Regulatory Notice 20-15

Membership Application Program

FINRA Amends Rules Governing Its Membership Application Program to Incentivize Payment of Arbitration Awards

Effective Date: September 14, 2020

May 21, 2020

Notice Type
- Rule Amendment

Suggested Routing
- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics
- Arbitration
- Membership Application Program
- Supervision

Referenced Rules & Notices
- FINRA Rule 1011 and IM-1011-2
- FINRA Rule
- FINRA Rule 1013
- FINRA Rule 1014 and IM-1014-1
- FINRA Rule
- FINRA Rule 1017
- SEA Rule 15c3-1

Summary

FINRA amended 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. The amendments will 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.[1]

These changes become effective on September 14, 2020.

The text of the amended rules is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

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- Alissa Robinson, Senior Director, Membership Application Program Group, at (212) 858-4764 or alissa.robinson@finra.org.

Background & Discussion

The MAP rules[2] govern the way in which FINRA reviews a new membership application (NMA) and a continuing membership application (CMA).[3] These rules require an applicant to demonstrate its ability to comply with applicable securities laws and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. FINRA evaluates an applicant's financial, operational, supervisory and compliance systems to ensure that the applicant meets the standards set forth in the MAP rules. Among other factors, the MAP rules require FINRA to consider whether persons associated with an applicant have material disciplinary actions taken against them by industry authorities, customer complaints, adverse arbitrations, pending arbitration claims, unpaid arbitration awards, pending or unadjudicated matters, civil actions, remedial actions imposed or other industry-related matters that could pose a threat to public investors.[4]

In an effort to help further address the issue of customer recovery of unpaid arbitration awards, the amendments make the following key changes to the MAP rules:

- **Mandatory Materiality Consultations**—A member firm must seek a materiality consultation for specified changes in ownership, control, or business operations, including business expansions, involving a "covered pending arbitration claim" (described below), unpaid arbitration awards or unpaid arbitration settlements;
- **Rebuttable Presumption to Deny an NMA Involving a Pending Arbitration Claim**—A rebuttable presumption to deny an application for new FINRA membership where such applicant or associated person is the subject of a pending arbitration claim;
- **Demonstration of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements, or Pending Arbitration Claims**—To overcome a presumption to deny an application due to unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements, or pending arbitration claims, as applicable, the applicant must demonstrate its ability to satisfy the awards, settlements or claims, and guarantee that any funds used to evidence the applicant's ability to satisfy them will be used for that purpose; and
- **Notification of Pending Arbitration Claims, Unpaid Arbitration Awards, or Unpaid Settlement Agreements Related to Arbitration**—An applicant for new or continuing membership must notify FINRA of any arbitration claim involving the applicant or its associated persons that is filed, awarded, settled or becomes unpaid before FINRA renders a decision on the application.

Mandatory Materiality Consultations

Rule 1017 specifies the changes in a member's ownership, control, or business operations that require a CMA and FINRA's approval.[5] In some cases, a change contemplated by a firm may not clearly fall within one of the events described in Rule 1017, and so before taking steps to prepare a CMA, a member has the option of seeking guidance, or a materiality consultation, from FINRA on whether such proposed event would require a CMA.[6] The materiality consultation process is voluntary, and FINRA has published guidelines about this process on FINRA.org.[7]

To help further incentivize payment of arbitration awards and settlements, the amended MAP rules preclude a member firm from effecting specified changes in ownership, control, or business operations, including business expansions, involving a "covered pending arbitration claim,"[8] unpaid arbitration award or unpaid settlement related to an arbitration without first seeking a materiality consultation from FINRA.[9]

As part of the materiality consultation, FINRA will consider the written request and other information or documents the member provides to determine in the public interest and the protection of investors that either: (1) the member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated change; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated change unless FINRA approves the CMA. If FINRA determines that a member must file a CMA, it will be subject to the application review process set forth under the MAP rules, including a review of any record of a pending arbitration claim and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.[10]

Mandatory Materiality Consultation for Business Expansion to Add One or More Associated Persons Involved in Sales

Among the events in Rule 1017 that require a CMA are a "material change in business operations," which is defined to include, but is not limited to: (1) removing or modifying a membership agreement restriction; (2) market making, underwriting or acting as a dealer for the first time; and (3) adding business activities that require a higher minimum net capital under SEA Rule 15c3-1.[11] In addition, a CMA is required for business expansions to increase the number of associated persons involved in sales, offices, or markets made that are a material change in business operations.[12] However, IM-1011-1 (Safe Harbor for Business Expansions) creates a safe harbor for incremental increases in these three categories of business expansions that will be presumed not to be material. Under this safe harbor provision, a member, subject to specified conditions and thresholds, may undergo such business expansions without filing a CMA.[13]

FINRA is concerned that the changes in a member firm's ownership, control, or business operations as currently described in Rule 1017, and the availability of the safe harbor for a business expansion to increase the number of associated persons involved in sales, could allow a member to, for example, hire principals and registered representatives with substantial pending arbitration claims without giving consideration to how the firm will supervise such individual or the potential financial impact on the firm if the individual, while employed at the hiring firm, engages in additional potential misconduct that results in a customer arbitration involving the firm.[14]

Accordingly, FINRA has amended the MAP rules to provide that if a member plans to add one or more associated persons involved in sales and one or more of those associated persons has a "covered pending arbitration claim,"[15] 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 first seeks a materiality consultation for the contemplated business expansion.[16]

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

Mandatory Materiality Consultation for Any Acquisition or Transfer of Member's Assets

Rule 1017 also requires a member to file a CMA for direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are NYSE members.[17]

FINRA is concerned that this 25 percent threshold could permit a firm with pending arbitration claims that ultimately produce awards or settlements to avoid satisfying those awards or settlements by transferring assets without encumbrance and then closing down. Accordingly, FINRA has amended the MAP rules to provide that if a member is contemplating *any* direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a "covered pending arbitration claim,"[18] an unpaid arbitration award or an unpaid settlement related to an arbitration, the member may not effect the contemplated transaction unless the member first seeks a materiality consultation for the contemplated acquisition or transfer. The materiality consultation is not required if the member is otherwise required to file a CMA.

During the course of this consultation, FINRA will consider, among other relevant facts and circumstances, whether the contemplated acquisition or transfer could result in non-payment of an arbitration claim should it go to award or result in a settlement, or the continued non-payment of such arbitration award or settlement.

Rebuttable Presumption to Deny an NMA

Rule 1014(a)(3) (Standard 3) is one of 14 standards for admission FINRA must consider in determining whether to approve an NMA or CMA.[19] Standard 3 requires FINRA to determine whether an applicant for new or continuing membership and its associated persons "are capable of complying with" the federal securities laws, the rules and regulations thereunder, and FINRA rules. Standard 3 sets forth several factors, including past and current disciplinary actions and customer claims, that FINRA must consider in making that determination.[20] The existence of specified factors "[raises] a question of capacity to comply with the federal securities laws and the rules of [FINRA]," which results in a rebuttable presumption to deny the application.[21] Under Rule 1014(b)(1) and Rule 1017(i), which pertain to NMAs and CMAs, respectively, the specified factors that trigger the rebuttable presumption to deny an application include whether:

- a state or federal authority or self-regulatory organization has taken permanent or temporary adverse action with respect to a registration or licensing determination regarding the applicant or an associated person;[22]
- an applicant or associated person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the SEC, the Commodity Futures Trading Commission, a federal or state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; an adjudicated or settled investment-related private civil action for damages or an injunction; or a criminal action (other than a minor traffic violation) that is pending, adjudicated, or that has resulted in a guilty or no contest plea;[23]
- an applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant's net capital, and any other member with respect to which these persons were a 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;[24]
- an associated person was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct;[25] and
- a state or federal authority or self-regulatory organization has imposed a remedial action, such as special training, continuing education requirements, or heightened supervision, on an associated person.[26]

FINRA is concerned about prospective applicants for new membership hiring principals and registered persons with pending arbitration claims without having to demonstrate how those claims will be paid if they go to award or result in a settlement. In addition, FINRA is concerned about a new member's supervision of such individuals who may have a history of noncompliance.[27] Accordingly, FINRA has amended Rule 1014(b)(1) to create a presumption to deny an NMA where the new member applicant or its associated persons are the subject of a pending arbitration claim.[28]

This presumption of denial for a pending arbitration claim does not apply to an existing member firm filing a CMA.[29] Instead, consistent with today's practice, FINRA will continue to consider whether an applicant or its associated persons are the subject of a pending arbitration claim in determining whether the applicant for continuing membership is "capable of complying with" applicable federal securities laws and FINRA rules.

Demonstration of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements or Pending Arbitration Claims

An applicant for new or continuing membership may overcome the presumption to deny an application by demonstrating to FINRA that it can meet each of the standards in Rule 1014(a) notwithstanding the existence of any of the specified factors set forth in Standard 3 listed above. In determining whether an applicant has overcome the presumption, FINRA will consider the application in light of the specific standards of Rule 1014(a), the public interest, protection of investors and FINRA's responsibility to provide a fair procedure in accordance with membership rules.

Where unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements, or pending arbitration claims are at issue in an application, new IM-1014-1 describes various ways in which an applicant may demonstrate its ability to satisfy all such awards, settlements or claims during the application review process.[30] Under IM-1014-1, an applicant may make this demonstration 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 FINRA may determine to be acceptable. An applicant may also 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.

To overcome the presumption to deny an NMA or CMA, IM-1014-1 requires the applicant to guarantee that any funds used to evidence the applicant's ability to satisfy any awards, settlements, or claims will be used for that purpose, and any demonstration by an applicant of its ability to satisfy these outstanding obligations will be subject to a reasonableness assessment by FINRA.

Notification of Pending Arbitration Claims, Unpaid Arbitration Awards, or Unpaid Settlement Agreements Related to Arbitration

Rule 1013(a) sets forth a detailed list of items that must be submitted with an NMA, and Rule 1017(b) sets forth the documents or information required to accompany a CMA, depending on the nature of the CMA. One of the standards for admission requires an applicant to file an application that is complete and accurate.[31] Further, Forms NMA and CMA instruct the applicant to ensure the accuracy of the application and state that the applicant is responsible for keeping the application current throughout the review process.[32]

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

Endnotes

1. *See* Securities Exchange Act Release No. 88482 (March 26, 2020), 82 FR 18299 (April 1, 2020) (Order Granting Approval of File No. SR-FINRA-2019-030).

2. FINRA is separately developing comprehensive changes to the MAP rules in connection with the retrospective review of this rule set. *See* Regulatory Notice 18-23 (July 2018) (*Notice 18-23*) (requesting comment on a proposal regarding the MAP rules).

3. Unless otherwise specified, the term "application" refers to an NMA or CMA, depending on context. Standardized Form NMA and Form CMA set forth the documents and information an applicant for new or continuing membership must gather to produce a complete application package for FINRA's review. Rule 1013(a)(1)(A) and Rule 1017(b)(2), which pertain to NMAs and CMAs, respectively, mandate the use of these forms. FINRA is separately developing changes to the forms to conform to the amended rules.

4. *See generally* Rule 1014(a) (Standards for Admission).

5. The events that require a member to file a CMA for approval before effecting the proposed event are a merger of the member with another member, unless both members are members of the New York Stock Exchange, Inc. (NYSE) or the surviving entity will continue to be a member of the NYSE; a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE; direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the NYSE; a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or a material change in business operations as defined in Rule 1011(l). *See* Rule 1017(a) (Events Requiring Application).

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

7. *See* The Materiality Consultation Process for Continuing Membership Applications. A request for a materiality consultation, for which there is no fee, is a written request from a member firm for FINRA's determination on whether a contemplated change in business operations or activities is material and would therefore require a CMA or whether the contemplated change can fit within the framework of the firm's current activities and structure without the need to file a CMA for FINRA's approval. The characterization of a contemplated change as material depends on an assessment of all the relevant facts and circumstances, including, among others, the nature of the contemplated change, the effect the contemplated change may have on the firm's capital, the qualifications and experience of the firm's personnel, and the degree to which the firm's existing financial, operational, supervisory

and compliance systems can accommodate the contemplated change. *See Notice 00-73*. *See also Notice 18-23* (seeking comment on a proposal to the MAP rules that would, among other things, codify the materiality consultation process).

8. *See infra* notes 15 and 18.

9. In a separate proposal, FINRA is proposing to mandate materiality consultations under other circumstances. *See* Securities Exchange Act Release No. 88600 (April 8, 2020), 85 FR 20745 (April 14, 2020) (Notice of Filing of File No. SR-FINRA-2020-011).

10. *See* Rule 1017(a)(6)(A) and (a)(6)(B).

11. *See* Rule 1011(l).

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

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

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

15. *See* Rule 1011(c)(1) (defining "Covered Pending Arbitration Claim" as "[a]n investment-related, consumer initiated claim filed against the Associated Person in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the hiring member's excess net capital." For purposes of this definition, the claim includes only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney's fees, and is the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.)

16. *See* IM-1011-2 (Business Expansion and Covered Pending Arbitration Claims).

17. *See supra* note 5.

18. *See* Rule 1011(c)(2) (defining "Covered Pending Arbitration Claim" as "[a]n investment-related, consumer initiated claim filed against the transferring member or its Associated Persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member's excess net capital." Under this definition, the claim amount would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney's fees, and will be the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.)

19. *See supra* note 4.

20. *See* Rule 1014(a)(3)(A) through (H).

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

22. *See* Rule 1014(a)(3)(A).

23. *See* Rule 1014(a)(3)(C).

24. *See* Rule 1014(a)(3)(D).

25. *See* Rule 1014(a)(3)(F).

26. *See* Rule 1014(a)(3)(G).

27. *See supra* note 14.

28. *See* Rule 1014(a)(3)(E).

29. *See* Rule 1017(i).

30. Rule 1017(c) describes the timing and conditions for effecting a change in ownership or control, a removal of a restriction in a membership agreement, or a material change in business operations, and the imposition of interim restrictions on the member based upon the standards in Rule 1014 pending a final determination. New paragraph (c)(4) under Rule 1017 expressly provides that notwithstanding these existing timing conditions, where a member or an associated person has an unpaid arbitration award or unpaid settlement related to an arbitration at the time of filing a CMA, the member may not effect such change until demonstrating that it has the ability to satisfy such obligations in accordance with Rule 1014 and IM-1014-1, and obtaining approval of the CMA. As described in *Notice 18-23*, FINRA is considering whether to eliminate the existing timing considerations for filing a CMA depending upon the type of contemplated change to require that any change specified under Rule 1017 should not be permitted until such time as the CMA has been approved by FINRA. *See supra* note 2.

31. *See* Rule 1014(a)(1).

32. *See* Forms NMA and CMA (containing identical language stating: "Each Applicant for membership with FINRA must, at all times, ensure the accuracy of its Application. The Applicant is responsible for keeping its Application current and accurate throughout the Application review process. The Applicant must amend or otherwise notify Staff of any information in, or any information omitted from, its Application that is or makes the application inaccurate, incomplete or misleading."). *See also supra* note 3.