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FINANCIAL SERVICES
FIRMS AND INDEPENDENT
FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

October 5, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-23 | FINRA Requests Comment on a Proposal Regarding the Rules Governing the New and Continuing Membership Application Process (Notice)

Dear Ms. Mitchell:

On July 26, 2018, the Financial Regulatory Authority, Inc. (FINRA) published the Notice, requesting public comment on proposed changes (Proposal) which, if adopted, would restructure FINRA's membership rule series.¹ Currently, FINRA's membership rules are codified in the NASD Rule 1010 Series (Series). The proposed changes were, in large part, based on comments FINRA received as part of its retrospective review of the Series.² Comments included suggestions that FINRA update and streamline the Series.³ This Proposal seeks to address those comments.

FSI commends FINRA for this, and other recent instances, where the regulator has addressed stakeholder comments by carefully considering them and taking steps to incorporate them into its regulatory framework. FSI acknowledges FINRA's increasing demonstration of its willingness to collaborate with its stakeholders. With respect to the current Proposal, certain aspects of the Proposal are very positive for both member firms and the investing public. For example, the Proposal would, for the first time, include the phrase "statutory disqualification" as a "sales practice event."⁴ Also, where an event occurs that triggers a membership application, FINRA members would be permitted to file a single application for an event that impacts more than one member. Each of the impacted members would no longer need to file separate applications, thereby adding efficiency to the membership process. FSI does, however, have a number of concerns about the Proposal.⁵

Most importantly, FSI is concerned that a number of unclear and undefined terms and phrases used in the Proposal may lead to unintended consequences. In particular, without the necessary clarity, FINRA members would not have adequate notice of the steps they would need to take to comply with the rule; or notice of when the rule applies to a change in the firm's

¹ See, generally, FINRA Regulatory Notice 18-23 (July 26, 2018) (Notice).

² See FINRA Regulatory Notice 15-10 (March 2015).

³ See Notice at. p. 3.

⁴ See Proposed FINRA Rule 1111(q); see also Notice at p. 4.

⁵ See Proposed FINRA Rule 1131(a); see also Notice at p. 14.

operations, ownership, control or assets. Moreover, the undefined terms and phrases insert a disconcerting level of subjectivity into the membership application process. That subjectivity may lead to inconsistent regulatory *interpretations* of the rules which, in turn, will lead to inconsistent regulatory *application* of the rules. These concerns, and others, are explained more fully below.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.⁶ These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).⁷

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate \$48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly \$6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U. S. economic activity.⁸

Discussion

FSI appreciates the opportunity to comment on FINRA's Proposal and, as stated above, FSI commends FINRA on its collaboration with industry stakeholders on these important issues. FSI members have reported improving, but continuing, frustration with the membership application process. The membership application process is important for applicants who are seeking to enter the securities industry and for FINRA members who are making material changes to their businesses to help them better serve their clients. The process is also important to the investing public because FINRA's decisions may keep bad actors out of the industry or prevent the firm from associating with a bad actor and prevent firms from incorporating expansions that are beyond their capacity. Each of those interests are important and the Proposal should endeavor

⁶ Cerulli Associates, Advisor Headcount 2016, on file with author.

⁷ The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

⁸ Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

to achieve the appropriate balance between them. With that in mind, FSI's recommendations and suggestions in response to the Proposal are set forth below, with specificity.

I. Introduction and Procedural Background

NASD Rule 1013 governs the application and interview process for applicants seeking FINRA membership. Those applications are referred to as New Member Applications (NMAs). Once approved for FINRA membership, certain material changes in a firm's ownership structure or its operations, as well as certain acquisitions or divestitures, would obligate the member to file an application seeking approval for those changes.⁹ Those applications are referred to as continuing membership applications (CMAs).¹⁰

In January 2010, FINRA published Regulatory Notice 10-01 (2010 Proposal) proposing changes to its membership rules designed to streamline the standards of review for NMAs and CMAs, clarify certain administrative aspects of the membership application process, update or eliminate outdated terminology, require certain additional information about the applicant, and incorporate certain provisions from the Incorporated NYSE membership rules.¹¹ FSI responded to that proposal by noting that the events triggering a membership application were not sufficiently tailored, documentation requirements were open-ended, and the proposal represented an inappropriate expansion of FINRA's jurisdiction.¹² FINRA did not adopt the 2010 Proposal.

Instead, FINRA, subsequently, published Regulatory Notice 13-29 (2013 Proposal), requesting public comment on a revised proposal incorporating some of the comments received in response to the 2010 Proposal.¹³ FSI, again, responded to the 2013 Proposal by making several recommendations.¹⁴ According to the letters published on FINRA.org, it appears that FSI was the only trade association that responded to the 2013 Proposal.

Thereafter, FINRA published Regulatory Notice 15-10, conducting a retrospective rule review of the Series. As noted above, the current Proposal is in response to the recommendations submitted as part of that retrospective rule review.¹⁵ Based on the public letters posted at FINRA.org, it appears that only four organizations commented on FINRA Regulatory Notice 15-10, and that FSI joined the Wholesale Markets Brokers' Association, Americas, as the only two trade groups offering comments on their members' behalves.¹⁶ This underscores FSI's long-term commitment to improving the membership application process for our members who have, or who at some point may have to, file membership applications with FINRA.

In response to Regulatory Notice 15-10, FSI recommended that FINRA consider:

⁹ See, generally, NASD Rule 1017.

¹⁰ *Id.*

¹¹ See FINRA Regulatory Notice 10-01 (January 2010).

¹² See letter dated March 5, 2010, from Dale E. Brown, President and CEO, FSI to Marcia E. Asquith, Office of the Corporate Secretary, FINRA (FSI's 2010 Letter) available at <http://www.finra.org/sites/default/files/NoticeComment/p121096.pdf>.

¹³ See FINRA Regulatory Notice 13-39 (Sept. 2013), available at

¹⁴ See letter dated November 4, 2013, from David T. Bellaire, Esq., Executive Vice-President and General Counsel, FSI to Marcia E. Asquith, Office of the Corporate Secretary, FINRA (FSI's 2010 Letter) available at <http://www.finra.org/sites/default/files/NoticeComment/p380607.pdf>.

¹⁵ See Notice at p. 3.

¹⁶ See Comment letters posted in response to FINRA Regulatory Notice 15-10, available at <http://www.finra.org/sites/default/files/NoticeDocument/p347347.pdf> <http://www.finra.org/industry/notices/15-10>.

- Providing additional clarity regarding when an application will be deemed “substantially complete,”
- Conducting simultaneous and collaborative reviews of a firm’s Form BDW and a CMA, in circumstances where a firm acquires an existing member, and the existing member plans to withdraw from FINRA membership, and
- Providing transparency into the criteria that an application must meet for it to qualify for fast track review.¹⁷

Below, FSI renews some of the concerns set forth above, and raises several new concerns, based upon the final proposed rule text.

II. Unintended Consequences of Undefined or Ambiguous Terms and Phrases

A. The Proposed Definition of Control is Unclear and Overly Broad

The Proposal would define the term “control,” for the first time.¹⁸ That definition combines the definitions of “controlling” in FINRA’s By-Laws and of “control” in the Uniform Application for Broker-Dealer Registration (Form BD).¹⁹ For the purposes of context, FINRA By-Laws define controlling as:

“...the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise. A person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary. Notwithstanding the foregoing, a presumption of control shall not apply where such person holds voting stock, in good faith, as an agent, bank, broker, nominee, custodian or trustee for one or more owners who do not individually or as a group have control of such entity[.]”²⁰

Form BD defines control as:

“[t]he power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. Any person that (i) is a director, general partner or officer exercising executive responsibility (or having similar status or functions); (ii) directly or indirectly has the right to vote 25% or more of a class of a voting security or has the power to sell or direct the sale of 25% or more of a class of voting securities; or (iii) in the case of a partnership, has the right to receive upon dissolution, or has contributed, 25% or more of the capital, is

¹⁷ See, Letter dated May 14, 2015, from David Bellaire, Executive Vice President & General Counsel, FSI to Marcia E. Asquith, Office of the Corporate Secretary, FINRA, available at http://www.finra.org/sites/default/files/notice_comment_file_ref/15-10_FinancialServicesInstitute_comment.pdf

¹⁸ See Notice at p. 4.

¹⁹ *Id.*

²⁰ See FINRA By-Laws, Art. I (h).

presumed to control that company. (This definition is used solely for the purpose of Form BD.)”²¹

Under the Proposal, control means:

“... the possession, direct or indirect, of the power or ability to direct or cause the direction of the management or policies of a person, whether through ownership of voting securities, by contract, or otherwise. ...A person shall be presumed to control another person if such person, directly or indirectly (ownership interest of less than 25 percent will not preclude aggregation): (A) is a director, general partner, managing member, officer or principal exercising executive responsibility (or person occupying a similar status or performing similar functions) of the other person; (B) has the right to vote 25 percent or more of a class of voting securities; (C) has the power to sell or direct the sale of 25 percent or more of a class of voting securities; (D) is entitled to receive 25 percent or more of the profits; or in the case of a partnership or limited liability company, has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital.”²²

The Proposal’s definition of control, not only incorporates the definitions from FINRA’s By-Laws and Form BD, it also appears to expand on them. Under the Proposal, “[a] person shall be presumed to control another person if such person, directly or indirectly ... is a director, general partner, managing member, officer or principal exercising executive responsibility ... of the other person”²³ As an initial matter, this proposed definition of control adds principals to the classes of persons with presumptive control.²⁴ More importantly, however, the proposed definition appears to apply the direct/indirect element of Form BD’s definition to officers, principals, managing members, and general partners.²⁵ Form BD only applies indirect indicia of control to the: i) power to direct a company’s management or policies ii) right to vote 25% or more of a voting class of securities; or iii) ability to sell or direct the sale of such securities.²⁶ The apparent result of this distinction is that, for the purposes of the Proposal, an indirect “general partner, managing member, officer, or principal” exercising executive responsibility²⁷ may be deemed as controlling the BD.

Neither Form BD, nor the Proposal, define what constitutes exercising executive responsibility. For the purpose of the membership rules, that phrase should be defined, particularly in light of: i) the expanded definition of control; and ii) the firm possibly misunderstanding the rule’s application, and not filing a CMA, may result in the firm being cited for an unapproved change. Firms should, specifically, be placed on notice regarding when an “indirect” general partner, officer, managing member or principal would be deemed to be exercising executive responsibility over the firm. As an alternative, prior to adopting the final rule,

²¹ See Uniform Application for Broker-Dealer Registration, Explanation of Terms (Form BD), at p. 2, available at <https://www.sec.gov/files/formbd.pdf>.

²² See Proposed FINRA Rule 1111(e)(emphasis added.)

²³ Id.

²⁴ Id.

²⁵ Id.

²⁶ See Form BD at p. 2, cited supra at fn.21.

²⁷ Id.

FINRA should issue draft comprehensive frequently asked questions (FAQs) on this issue and should provide its member firms with the opportunity to comment on the draft before issuing the final FAQs.

The changes to the definition of control are important for two reasons. First, if the Proposal is adopted, firms would be required to file a CMA for capital structure changes that would cause a person to, for the first time, control 25% or more of the firm.²⁸ Under the current rules, these types of changes would only result in a CMA if they were tied to change in the firm's equity ownership or its partnership capital that resulted in a person controlling 25% or more of the firm's equity or of its partnership capital.²⁹ Under the Proposal, it would no longer matter if the person controlled the firm's equity or partnership capital. Instead, the threshold inquiry would be a broader one, i.e., whether the person now controls the member.

Second, under the Proposal, firms would also be required to file CMAs for changes of control persons, other than those stemming from elections or appointments transpiring in the "normal course business".³⁰ The Proposal does not define "normal course of business." However, the Proposal does explain that the change of control person will trigger a CMA, regardless of whether the change accompanied a change in the firm's capital structure.³¹ To alleviate any ambiguity, and bring clarity to this aspect of the Proposal, FINRA should define "normal course of business."

B. Principals Should be Excluded from Persons With Presumptive Control

FINRA positioning itself in potentially immaterial transactions on the sole basis of a change in principal, seems overreaching. While FINRA attempts to temper that potential overreaching by qualifying control to only apply to principals "exercising executive authority," that phrase is undefined and, thus, not quantified in a way that would allow firms to measure when it applies. FINRA would also have broad discretion and how it interprets "exercising executive authority" and to whom it will apply.

FSI suggests deleting the reference to principals altogether, to bring the Proposal's definition in line with Form BD. Principals, as well as most of the classes of persons referenced in the proposed definition, would need to be registered under FINRA rules. FINRA would, accordingly, have the opportunity to review the addition of these persons as it conducts its regulatory oversight of the firm. Also, FINRA rules require firms to vet all new registered persons they hire.³² Thus, firms should be entrusted to vet their principals, as with any rule and, to the extent they do not, they would suffer the consequences that come with violating FINRA rules.

C. The Phrase "Or Otherwise" Should be Omitted from the Definition of Control

The proposed definition of control, includes control "by contract, or otherwise."³³ As FSI noted in response to the 2010 Proposal, the reference to "or otherwise" introduces a level of subjectivity, and the potential for inconsistency, into the application process.³⁴ FSI recommended

²⁸ See Proposed FINRA Rule 1131(b)(4).

²⁹ See NASD Rule 1017(a)(4).

³⁰ See Proposed FINRA Rule 1131(b)(5).

³¹ *Id.*; see, also Notice at p. 15.

³² See FINRA Rule 3110 (e)(explaining that "[e]ach member shall ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the member applies to register that applicant with FINRA and before making a representation to that effect on the application for registration").

³³ See Proposed FINRA rule 1111(e).

³⁴ See FSI's 2010 Letter at p. 2.

that FINRA remove the phrase “or otherwise” in the text of that proposed rule.³⁵ While that phrase is also used in Form BD, FSI renews that suggestion with respect to the current Proposal. In addition to its prior concerns, FSI notes that this could lead to individual regulatory abuse, or improper exercise of individual regulatory discretion, by specific members of FINRA’s staff. In particular, the ambiguity of the phrase could be exploited to require membership applications as a way to prevent certain firms from engaging in transactions or undertaking other changes.

D. The Proposed Definition of Control is Unclear as it Pertains to Aggregation

The Proposal seeks to clarify that if a person owns less than 25% of a member firm, this would not preclude aggregation.³⁶ However, it is unclear what FINRA means by “aggregation.” It appears that FINRA intends to clarify that, where a person holds an ownership interest in more than one company, in the same family of companies, FINRA may look at the person’s aggregated ownership interest to determine whether a membership application should be filed. However, that is unclear and should be clarified. FINRA may also be attempting to convey that a series of small transactions may trigger a filing requirement if these transactions, in the aggregate, constitute a change in ownership or control. To the extent that is FINRA’s intention, not only should the intent be clarified, but the circumstances under which this would apply should also be clear. As FSI suggests throughout this comment letter, for other undefined terms FSI recommends that prior to adopting the final rule, FINRA should issue draft comprehensive FAQs on this issue and should provide its member firms with the opportunity to comment on the draft before issuing the final FAQs.

E. FINRA Should Define and Clarify What Constitutes a “Meaningful Review” Under Proposed FINRA Rule 1112(b)

Proposed FINRA Rule 1112 (b), provides that:

Within 15 days of the Application Submission Date, the Department shall conduct an initial assessment to determine whether it includes the documents or information necessary for the Department to commence a meaningful review. Where the Department has completed its initial assessment of the Application and determined that the Application omits the documents or information necessary to commence a meaningful review, the Department shall notify the Applicant, in writing, that such Application is incomplete and describe the deficiency. The Applicant shall have five business days after the date on which the Department has issued the written notification of deficiency to cure the deficiency described therein. Upon the Applicant's failure to timely cure the deficiency, the Department shall reject the Application. FINRA shall refund the Application fee, less \$500, which FINRA shall retain as a processing fee. An Application that has been rejected does not constitute final action by FINRA for purposes of the Rule 1160 Series.

The Proposal does not contain a definition of “meaningful review.” That ambiguity introduces subjectivity into the membership application process and, as such, will likely lead to inconsistent determinations regarding: i) what constitutes a meaningful review; and ii) whether the information submitted by an applicant is sufficient for that purpose.

³⁵ *Id.*

³⁶ See Notice at p. 5; see, also FINRA Proposed Rule 1131.

While applicants will be notified if their filing is deficient, an applicant would only have five days to remediate it and failure to do so may result in FINRA rejecting the application.³⁷ For firms that are in the throes of attempting to close a vital transaction, allowing FINRA to reject an application on subjective and undefined bases, may have profoundly adverse consequences for the member's business. This is, particularly worrisome, since FINRA's rejection of an application on this basis, would not be "final action"³⁸ and, as such, is not reviewable under Section 19(d)(2) of the Securities and Exchange Act of 1934.³⁹

Also relevant is that the Notice highlights the adverse impact of FINRA requiring a firm to reverse or unwind a consummated, but unapproved, ownership change.⁴⁰ FINRA offers that adverse impact as the basis for proposing to prohibit firms from effecting changes in ownership until FINRA has issued its membership decision.⁴¹ Depending on the nature of the proposed transaction, and the business rationale for it, summarily rejecting an application on ambiguous bases, and causing the firm to have to refile the application, may also have a similar adverse impact on a firm. It will introduce an extended, and unnecessary, delay into the membership process and on the firm's ability to effect the change.

FINRA requires firms to submit applications for these particular business changes because, in FINRA's opinion, these changes are material. As such, they are not routine. They may also be time sensitive and vital to a firm's continued business and thus continued service of their clients. Further, as also noted elsewhere, the subjectivity caused by FINRA's failure to define or clarify "material review" may lead to inconsistency in how the rule is both interpreted and applied.

Thus, FSI recommends that for each event that would require a membership application, and that may be rejected under Proposed FINRA Rule 1112 (b), FINRA list the documents, or types of documents, that would allow it to commence a meaningful review. This revision would give members notice of what they need to file, would omit subjectivity, reduce the opportunity for inconsistency, and incorporate greater efficiency into the application process. As an alternative, prior to adopting the final rule, FINRA should issue draft comprehensive frequently asked questions (FAQs) on this issue and should provide its member firms with the opportunity to comment on the draft before issuing the final FAQs.

F. FINRA Should Define and Clarify What Constitutes a "Substantial Changes" that "Materially Impacts" FINRA's Review of a Membership Application, Under Proposed FINRA Rule 1012(b)

The Proposal would incorporate Proposed FINRA Rule 1012 (b), which would allow FINRA to lapse a membership application where the firm makes substantial changes to the application. According to the Proposal, FINRA would only lapse an application where the newly introduced changes materially impact its ability to review the application.⁴² Nonetheless, the Proposal does not clarify what constitutes a "substantial change", nor does it identify the circumstances under which FINRA's review of the application would be materially impacted. Importantly, the Proposal notes that the substantial change is a change to the *application*.⁴³ Meaning, the lapse may be

³⁷ See Proposed FINRA Rule 1112(b).

³⁸ *Id.*

³⁹ See Proposed FINRA Rule 1168.

⁴⁰ See Notice at p. 16.

⁴¹ *Id.*

⁴² See Proposed FINRA Rule 1012(b)(2).

⁴³ *Id.*

triggered by a change to the underlying transaction, but it may also be triggered by a change to the firm's circumstances or business operations that would require it to update a previously filed application.

With respect to FINRA's failure to define "substantial change" or clarify when its review would be materially impacted, FSI reiterates the concerns set forth above, including that this proposed rule fails to place firms on notice regarding how to comply with it, introduces subjectivity into the application process, increases the opportunity for inconsistency in how the rule is interpreted and applied, and reduces the overall efficiency of the process. Thus, FSI recommends that FINRA define the phrase "substantial changes" and explain the circumstance that would materially impact its review. As previously suggested, FSI suggests that as an alternative, prior to adopting the final rule, FINRA should issue draft comprehensive FAQs on this issue and should provide its member firms with the opportunity to comment on the draft before issuing the final FAQs.

G. The Definition of Disciplinary History Should Clarify What Constitutes a "Finding of a Violation"

Subject to certain exclusions, the Proposal provides firms with a safe harbor from the CMA process for certain business expansions.⁴⁴ Firms with a disciplinary history are precluded from using the safe harbor.⁴⁵ For the purpose of the Proposal, the definition of disciplinary history would include a "finding of a violation" of certain securities rules.⁴⁶ For the sake of clarity, the Proposal should specify that a "finding of a violation" would mean that the member is the subject of a final order by the SEC, a self-regulatory organization, or a foreign financial regulatory authority (or a comparable foreign authority) determining that the member violated the relevant rule. The purpose of this recommendation is to clarify that firms would not be prohibited from availing themselves of the safe harbor for examination findings and non-adjudicated matters.

III. Refunds on Membership Applications

A. Members Should Be Refunded Their Membership Application Fee, Less the Processing Fee, on Applications Lapsed Based on Substantial Changes to the Application

Applicants should be refunded their membership application fee if the application is lapsed based on: substantial change to the application: i) resulting from changes made by an applicant at the direction of a third party to the transaction; or ii) based on changes to the applicant's business or operations that occurred after the application was initially submitted. The longer the time period between the parties agreeing on the terms of a transaction, and closing a transaction, the greater the opportunity for changes to occur in the transaction and in the firm's operations. In many cases, these changes would cause the firm to be required to amend its initial submission. Since the delay will often be caused by the firm having to undergo the membership application process, it should not be penalized for these delays and FINRA should not profit from it. This is discussed in more detail below.

FINRA may lapse an application if substantial changes are made to the application.⁴⁷ The applicant would be notified of FINRA's intent to lapse the application and would, thereafter, have

⁴⁴ See, generally, Proposed FINRA Rule 1033.

⁴⁵ See Proposed FINRA Rule 1033(c)(2).

⁴⁶ See Proposed FINRA Rule 1011(i).

⁴⁷ See Proposed FINRA Rule 1012(b)(2). Currently NASD Rule 1012(b) provides that FINRA will not refund membership application fees on lapsed applications.

five days to cure the deficiency.⁴⁸ Unlike other bases for lapsing an application, i.e., failing to execute a membership agreement, attend a membership interview, or provide responsive information,⁴⁹ it is difficult to imagine any method to cure a deficiency resulting from a substantial change, other than revising the application to conform to what was initially filed. In many circumstances, this may not be possible or practicable and, thus, the likely outcome is for FINRA to lapse the application; and for the applicant to be required to resubmit it or abandon the proposed change.

Notably, the Proposal allows FINRA to lapse an application regardless of whether the substantial change occurred 20 days after the application was initially submitted, or if it occurred 120 days after it was initially submitted. FINRA would only need to determine that, in its opinion, the change is substantial, material, and that it materially impacts its ability to review the application.⁵⁰ For those purposes, the timing of the event leading to FINRA lapsing the application is irrelevant. The timing of the lapse will, however, be relevant in determining whether the applicant's membership application fee is refunded.

If FINRA lapses an application within 30 days of the Application Filed Date,⁵¹ the application fees, less a \$500 process fee, would be refunded to the applicant.⁵² If the application is lapsed on day 35, FINRA retains the entire membership application fee and, if the applicant elects to refile, it must pay the full fee, again.⁵³ Membership application fees may range from \$5,000 to \$100,000, depending on the size of the firm and the nature of the event triggering the application.⁵⁴ Meaning, if FINRA lapses an application on day 31, based on its subjective determination that a firm has substantially changed its application in a manner materially impacting its review, FINRA may: ii) retain a fee of up to \$100,000, less a \$500 processing fee; and ii) the applicant would need to pay another \$100,000, if it decides to refile.

As noted above, the requirement that firms file membership applications, and wait up to 150 days for FINRA to issue a decision, delays transactions; and, the longer the delay, the more likely it is that changes will occur which, in many situations, will be out of the firm's control. In these circumstances, applicants should not be triple-penalized by FINRA lapsing the application, requiring the firm to pay the full amount of the membership fee for applications lapsed after the thirtieth day, and being subject to further delay in closing a material transaction. Moreover, the additional delay caused by lapsing the application, and requiring the firm to refile, may have the unintended consequence of resulting in additional changes to the subsequently filed application. Thus, FSI recommends that, for lapses based on substantial changes to the transaction made by the applicant at the direction of third-party to the transaction, or based upon changes to the firm's business or operations that occurred after the applicant initially filed the application, firms only be charged a \$500 processing fee; regardless of when the lapse occurred.

⁴⁸ *Id.*

⁴⁹ See Proposed FINRA Rule 1012 (b)(1)(A)-(C).

⁵⁰ See Proposed FINRA Rule 1012 (b)(2).

⁵¹ Unless otherwise noted, capitalized terms used herein, without definition, shall have the meaning ascribed to them in the Proposal.

⁵² See Proposed FINRA Rule 1012(b)(3).

⁵³ *Id.*

⁵⁴ See Schedule A to FINRA By-Laws Art. VI Sec.4 (h)(i).

B. Members Should Be Refunded Their Membership Application Fee for Applications that Are Not Voluntarily Withdrawn

The Proposal should be amended to specify that an applicant's membership application fee will be refunded where FINRA directly or indirectly requests, suggests, or otherwise encourages, an applicant to withdraw its application. Under Proposed FINRA Rule 1112 (e), an applicant's membership application fee would not be refunded where the applicant withdraws its application after 30 days of the Application Filed Date.⁵⁵ There are situations where FINRA encourages applicants to withdraw an application, including where FINRA intends to deny the application. While FINRA should continue to notify firms that their application will be denied before issuing the denial letter, FINRA should not monetarily benefit from situations in which it encourages the applicant to withdraw its application. Not only would FINRA be able to keep the application fee and, possibly receive a second application fee, but FINRA would also avoid having to go through the appeal process. The fact that both parties avoid litigation, should be sufficient.

C. As an Alternative, FINRA Should Consider Adopting a Sliding Scale Where the Amount of the Refund Will be Determined by When the Application is Lapsed or Withdrawn

As an alternative to refunding membership applications in the circumstances identified above, and to create a more equitable and easily applied standard, FINRA should consider adopting a sliding scale to determine refunds on lapsed or withdrawn applications. That sliding scale should be based on: i) the 150-day period (Application Period) FINRA has to review the membership application and issue a decision; and ii) the point during the Application Period when the application lapsed or was withdrawn.

By way of example, if a membership application is lapsed or withdrawn on the 45th day of the Application Period, regardless of the reasons, the applicant would be refunded 30% of its application fee. The 30% represents that 30% of the Application Period has expired. While FSI appreciates that FINRA may have done more than 30% of the work associated with its review of the application, it may also have only done 10% of the work. Nonetheless, the Application Period, presumably, represents the timeframe in which FINRA believes is necessary to review the average application and, therefore, is the most appropriate standard of measurement.

IV. FINRA Should Incorporate Decision Deadlines for Mandatory Materiality Consultations

Proposed FINRA Rule 1132 would govern the circumstances, and process, for voluntary materiality consultation (MatCon) filings and would, under certain proscribed circumstances, make MatCon filings mandatory. FINRA has published prior Regulatory Notices seeking to convert the MatCon process from a voluntary process, to a mandatory one. In response, FSI has repeatedly urged FINRA to adopt rule-based procedures that would govern the MatCon process.⁵⁶ The present Proposal introduces such procedures.

⁵⁵ Currently, NASD Rules 1013(a)(5) and 1017(f) infer that FINRA has the authority to retain application fees for applications that are withdrawn more than 30 days after they were filed. However, unlike the Proposal, those rules do not expressly provide FINRA with this authority.

⁵⁶ See, e.g., Letter dated April 9, 2018 from Robin Traxler, Vice President, Regulatory Affairs & Associate General Counsel, FINRA to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, at p. 4, available at http://www.finra.org/sites/default/files/notice_comment_file_ref/18-06_fsi_comment.pdf; Letter dated June 29, 2018 from Robin Traxler, Vice President, Regulatory Affairs & Associate General Counsel, FINRA to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA, at p. 6, available at http://www.finra.org/sites/default/files/notice_comment_file_ref/18-16_FSI_Comment.pdf.

FSI appreciates FINRA considering this change. FSI recommends, however, that the standards for FINRA's review of MatCons, as set forth in Proposed FINRA Rule 1132(d), include a deadline for FINRA to issue decisions on mandatory MatCon filings. If the decision results in the member being required to file a membership application, it can be detrimental for the member, and disruptive to the member's business, to wait an undefined and indefinite period for the MatCon determination, followed by the 150-day period for FINRA to issue a membership application. Therefore, FINRA should be required to issue a decision on a mandatory MatCon filing within 30 days of FINRA receiving the information set forth in Proposed FINRA Rule 1132(c) – Content of Request for Materiality Consultation.

V. Changes in Measuring FINRA's Deadlines to Issue a Membership Decision and Applicants' and FINRA's Deadlines Related to the Initial Assessment Process

A. FINRA's Newly "Shortened" Deadline to Issue a Decision on a Membership Application Should be Calculated from The Application Submission Date

As an initial matter, the Proposal appears to reduce FINRA's time to issue a membership decision from 180 days to 150 days.⁵⁷ However, the time to issue a decision is calculated from the Application Filed Date.⁵⁸ The Application Filed Date is the date that FINRA determines it has enough information to conduct a meaningful review of the application.⁵⁹ As set forth in the Proposal, this process for FINRA to make this determination can take up to twenty days,⁶⁰ particularly in the light of firms not having notice regarding what documents they would need to submit for FINRA to conduct a meaningful review. Based on this, in reality, the Proposal may only result in a ten-day reduction in FINRA's time to issue a membership decision.

Notwithstanding, measuring FINRA's deadline to issue a membership application from the Application Filed Date has the unintended consequences of leaving room for some examiners to use the initial assessment process to extend the time to issue a decision. In particular, some examiners may use this process as way to manage workflow. To that point, FSI members have noted that once the 30-day period proscribed under rule NASD 1017(e) is close to expiry, FINRA examiners often issue request letters containing items the applicant had already submitted or documents that did not seem, at all, relevant to the underlying transaction. By issuing a request letter on the thirtieth day, FINRA extends its time to issue a decision to thirty days after the applicant responds to FINRA's latest request.⁶¹

The Proposal would allow for similar potential abuses. FINRA examiners would be able to exploit a subjective and undefined standard to require that applicants submit additional information. That request delays the Application Filed Date and, as such, delays FINRA's time to issue a membership decision. Except in this case, these tactics may not only result in a delayed membership decision, they may also result in an application being subjectively rejected based on an individual interpretation of "meaningful review" and the documents required to conduct such a review. Also, the Proposal clarifies that FINRA's determination is not final and, as such, is not appealable.⁶²

⁵⁷ See Proposed FINRA Rule 1151(a).

⁵⁸ *Id.*

⁵⁹ See Proposed FINRA Rule 1112(a)(2).

⁶⁰ See Proposed FINRA Rule 1112(b).

⁶¹ See NASD Rule 1017 (e) (providing that, for CMAs, after FINRA's initial request for information, and the applicant's response to that request, FINRA has 30 days to either request additional documents or issue a decision).

⁶² See Proposed FINRA Rule 1112(b).

Unlike the Application Filed Date, the Application Submission Date is standard or measurement that is not vulnerable to manipulation and is, therefore, the standard of measure that should be used in calculating FINRA's time to issue a decision. The Application Filed Date is subject to the individual staff member's interpretation of "meaningful review" and as such is vulnerable to manipulation for the purpose of extending FINRA's deadline to issue a decision. Therefore, FINRA should be required to issue a membership application decision within 150 days of the Application Submission Date.

B. FINRA's Time Conduct an Initial Assessment of a Membership Application Should be Reduced to Ten Days; and Applicants' Time to Respond to A Notice of Deficiency Should Be Proportionately Extended to Ten Days

As explained above, if the Proposal becomes effective, FINRA would have 15 days from the Application Submission Date to assess a membership application.⁶³ Thereafter, FINRA would notify the applicant of any deficiency in the application that would prevent FINRA from conducting a meaningful review.⁶⁴ After receiving that notice, FINRA members would have five days to not only respond, but to cure the stated deficiency.⁶⁵ Meaning, a well-intentioned applicant could respond in the five-day time period, but if FINRA determines that the response does not cure the deficiency, the application may still be rejected.

The Proposal fails to provide any flexibility in an applicant's time to cure based on the nature of the deficiency. It also does not account for the administrative issues presented in most companies in order to gather and prepare documents for submission, which will often require internal collaboration from more than one business unit. In many cases, five days will simply not be enough. At this point in the application process, FINRA will not be subject to those same administrative burdens. Thus, FSI recommends that FINRA's time to assess the application be reduced to ten days, and that the applicant's time to respond be lengthened to ten days. This change introduces some balance into this aspect of the proposed process.

VI. FINRA Should Provide Clarity and Transparency into the Criteria FINRA Will Consider in Determining Whether a Membership Application is Eligible for Expedited Review

If adopted the final proposal should include the factors FINRA will consider in determining whether a membership application is eligible for expedited review. The Proposal would include supplementary material explaining that, "[a]s a part of the initial assessment, [FINRA] may, in its discretion, determine that the Application is eligible for expedited review and shall notify the Applicant of such eligibility."⁶⁶

Also, the seeming mystery surrounding how, and whether, membership applications are selected for expedited review is, particularly, frustrating to some FSI members. This knowledge would be helpful in aiding firms entering into transactions subject to FINRA's membership rules. As FINRA member firms request transparency, and FINRA attempts to provide it, it is crucial that FINRA provide insight into the criteria It uses to determine which applications qualify for expedited review.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ See Proposed Supplementary Material .02 to Proposed FINRA Rule 1112.

VII. Absent FINRA Imposing Interim Restrictions, Firms Should Continue to Be Permitted to Effect Indirect Changes of Ownership Prior to the Membership Proceedings Conclusion

Currently, NASD Rule 1017(c)(1) requires FINRA member firms to file membership applications at least 30 days prior to effecting an ownership changes but, unless FINRA imposes interim restrictions on the transaction, the firm may effect the ownership change before the membership proceedings conclude. Under the Proposal, if adopted, firms will no longer be able to effect those changes until FINRA issues a membership application decision.⁶⁷ In stating its rationale for this proposed change, FINRA notes the inherent risk associated with these transactions, as well as the logistical impact of a firm having to reverse or unwind an unapproved transaction consummated prior to the firm receiving a membership decision.⁶⁸

Particularly for firms with layered organizational structures that include several layers of indirect ownership, an ownership change may occur at a level that is decidedly removed from the firm. In these cases, the firm may not be impacted by the change at all; yet, a membership application is still required.⁶⁹ In most cases, these changes will be low risk to the firm or to its clients because, in part, it is improbable that they would impact the firm's day-to-day management or supervision. Since there is no impact to the firm, there would appear to be no basis for FINRA to require the firm to unwind or reverse the transaction. However, to address FINRA's concerns, FINRA may consider prohibiting indirect ownership changes that result in changes to the firm's business activities, day-to-day management, supervision, assets or liabilities, until the member receives FINRA approval for that change.

Firms should be permitted to effect indirect ownership changes within 30 days of filing its request for a CMA waiver, or filing a CMA, whichever is applicable. Firm should be allowed to close these transactions regardless of whether FINRA has issued a decision regarding the membership application or a CMA waiver; so long as the change would not result in changes in the firm's day-to-day management or supervision.

VIII. Changes to the Appeal Process

A. FINRA Should Not Be Permitted to Render Membership Decisions on the Basis of Withheld Documents

The Proposal would, for the first time, expressly allow FINRA to withhold certain documents during appeals from adverse membership decisions.⁷⁰ The documents FINRA would be authorized to withhold include internal FINRA memos, notes prepared by FINRA employees that FINRA does not intend to offer into evidence, and examinations, investigations, or enforcement proceedings initiated by, or being considered by, FINRA or other regulators.⁷¹ FINRA is also not automatically required to produce a list of the withheld documents, unless it is required to do so by the National Adjudicatory Council or the Subcommittee.⁷²

Absent a compelling reason, during an appeal, FINRA should not be permitted to withhold any documents it relied upon in reaching its membership application decision. Alternatively, but to the same end, FINRA should not be permitted to issue an adverse decision based on information

⁶⁷ See Notice at p. 17.

⁶⁸ *Id.*

⁶⁹ See Proposed FINRA Rule 1131(b)(4)

⁷⁰ See Proposed FINRA Rule 1164(c).

⁷¹ *Id.*

⁷² See Proposed FINRA Rule 1164(d).

that it knows, or should have known at the time the membership decision was issued, would likely be withheld during an appeal.

Setting aside the obvious concerns this raises about FINRA potentially considering incomplete investigations or examinations as a basis for denying a membership application, withholding this information adversely impacts the applicant's ability to understand the full basis of the denial and, therefore, to adequately challenge it. Thus, information that FINRA relied upon in issuing its decision should be disclosed, absent compelling circumstances. Such compelling circumstances would include information typically shielded from discovery such as attorney work-product, information protected from disclosure by attorney-client privilege, and information that may not be disclosed under applicable federal law. Additionally, certain information, such as the identity of a person who anonymously reports a rule violation to FINRA, should not be disclosed; because protecting anonymity under these circumstances will create a safe environment for industry persons to report wrongdoing without fear of reprisal.

However, most of the other documents should be disclosed, if they were either the basis for FINRA's decision, or if FINRA relied on them in reaching its decision. Withholding these documents would severely handicap an applicant's ability to succeed on appeal. As an alternative, the final rules should prohibit FINRA from issuing adverse membership decisions based on information that will be withheld during an appeal.

B. The Basis for Applicant's Motion to Compel Disclosure of a Withheld Document Should be Expanded

Under the Proposal, a motion to compel disclosure of withheld documents would only be successful whether the document was withheld in violation of Proposed FINRA Rule 1164.⁷³ With the exception of documents withheld for compelling reasons, as described above, a motion to compel FINRA to produce withheld documents should be granted where: i) FINRA relied upon the document in reaching its decision on the membership application; and ii) FINRA's failure to disclose the document would adversely impact the applicant's ability to either: a) fully understand the basis of FINRA's decision; or b) challenge the basis of FINRA's decision.

IX. FINRA Should Provide Clarity Regarding When and Whether, Factoring Agreements Between Affiliates Would Require a Membership Application

From time to time, members may enter into a factoring agreement with its parent or an affiliate, wherein the member agrees to sell its accounts receivables to the parent or affiliate. In exchange, the parent or affiliate will provide the firm with a sum of cash. These agreements may be beneficial to members because they shift the risk of non-payment from the firm, to the other party, and the firm has immediate access to cash. Nonetheless, a firm shifting the entire amount of its receivables to a third party, may impact the firm's capital and its ability to pay its debts.

Currently, FINRA Rule 4110 requires carrying members to obtain written approval before entering into factoring agreements.⁷⁴ Both carrying and clearing members are required to obtain written approval from FINRA before entering into a factoring agreement that would reduce their tentative net capital by 10%.⁷⁵ Also, FINRA's current membership rules appear to require firms to file CMAs for factoring agreements.⁷⁶

⁷³ See Proposed FINRA Rule 1164.

⁷⁴ See FINRA Rule 4110 (d)(1)(B).

⁷⁵ See FINRA Rule 4110 (d)(1)(A).

⁷⁶ See FINRA Rule 1017 (a)(3).

Neither the current iteration of FINRA's membership rules, nor that Proposal, account for the fact that, in most circumstances, the parent or affiliate is providing the firm with "cash in hand." Thus, the Proposal should include a carve out for factoring agreements where the member is paid a sum that is equal to, or greater than, 75% of the member's expected accounts receivable. Firms should note that, to the extent applicable, they would need to comply with the requirements of other FINRA rules, including FINRA Rule 4110.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

A handwritten signature in blue ink that reads "Robin Traxler". The signature is written in a cursive style with a large, sweeping initial "R" and a long horizontal line extending from the end of the name.

Vice President, Advocacy Policy & Associate General Counsel