

Regulatory Notice

13-29

Membership Application Proceedings

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

Comment Period Expires: November 4, 2013

Executive Summary

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

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

Questions concerning this *Notice* should be directed to:

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



Financial Industry Regulatory Authority

September 2013

Notice Type

- ▶ Request for Comment
- ▶ Consolidated Rulebook

Suggested Routing

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

Key Topics

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

Referenced Rules & Notices

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

Action Requested

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

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to: Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

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

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

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

Background & Discussion

FINRA's current membership rules, the NASD Rule 1010 Series, provide a means for FINRA, through its Membership Application Program (MAP), to assess the proposed business activities of potential and current member firms with the ultimate goal of ensuring that each applicant is capable of conducting its business in compliance with applicable rules and regulations, and that its business practices are consistent with just and equitable principles of trade.

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

A. Proposed FINRA Rule 1111 (Definitions)

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

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

Proposed FINRA Rule 1111(a) defines, for the first time, the term “Affiliate” to mean: (1) a person that directly or indirectly controls an applicant (excluding a natural person who controls an applicant solely in his or her role as a director, general partner, limited liability company (LLC) managing member or officer exercising executive responsibility (or occupies a similar status or performs a similar function)); or (2) an entity that is controlled by, or is under common control with, an applicant. This proposed definition is substantially similar to the definition of “Affiliate” previously proposed in *Regulatory Notice 10-01*, but includes a reference to “LLC managing member” to reflect that LLCs are an increasingly common organizational structure and that an LLC managing member performs a role similar to a general partner of a partnership.

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

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

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

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

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

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

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

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

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

As discussed further below in the context of proposed FINRA Rule 1160, the proposal relocates with changes NASD Rule 1011(k)’s definition of the term “material change in business operations” to proposed FINRA Rule 1160, as that term establishes the standards for when a member firm has a material change in business operations that requires the filing of a CMA.

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

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

Specifically, the proposed rule defines “sales practice event” to mean “any customer complaint, arbitration, ‘statutory disqualification’ as defined in [SEA Section 3(a)(39)], or civil litigation that has been reported to the Central Registration Depository, that currently is required to be reported to the Central Registration Depository, or otherwise has been reported to FINRA.” As previously noted in *Regulatory Notice 10-01*, the proposed change would effectively expand the definition to include certain misconduct by an applicant or associated person, such as having been convicted of misdemeanor tax evasion, that it does not currently capture.

6. Other Proposed FINRA Rule 1111 Definitions

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

- ▶ amending the definition of “Applicant” to clarify that, in the context of proposed FINRA Rule 1160, an applicant may also be referred to as a “member” (see proposed FINRA Rule 1111(b));
- ▶ adding the term “Executive Vice President(s)” to the definition of “Interested FINRA Staff” (see proposed FINRA Rule 1111(l)); and
- ▶ adding the term “LLC managing members” to the definition of the term “principal place of business” to reflect the existence of limited liability companies (see proposed FINRA Rule 1111(m)).

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

B. Proposed FINRA Rule 1112 (General Procedures)

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

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

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

(a) Methods for Filing Application and Delivering Communications

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

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

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

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

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

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

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

(b) Failure to Schedule or Pass Required Examinations

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

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

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

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

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

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

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

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

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

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

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

(a) Constituent Documents

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

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

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

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

(c) Investment Advisory-Related Contractual Information

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

(d) Affiliate Organizational Chart

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

(e) Summary of Affiliate Business Relationship

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Proposed FINRA Rule 1121.02 transfers NASD IM-1013-1 (Membership Waive-in Process for Certain New York Stock Exchange Member Organizations) and NASD IM-1013-2 (Membership Waive-in Process for Certain NYSE Alternext US LLC Member Organizations), the provisions permitting certain NYSE and NYSE MKT (identified in NASD IM-1013-2 as NYSE Alternext) member organizations to be eligible for a streamlined application process for FINRA membership, with the following changes. First, the proposal deletes the descriptions of the application processes, while retaining the provisions specifying that the waive-in members are subject to the FINRA By-Laws and Schedules to By-Laws, including Schedule A, the consolidated FINRA rules and the NYSE rules incorporated by FINRA. In addition, the proposed supplementary material clarifies that a waive-in member must execute a membership agreement prior to expanding its business operations. If the business expansion would be considered a material change in business operations, as that term is defined in proposed FINRA Rule 1160, proposed FINRA Rule 1121.02 requires the waive-in member to submit a CMA and obtain approval prior to engaging in the expanded business activity. Upon approval of such business expansion, the firm shall be subject to all NASD rules in addition to the consolidated FINRA rules and the NYSE rules incorporated by FINRA.

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

Proposed FINRA Rule 1130 adopts NASD Rule 1014 (Department Decision), which sets forth the standards or criteria the Department uses to evaluate whether to grant or deny an NMA or CMA (e.g., completeness and accuracy of the application and supporting documentation, the acquisition of all requisite licenses and registrations, a sufficient level of net capital, the establishment of all necessary contractual agreements and business relationships, an adequate supervisory system). As further described below, the proposal streamlines and consolidates the standards to reduce their total number from 14 to 11 and makes other substantive changes.

1. Proposed FINRA Rule 1130: Preamble

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(a) Mergers and Acquisitions of Members

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

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

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

(c) Change in Ownership Interest

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

(d) Change in Control Person

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

(e) Material Change in Business Operations

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

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

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

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

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

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

(b) CMA Waiver Request Process

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

I. Proposed FINRA Rule 1190 (Foreign Members)

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

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

J. Proposed Eliminated Requirements

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

Request for Comment

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

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

We request quantified comments where possible.

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. *See* Form BD (Explanation of Terms) (defining “control affiliate” to mean a “person named in Items 1/A, 9 or in Schedules A, B, or C as a control person or any other individual or organization that directly or indirectly controls, is under common control with, or is controlled by, the applicant, including any current employee, except one performing only clerical, administrative, support or similar functions, or who, regardless of title, performs no executive duties or has no senior policy making authority”).
4. This definition of “Associated Person” only applies to FINRA’s membership rules. For other FINRA rules, the FINRA By-Laws definition of who is an “associated person of a member” applies. *See* FINRA By-Laws Art. I(rr) (defining “person associated with a member” or “associated person of a member”); *see also* [Notice to Members 98-38](#) n.5 (May 1998) (citing the same By-Laws definition to clarify the term “associated person”).
5. As proposed in *Regulatory Notice 10-01*, FINRA Rule 1111 defined the term “control” for purposes of the membership rules as “the power to direct or cause the direction of the management or policies of a person whether through ownership of securities, by contract, or otherwise. A person is presumed to control another person if such person, directly or indirectly: (1) has the right to vote 25 percent or more of the voting securities; (2) is entitled to receive 25 percent or more of the net profits; or (3) is a director, general partner or officer (or person occupying a similar status or performing similar functions) of the other person. Any person that does not meet the provisions of subparagraph (1), (2) or (3) shall be presumed not to control such other person. Any presumption under this definition may be rebutted by evidence, but shall continue until a determination to the contrary has been made by FINRA.”
6. *See* Incorporated NYSE Rule Interpretation 311(g)/02 (Divisions of Member Organizations — Names) (requiring, among other things, that divisions that are not separate legal entities not be identified by the use of such words as “Company,” “Corporation” or “Incorporation,” which connote separate entities). As noted later, this is one of the provisions FINRA is proposing to delete as either redundant or obsolete.

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

- increase in the number of sales personnel, office locations or markets made beyond the scope of the safe harbor provisions of proposed FINRA Rule 1160.01;
 - listing of the member (on an identified or anonymous basis) on any facility or medium that is designed to solicit offers or inquiry with respect to the possible purchase of the member in whole or in part, or the transfer of some or all of the member's assets; or
 - discovery of any existing or impending condition(s) that the member reasonably believes could lead to capital, liquidity or operational problems or impairment of recordkeeping, clearance or control functions.
11. FINRA will consider whether to address the notification of the deleted events in a separate rulemaking effort involving Incorporated NYSE Rule Interpretation 401/04 (Early Reporting of Developing Problems).