claim filed against the transferring member or its Associated Persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member's excess net capital.

For purposes of this definition, the claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees, and shall be the maximum amount for which the Associated Person or transferring member, as applicable, is potentially liable regardless of whether the claim was brought against additional persons or the Associated Person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

(c) through (n) renumbered as (d) through (o).

* * * * *

IM-1011-2. Business Expansions and Covered Pending Arbitration Claims

The safe harbor for business expansions in IM-1011-1 is not available to any member that is seeking to add one or more Associated Persons involved in sales and one or more of those Associated Persons has a Covered Pending Arbitration Claim (as defined in Rule 1011(c)(1)), an unpaid arbitration award or unpaid settlement related to an arbitration; in such circumstances, if the member is not otherwise required to file a Form CMA in accordance with Rule 1017, the member must comply with the requirements of Rule 1017(a)(6)(B).

* * * * *

1013. New Member Application and Interview

(a) through (b) No Change.

(c) Notification of Pending Arbitration Claims, Unpaid Arbitration Awards, or Unpaid Settlement Agreements Related to Arbitration

The Applicant shall promptly notify the Department in writing of any arbitration claim involving the Applicant or its Associated Persons that is filed, awarded or becomes unpaid before a decision constituting final action of FINRA is served on the Applicant.

* * * * *

1014. Department Decision

(a) Standards for Admission

After considering the application, the membership interview, other information and documents provided by the Applicant, other information and documents obtained by the Department, and the public interest and the protection of investors, the Department shall determine whether the Applicant meets each of the following standards:

(1) through (2) No Change.

(3) The Applicant and its Associated Persons are capable of complying with [the federal]applicable securities laws[, the rules] and regulations [thereunder], and with applicable FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. In determining whether this standard is met, the Department shall take into consideration whether:

(A) No Change.

(B) an Applicant's or Associated Person's record reflects a sales practice event[, a pending arbitration,] or a pending private civil action;

(C) an Applicant or Associated Person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the SEC, the Commodity Futures Trading Commission, a federal[, or state regulatory agency, [or]a foreign financial regulatory [agency]authority, or a self-regulatory organization; an adjudicated[, or settled investment-related private civil action for damages or an injunction; or a criminal action (other than a minor traffic violation) that is pending, adjudicated, or that has resulted in a guilty or no contest plea; [or]

(D) an Applicant, its control persons, principals, registered representatives, other Associated Persons, any lender of [5]five percent or more of the Applicant's net capital, and any other member with respect to which these persons were a control person or a [5]five percent lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements;

(E) an Applicant or Associated Person is the subject of a pending arbitration claim;

(D) through (F) renumbered as (F) through (H).

(4) through (14) No Change.

(b) Granting or Denying Application

(1) In reviewing an application for membership, the Department shall consider whether the Applicant and its Associated Persons meet each of the

standards in paragraph (a). Where the Department determines that the Applicant or its Associated Persons are the subject of any of the events set forth in Rule 1014(a)(3)(A), [and] (C), (D), (F) and [through] ([E]G), and (E) for new member applications, a presumption exists that the application should be denied. The Applicant may overcome the presumption by demonstrating that it can meet each of the standards in paragraph (a), notwithstanding the existence of any of the events set forth in Rule 1014(a)(3)(A), [and] (C), (D), (F) and [through] ([E]G), and (E) for new member applications.

(2) through (3) No Change.

(c) through (g) No Change.

IM-1014-1. Evidence of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements or, for New Member Applications, Pending Arbitration Claims

To the extent that the Applicant or Associated Person is subject to unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements or, for new member applications, pending arbitration claims, the Applicant may submit with an application documentation that evidences the ability to satisfy all such awards, settlements or claims through supporting documentation. Such documentation may include an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund or the retention of proceeds from an asset transfer, or such other forms that the Department may determine to be acceptable. The Applicant may provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claims. To overcome the presumption to deny the application, the

Applicant must guarantee that any funds used to evidence the Applicant's ability to satisfy any awards, settlements or claims will be used for that purpose. Any demonstration by an Applicant of its ability to satisfy these outstanding obligations will be subject to a reasonableness assessment by the Department.

* * * * *

1017. Application for Approval of Change in Ownership, Control, or Business Operations

(a) Events Requiring Application

A member shall file an application for approval of any of the following changes to its ownership, control, or business operations:

(1) through (3) No Change.

(4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; [or]

(5) a material change in business operations as defined in Rule 1011(k)[.];

or

(6)(A) notwithstanding subparagraph (3) of Rule 1017(a), any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an Associated Person of the transferring member has a Covered Pending Arbitration Claim (as defined in Rule 1011(c)(2)), unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, unless the member has first submitted a written

request to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated acquisition or transfer. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, the Department shall consider the written request and other information or documents provided by the member to determine in the public interest and the protection of investors that either (i) the member is not required to file a Form CMA in accordance with Rule 1017 and may effect the contemplated acquisition or transfer; or (ii) the member is required to file a Form CMA in accordance with Rule 1017 and the member may not effect the contemplated acquisition or transfer unless the Department approves the Form CMA; or

(B) notwithstanding IM-1011-1, any addition of one or more Associated Persons involved in sales as described in IM-1011-2, and one or more of those Associated Persons has a Covered Pending Arbitration Claim (as defined in Rule 1011(c)(1)), an unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, unless the member has first submitted a written request to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated business expansion. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, the Department shall consider the written request and other information or documents provided by the member to determine

in the public interest and the protection of investors that either (i) the member is not required to file a Form CMA in accordance with Rule 1017 and may effect the contemplated business expansion; or (ii) the member is required to file a Form CMA in accordance with Rule 1017 and the member may not effect the contemplated business expansion unless the Department approves the Form CMA. The safe harbor for business expansions under IM-1011-1 shall not be available to the member when a materiality consultation is required under this paragraph (a)(6)(B).

(b) No Change.

(c) Effecting Change and Imposition of Interim Restrictions

(1) through (3) No Change.

(4) Notwithstanding subparagraphs (1) through (3) of Rule 1017(c), where a member or Associated Person has a unpaid arbitration award or unpaid settlement related to an arbitration at the time of filing an application under Rule 1017, the member may not effect such change until the member has demonstrated in the application its ability to satisfy such obligation in accordance with Rule 1014 and IM-1014-1.

(d) through (f) No Change.

(g) Membership Interview

(1) through (3) No Change.

(4) During the membership interview, the Department shall review the application and the considerations for the Department's decision set forth in paragraph [(h)](i)(1) with the Applicant's representative or representatives. The

Department shall provide to the Applicant's representative or representatives any information or document that the Department has obtained from the Central Registration Depository or a source other than the Applicant and upon which the Department intends to base its decision under paragraph [(h)](i). If the Department receives such information or document after the membership interview or decides to base its decision on such information after the membership interview, the Department shall promptly serve the information or document and an explanation thereof on the Applicant.

(h) Notification of Pending Arbitration Claims, Unpaid Arbitration Awards, or Unpaid Settlement Agreements Related to Arbitration

The Applicant shall promptly notify the Department in writing of any arbitration claim involving the Applicant or its Associated Persons that is filed, awarded or becomes unpaid before a decision constituting final action of FINRA is served on the Applicant.

[(h)](i) Department Decision

(1) The Department shall consider the application, the membership interview, other information and documents provided by the Applicant or obtained by the Department, the public interest, and the protection of investors. In rendering a decision on an application submitted under Rule 1017(a), the Department shall consider whether the Applicant and its Associated Persons meet each of the standards in Rule 1014(a). Where the Department determines that the Applicant or its Associated Person are the subject of any of the events set forth in Rule 1014(a)(3)(A), [and] (C), (D), (F) and [through] ([E])G, a presumption exists that the application should be denied. The Applicant may overcome the

presumption by demonstrating that it can meet each of the standards in Rule 1014(a), notwithstanding the existence of any of the events set forth in Rule 1014(a)(3)(A), [and] (C), (D), (F) and [through] (E)G.

(A) through (B) No Change.

(2) through (4) No Change.

(i) through (l) renumbered as (j) through (m).

* * * * *

Capital Acquisition Broker Rules

* * * * *

100. MEMBER APPLICATION AND ASSOCIATED PERSON REGISTRATION

* * * * *

111. Membership Proceedings

(a) No Change.

(b) Safe Harbor for Business Expansions

All capital acquisition brokers are subject to FINRA IM-1011-1 and IM-1011-2.

(c) No Change.

* * * * *

113. Department Decision

(a) All capital acquisition brokers and applicants for membership in FINRA as a capital acquisition broker are subject to FINRA Rule 1014 and IM-1014-1.

(b) No Change.

* * * * *