

# 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](http://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

## 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](mailto: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.<sup>1</sup>

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).<sup>2</sup>

## 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.<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup>

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.<sup>6</sup> 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).<sup>7</sup> 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 1013<sup>8</sup> 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.<sup>9</sup>

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.<sup>10</sup>

### 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.<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup>

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.