February 1, 2010

FINRA Proposes Changes to New and Continuing Membership Application Processes

On January 4, 2010, the Financial Industry Regulatory Authority ("**FINRA**") proposed for public comment new rules (the "**Proposed Rules**") that would govern FINRA's New Membership Application ("**NMA**") and Continuing Membership Application ("**CMA**") processes.[1]

Of particular note, the Proposed Rules would (i) require applicants to provide, and allow FINRA to consider, detailed information on the applicant's Affiliates,[2] (ii) expand the categories of changes that would trigger a CMA filing, and (iii) institute new advance notice requirements for certain significant events that do not trigger a CMA.

New Member Application

Application for membership in FINRA is a very thorough process that seeks to ensure that each applicant is "capable of conducting its business in compliance with applicable rules and regulations." The NMA process requires extensive disclosure of information about the applicant, including information about its key personnel, business plans and contractual arrangements, supervisory and compliance structures and financial condition.

Expanded Disclosures

The Proposed Rules would expand the information to be filed as part of the NMA to expressly include the applicant's constituent documents, charts indicating the individuals responsible for supervising the applicant's various offices and business lines, the applicant's anti-money laundering procedures, information on the applicant's independent audit firm and the applicant's most recent audit report, many of which are informally required under current procedures even if not specified in the NMA rules. The Proposed Rules will also require full disclosure of the applicant's funding sources, which FINRA will evaluate to determine that they "are not objectionable." Further, extensive disclosure would be required of the applicant's relationships with Affiliates, allowing FINRA to consider Affiliates' disciplinary histories in evaluating the applicant's ability to comply with the securities laws.

The Proposed Rules would also require disclosure to FINRA of any plan to engage in other activities, such as investment advisory business, whether or not exempt from registration with the Securities and Exchange Commission ("**SEC**") under the Investment Advisers Act of 1940.[3] FINRA would be allowed to impose higher net capital requirements on members planning to engage in such activities.

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[1] FINRA Regulatory Notice 10-01, *Membership Application Proceedings*, *available at* http://www.finra.org/Industry/Regulation/Notices/2010/P120671 (the "**Regulatory Notice**"). The proposal is part of FINRA's rulebook consolidation process, which seeks to harmonize and consolidate the rules of the National Association of Securities Dealers, Inc. ("**NASD**") and the New York Stock Exchange ("**NYSE**").

[2] The Proposed Rules define "**Affiliate**" as a person (other than natural persons) that directly or indirectly controls, is controlled by, or is under common control with an applicant. "**Control**" is defined as the power to direct or cause the direction of the management or policies of the applicant through ownership of securities, by contract or otherwise. Control is presumed, among other ways, if the entity owns 25 percent or more of the applicant's voting securities. This definition of "control" differs slightly from the definition of "controlling" in FINRA's By-Laws, which contains a presumption of control at 20 percent ownership.

[3] This proposal may be a response to events involving Bernard L. Madoff Investments Securities LLC, the registered broker-dealer whose investment advisory business was a large-scale Ponzi scheme. However, the text of the Proposed Rule could also potentially capture other types of advisory businesses, such as financial or merger and acquisition advice.

Detailed Affiliate Disclosures

The Proposed Rules would require applicants to provide FINRA with an organization chart identifying all of the applicant's Affiliates, their legal relationships to the applicant and "a brief summary of each Affiliate's principal activity."

In addition to the brief summary, the Proposed Rules would require "a detailed and comprehensive summary of the business relationship" between the applicant and any Affiliate:

- whose "financial information is consolidated with that of the [a]pplicant;"
- whose liabilities have been guaranteed by the applicant;
- that is the source of flow-through capital to the applicant;
- that provides certain operational support or services to the applicant;
- that has the ability to withdraw capital from the applicant;
- that has a "mutually dependent financial relationship" with the applicant, such as expense sharing arrangements;
- that has a "financial and/or marketing relationship" with the applicant; or
- that provides certain products or services as part of the applicant's operations that FINRA rules would require the applicant to supervise (together, "**Special Affiliates**").

Under the proposal, FINRA would also have the discretion to request evidence of any of these relationships from the books and records of both the applicant and the Special Affiliate. In making its membership decision, FINRA would be allowed to consider the disciplinary history of any of the applicant's Affiliates to determine whether the applicant would be capable of complying with the securities laws.

In some respects, this affiliate disclosure requirement draws upon, and is more expansive than, the NYSE's current (and very burdensome) requirement for submission of information regarding affiliates (referred to as "approved persons") that are engaged in a "securities or kindred business." Significantly, unlike the NYSE rule, Affiliates would not be required to consent to FINRA's jurisdiction. The proposal would also adopt an NYSE requirement prohibiting members from identifying business divisions that are not separate legal entities with "Company," "Corporation" or "Incorporated."

Continuing Membership Application

Currently, NASD Rule 1017 requires FINRA members to file an application with FINRA and receive approval of certain corporate events, such as a merger with or acquisition of another FINRA member, transfer of 25 percent or more of a members' assets or revenues, transfer of ownership or control of 25 percent or more of a member's equity to one person and certain material changes to a member's business operations.

New CMA Triggers

The Proposed Rules would expand the events that would trigger the requirement to file a CMA, potentially delaying corporate actions that currently would not require FINRA approval:

- Mergers with or acquisitions of any broker-dealer, even if the other broker-dealer is not a FINRA member;

- Certain mergers and acquisitions involving NYSE members;[4]
- Divestitures[5] of 25 percent or more of the member's assets or any asset or business line generating 25 percent of revenues;
- Transactions resulting in an entity holding a "presently exercisable option" to own or control 25 percent of the member; or
- Material changes in business that would result in the member, including:
  - becoming self-clearing for the first time,
  - clearing transactions for other broker-dealers for the first time, or
  - changing its exemptive status under the Customer Protection Rule (Rule 15c3-3(k) under the Securities Exchange Act of 1934 (the "**Exchange Act**")).

The proposal would incorporate into supplementary material a revised version of the current "safe harbor" from CMA filing for limited business expansions. The revised safe harbor would be generally the same as the current version, but would not be available to a member acquiring an office or sales personnel from another member where the other member or the personnel to be acquired have a disciplinary history (as defined).

The Proposed Rule would also give FINRA explicit authority to waive the CMA filing for changes in ownership or control if the change does not result in any practical change to the member's business activities, management, supervision, assets, liabilities or ultimate ownership or control.

NMA and CMA Procedural Changes

The Proposed Rules would change a number of NMA and CMA procedures and timing requirements. If adopted, members and applicants would need to pay close attention to the new procedures and timing, especially in the merger and acquisition context, to avoid delays and potential lapsed applications. The proposed changes to procedures and timing include:

- the time to schedule a membership interview relating to an NMA would be reduced from 60 days to 30 days after the filing of all additional information requested by FINRA;
- the amount of time within which applicants must reply to a written request by FINRA for information or documents before their NMA or CMA lapses would be reduced from 60 to 30 days;
- applicants filing an NMA or CMA would be required to schedule any qualifying examinations for its associated persons necessary for the new business or change in business, as applicable, within 30 days of filing and ensure that the associated persons successfully complete the examinations within 120 days of filing;
- changes in ownership or control may only take place 30 days after submission of a "complete" CMA; and

[4] In order to avoid duplication of review by both FINRA and the NYSE, the existing rules contain an exemption from the requirement to file a CMA for certain transactions involving NYSE member firms. The Proposed Rules would remove these exemptions because the NYSE no longer conducts independent reviews.

[5] The current rule only explicitly requires the filing of a CMA for acquisitions or transfers, not divestitures. The proposed revision may be merely a clarification, because under current rules material dispositions of assets or businesses would trigger notice or approval if they are deemed to constitute a "material change in business operations."

- in circumstance where two or more members would be required to file a CMA for a particular transaction, FINRA may allow either a joint application or the application to be filed by only one member. This proposal should eliminate some complexity and duplication that arises in transactions involving mergers of members or changes of ownership or control of multiple members.

New Advance Notice Requirements

The Proposed Rules would create a new requirement to provide FINRA with advance notice of certain events that are not significant enough to trigger a CMA filing. The Proposed Rule would generally require at least 30 days' notice. However, where 30 days' advance notice would be impracticable, the Proposed Rule would only require prior notice "as soon as practicable." Depending upon how this proposed advance notice is enforced in practice, it could force members to delay corporate actions or create impediments to potential transactions of even relatively minor significance.

For example, events that would require a CMA at a 25 percent threshold, such as transfers of assets or changes in ownership, would require advance notice at a ten percent threshold. In addition, the Proposed Rule would require advance notice of:

- the creation, significant change or termination of a business relationship between a member and a Special Affiliate;
- changes in key personnel;
- changes to a member's service bureau, clearance activities or bookkeeping method;
- business expansions requiring significant capital infusions or additional licenses, registrations, memberships or regulatory approvals;
- addition of products or services that are of a new type of investment, transaction, or risk from those previously approved;
- certain increases in sales personnel, offices or markets;
- listing of a member on any facility to solicit offers for the potential purchase of a member or its assets; or
- the discovery of a condition which could reasonably lead to capital, liquidity, operational, recordkeeping, clearance or control problems or impairments.

For certain types of events, FINRA may determine that notice is insufficient and require a full CMA. Further, the Proposed Rules would require a member to file a full CMA if it is triggered, even if advance notice was already provided.

The requirement to provide FINRA with notice of the creation, significant change or termination of a business relationship with a Special Affiliate may be particularly wide-reaching and require significant monitoring. For example, the Proposed Rule may require notice to FINRA in advance of certain common events, such as a member entering into an arrangement with an affiliated foreign broker-dealer under SEC Rule 15a-6[6] or selling securities issued by Affiliates. If the proposal is adopted, members and their Affiliates would also need to consider other potential effects of the proposal before entering into a business relationship. For example, the proposal could open up a Special Affiliate to FINRA's scrutiny,

[6] Such arrangements, which are subject to numerous limitations and requirements, allow a foreign broker-dealer affiliate to deal with U.S. customers without registering with the SEC under Section 15 of the Exchange Act.

which would have the authority under the Proposed Rules to seek evidence or information about the Special Affiliate's business relationship with the member from the books and records of the Special Affiliate.

Continuous Access to Affiliate Information

FINRA's authority to seek information about Affiliates would not be limited to the NMA process. The Proposed Rules would require members to promptly provide FINRA, upon request at any time, any information concerning its Affiliates that an NMA applicant could be required to provide under the proposed revisions to the NMA rules.

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FINRA requests comments on the proposal by March 5, 2010. The Proposed Rules will not become effective, and the existing rules will not be eliminated, until the rule changes are filed with and approved by the SEC following a second comment period.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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