Beyond borders

Finra's approval requirement: considerations for non-US acquirers of US broker-dealers

It is widely known that in order to complete deals involving US companies, non-US firms must successfully navigate a labyrinth of local and US regulatory hurdles. One of those regulatory gating items that is relevant to many transactions involving US financial groups – but which is not widely known outside the US – is application with and approval by the Financial Industry Regulatory Authority (Finra). This requirement arises when a target company, or one of its subsidiaries, is a US-registered broker-dealer, and when implicated, will often have important timing, risk and strategic implications that a bidder should take into account, even when the broker-dealer is a tiny subsidiary and constitutes only a small or insignificant component of the overall target in terms of assets or revenues.

Firms bidding for a broker-dealer commonly seek to receive Finra approval as a closing condition, which the seller often resists

This article is intended to provide prospective non-US acquirers with a general introduction to the Finra application and approval requirement. It explains the circumstances when Finra approval is required, describes the basic mechanics of the Finra application and approval process and discusses several practical considerations relevant to non-US acquirers.

Finra's continuing membership application requirement

In the US, securities brokers and dealers – which include investment banks and many trading and financial advisory firms, among others – must register with the US Securities and Exchange Commission (SEC) as broker-dealers and with the US states in which they operate. In almost all cases, broker-dealers must also become members and comply with the rules of Finra

NASD rule 1017 requires Finra member broker-dealers to submit a continuing membership application (CMA) to Finra when a transaction would result in either (i) a change in the equity ownership of the broker-dealer that results in a new person or entity, directly or indirectly, owning or controlling 25% or more of the equity of the broker-dealer (a change of control), or (ii) a material change in business operations of the broker-dealer, among other circumstances (the CMA requirement). Finra interprets the change of control prong as being triggered by the introduction of a new 25% or more owner anywhere up the chain of the broker-dealer's ownership. What constitutes a material change in the broker-dealer's business operations varies based on the circumstances, but may include, for instance, certain expansions into new business lines or the opening of new branch offices. Since many US financial groups have one or more broker-dealer subsidiaries, deals involving US financial group targets commonly satisfy one or both of these prongs of rule 1017 and thereby implicate the CMA requirement.

Timing considerations

When the CMA requirement is triggered, the Finra member broker-dealer (not the proposed buyer) is responsible for preparing and submitting the application to Finra through its online Firm Gateway system. This may present complications in hostile transactions where the target has no incentive to complete and file the application.

In the case of a change of control of a broker-dealer as described above, the application must be submitted to Finra at least 30 days prior to the change. The transaction causing the change of control may technically be consummated at the end of this 30-day period, provided that Finra has neither rejected the application nor prohibited the change from occurring until approval is granted. However, seeking to close a transaction before Finra approval is obtained presents certain risks. For example, Finra may, based on its initial review of an application and before the 30-day notice period elapses, notify the broker-dealer that the proposed change of control may not be completed until approval is obtained. In addition, if Finra does not prohibit the change of control from occurring before approval is obtained, it may nonetheless impose interim restrictions on the broker-dealer's operations.

In any event, an application must ultimately be approved by Finra. If Finra does not approve the application, it can require the broker-dealer to withdraw its registration with the SEC, or theoretically require the transaction be unwound. Any of these scenarios may have an outsized effect – even where the broker-dealer has small assets or revenues – since the broker-dealer may perform a critical function for the target, such as allowing the target to distribute securities that are issued by one of its subsidiaries. As a result, firms bidding for a broker-dealer or a company with a broker-dealer subsidiary commonly (but not always) seek to include the receipt of Finra approval as a closing condition, which is often met with resistance by the seller, since it may take up to six months, and sometimes longer, to obtain approval after the initial submission of a complete application.

Unlike a change of control, a material change to a broker-dealer's business operations may not be effected until Finra approval is obtained. Finra approval of a CMA for a change of control and a material change to the broker-dealer's business operations will likely take longer to obtain than a change of control alone. Additional time may be necessary, for example, for the broker-dealer to design and implement changes to its written supervisory procedures to support the new business activities or for the broker-dealer's personnel to satisfy any relevant licencing requirements, and Finra's review team would need additional time to analyse a more complex application. Therefore, firms that intend to make changes to a broker-dealer's business as part of, or in conjunction with, an acquisition sometimes apply for and obtain Finra approval of the change of control and close the transaction before proceeding with any material changes to the broker-dealer's business. Thereafter, it would be necessary to seek and obtain Finra approval of a separate application for the changes to the broker-dealer's business.

If a change of control of the broker-dealer occurs without complying with the 30-day advance filing requirement or over Finra

objections, or if a material change to the broker-dealer's business operations is effected prior to Finra approval, then the broker-dealer, its board and senior management may be exposed to fines and other sanctions for rule violations. The acquirer could be subject to bad publicity and other potential collateral consequences.

The application

Although the broker-dealer is responsible for preparing and submitting the application to Finra, the proposed buyer would need to work closely with the broker-dealer to provide much of the information for the application, since Finra requires extensive details concerning the proposed buyer and certain of its affiliates and personnel. While each application is unique and requires different information and supporting documents specific to the broker-dealer and the contemplated transaction, for a change of control application, a proposed buyer would need to provide, or cooperate with the broker-dealer to prepare, certain minimum information, including, for example:

- Information about the proposed buyer and its personnel and affiliates: The names and business activities of the proposed buyer and its affiliates, and pre- and post-transaction corporate family organisational charts for the broker-dealer. In addition, detailed information about current, past or pending regulatory, civil or criminal actions or matters, ongoing investigations, sales practice issues and securities-related termination issues that involve the proposed buyer and certain personnel and affiliates, regardless of whether these events occurred or are occurring in the US or elsewhere.
- Transaction information: Details concerning the proposed transaction and change in control, including, among other things:
  - documentation regarding the proposed new owner's sources of funding for the purchase and recapitalisation of the broker-dealer;
  - copies of transaction documents, such as letter(s) of intent, asset purchase agreements, merger agreements and board resolutions; and
  - information about any dependencies or conditions for the transaction that must be satisfied before closing, such as other regulatory approvals or shareholder approvals.
- Impacts on business relationships: Information concerning whether any of the broker-dealer's existing agreements or business relationships will be modified, or any new agreements will be necessary, in order to effectuate the change.
- Other impacts: Descriptions of any impacts on the broker-dealer's facilities and their adequacy, communications and operations systems, financial controls, compliance and supervisory program, and continuing education and training program, among other things.

If the buyer wishes to modify the broker-dealer's business activities in connection with the acquisition, then additional information will be required, including, among other things, details concerning any necessary changes to the firm's compliance and supervisory program to support the proposed changes, financing and new licencing requirements for personnel.

Potential hot button issues for non-US buyers

If implicated in a given transaction, the Finra CMA requirement and process will likely be unfamiliar to a non-US buyer and will require special attention, not to mention substantial legwork. One aspect of the Finra application process that may present particular challenges would be the need for a non-US buyer to supply information to include in the application regarding regulatory and criminal events and ongoing investigations concerning itself and certain of its affiliates and personnel. Local regulatory requirements that restrict disclosure of confidential supervisory information may impact a non-US firm's ability to readily share such information with third-parties, including with US regulators. Depending on the circumstances, the buyer may need to explain the Finra approval requirement to its local regulators, and potentially request permission to disclose such information for the application.

In addition, the existence of certain regulatory or criminal events or ongoing investigations involving the proposed buyer or its affiliates may hinder or delay Finra approval, since Finra rules establish a rebuttable presumption that the organisation will deny an application when certain regulatory events or investigations exist. Therefore, a non-US buyer would be well-advised to prepare and provide to the broker-dealer to include in the application summaries of any remedial steps or corrective measures that it has taken to address any regulatory deficiencies or legal issues raised during any such situations.

After Finra staff conducts their initial review of a submitted application, they customarily send the broker-dealer one or more rounds of questions and requests for further information, many of which will undoubtedly concern the proposed new owner and will therefore require significant input from the non-US buyer. For example, if the application states that the buyer was previously sanctioned by its home country authorities, Finra may request additional details regarding the underlying facts, findings, sanctions or any remedial actions and corrective measures the firm has taken. Finra may also request further details regarding the status of any local regulatory approvals for the proposed transaction. There is no SEC or Finra prohibition or restriction on a non-US firm owning a broker-dealer. That said, because Finra staff will be less familiar with most non-US firms – particularly compared to US financial institutions that already have one or more broker-dealer subsidiaries – a non-US buyer should not be surprised by multiple sets of follow-up questions and information requests.

Post-closing considerations

If and when Finra approves the application and the transaction closes, there are several US regulatory issues that will impact the buyer going forward as a result of its relationship with the broker-dealer. By way of example, the new owner may in certain circumstances be subject to liability for the broker-dealer's actions under section 20(a) of the Exchange Act. The new owner may also be subject to certain restrictions on purchasing securities in initial public offerings under Finra rule 5130 as a result of its ownership of the broker-dealer.

In addition, an SEC-registered broker-dealer must keep its SEC registration form (Form BD) updated on a continuous basis. Because Form BD requires broker-dealers to disclose select regulatory and criminal events concerning their parents and affiliates, the new owner would need to establish a system to monitor for, and promptly notify the broker-dealer of, the occurrence of any relevant disclosable event. Also, the new owner's relationship with the broker-dealer may impact future transactions and reorganisations that the new owner may consider. For instance, a subsequent sale of the broker-dealer or the entity that owns the broker-dealer, or the insertion of a new holding company above the broker-dealer, would trigger a new Finra application and approval requirement.

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