CARTER LEDYARD & MILBURN LLP
Counselors at Law

Faith Colish
Counsel
•
Direct Dial: 212-238-8873
E-mail: colish@clm.com

2 Wall Street
New York, NY 10005-2072
•
Tel (212) 732-3200
Fax (212) 732-3232

701 8th Street, N.W., Suite 410
Washington, DC 20001-3893
(202) 898-1515
•
570 Lexington Avenue
New York, NY 10022-6856
(212) 371-2720

March 4, 2010

VIA E-MAIL TO PUBCOM@FINRA.ORG

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1506

Re: Regulatory Notice 10-01
Proposed FINRA Rules regarding New Member
Applications and Continuing Membership Applications

Dear Ms. Asquith:

This letter contains my comments on proposed FINRA Rules 1110 through 1180 relating to New Member Applications ("NMAs") and Continuing Membership Applications ("CMAs"). Although I have benefited from exchanging views with others who have had experience with the NMA and CMA processes, the views expressed in this letter are my own and are not submitted on behalf of any client, organization, or other person.

At the outset I note that proposed FINRA Rules 1110-1180 generally follow the structure of NASD Rules 1000-1019 (the "NASD 1010 Rules"). This is good as it will reduce the effort required for practitioners who are accustomed to the NASD involved in making the transition from the NASD 1010 Rules.

The remainder of my comments are presented in the order of appearance of the relevant provisions of the proposed new FINRA rules, and not necessarily in order of importance.

Rule 1111 - Definitions.

(a) **"Affiliate"** - By excluding natural persons from the definition of this term, FINRA creates a discrepancy between the term Affiliate for NMA/CMA purposes and the term "control affiliate" as used in Form BD, Schedules A and B. If this is intentional, the adopting release should so specify. Obviously, applicants and members will continue to use Form BD as it exists, unless and until it is amended by the SEC.

(b) "Associated Person"

Paragraph (1) of this section covers "a natural person registered under FINRA Rules." This should be clarified to specify a natural person registered under FINRA Rules as a representative or principal of the Applicant in question. A person registered under FINRA Rules as a representative or principal of a completely unaffiliated FINRA member should not be deemed to be an "Affiliate" of an Applicant, even if that individual happens to be a minority (non-controlling) shareholder of the Applicant.

Paragraph (2) of this definition now expressly includes "an LLC managing member" of an Applicant or FINRA member It is not clear if this is intended to exclude LLC members who are not managing members.[1] If an analogy is made to the inclusion of any "partner" of the Applicant, then presumably any member of an Applicant should also be considered an Associated Person of the Applicant. However, the reference to "partner" could be clarified to specify whether a limited partner is also an Associated Person, especially if the limited partner owns less than 25% of the Applicant, and does not otherwise control the Applicant.

In any event, it should be made manifestly clear that the term Associated Person does <u>not</u> include a limited partner of second-tier, third-tier, or more remote owner of the Applicant, when the limited partner owns less than 25% of the entity in which he/she/it is a direct investor and where the limited partner does not otherwise control the Applicant. I have observed situations in which FINRA staff, without citing any authority in the existing NASD 1010 Rules, has required detailed information on these remote investors, including their names, addresses, *and Social Security numbers.* This kind of information has been extracted from Applicants and/or from prospective investors in an Applicant CMA notwithstanding without regard for confidentiality covenants between the limited partners and the entity in which they are direct investors and without any assurance from FINRA staff that this highly sensitive information would not be furnished in response to a subpoena in an unrelated civil action. In my view this demand for information was not only excessive and needlessly intrusive but also unauthorized by NASD rules and Applicants have acquiesced only in the face of an intransigent position of FINRA staff. An Applicant might file an appeal to a higher authority of FINRA or to the SEC itself, but the risk of delaying a time-sensitive application may well outweigh the rightful desire to resist such demands. The new FINRA rules, or at least the Regulatory Notice that accompanies the adoption of the new rules, should make it clear that this specific abuse of power is not authorized.

(d) "Control." The language of this definition tracks the definition of this term for purposes of Form BD and is acceptable. It is noted, however, that the absence of "control" has not

---

[1] An LLC manager of an Applicant, whether or not he/she is also a member of the Applicant, would presumably be an Associated Person of the Applicant because this position is within the proper scope of paragraph (1) - a natural person registered with FINRA *as a representative or principal of the Applicant,* and paragraph (2) which already includes an officer of the Applicant.

been sufficient to limit the assertion by FINRA staff of the authority to get names, addresses, and *Social Security numbers* of manifestly non-controlling remote owners or potential owners of an Applicant (see the discussion above). The new Rules, or at least the Regulatory Notice that accompanies their adoption, should set forth clear limitations on the authority of FINRA staff to demand this kind of sensitive, personal information about non-control persons of the Applicant.

In addition, it may be useful to include in this definition a qualification that "control" is not presumed solely on the basis of being a holder of record of voting stock of an Applicant (or owner of an Applicant) when the owner holds the stock in good faith as agent, bank broker, nominee, custodian or trustee for one or more owners who do not individually or as a group have control of the entity in question.

(n) **"Sales practice event"** - The broadening of this term to include any "statutory disqualification" seems both unnecessary and excessive. If an Associated Person becomes subject to a statutory disqualification the Applicant is automatically prohibited from retaining that Associated Person unless there has been a successful filing of an MC-400 application. If such an application is granted, it does not seem necessary to continue the stigma that would deprive the Applicant of the ability to rely on the "safe harbor" in Supplementary Material .01, currently IM-1011-1 (about which see the comments below), for expansion of its business within prescribed limits that would otherwise constitute a non-material change. This is particularly relevant in cases where the statutory disqualification is based on events that have no direct bearing on sales practices or on an individual's fitness for employment in the securities business. For example, a statutory disqualification results from conviction of *any* felony within the past 10 years (Securities Exchange Act Section 3(a)(39)(F)). In some jurisdictions this would include a third-offense conviction of driving while intoxicated, even though a first or second offense of the same kind is a misdemeanor.

Rule 1112 - General Procedures

(a) **Filing by Applicant or Service by FINRA**

Paragraph (4)(D) of this Section would specify that electronic filing is complete when it is "recorded by FINRA's electronic systems." This currently means the FINRA Gateway system. There have been occasions when an Applicant (or its counsel) have attempted to make a Gateway filing within the allotted time but due to malfunction of the Gateway system FINRA does not "record" the receipt of the submission until some time after the sender has made a bona fide attempt to submit it. If the sender can document that it has taken all reasonable steps to submit the material within the deadline, but FINRA's technology does not immediately reflect that submission, the Applicant should be permitted to demonstrate its timely steps to make the filing. In the alternative, the Applicant should be permitted to deliver the text of material to an "overnight courier" pursuant to paragraph (a)(4)(B) under which filing is deemed to be made at the point of delivery from the Applicant to the courier and not the point of receipt by FINRA from the courier.

(b) Lapse of Application

Paragraph (1)(A) of this section would shorten the time from 60 days to 30 days for the Applicant's response to the initial request from FINRA staff for information. This proposal has its pros and cons. There seems to be little reason to distinguish between the Applicant's response time to the initial request from the traditional 30-day response time for responses to subsequent requests. On the other hand, I have heard of situations where the applicant was a foreign entity that needed to obtain consent of foreign authorities to comply with FINRA staff requests, which has sometimes been difficult to do within the existing 60-day time limit. Perhaps a reasonable compromise would be to require response to an initial request within 30 days unless the Applicant can show good cause why that time should be extended to not more than 60 days, and in no event for longer than is justified by the Applicant's request for an extension.

Paragraphs (1)(D)(i) and (1)(E)(i) of this section would require an Applicant to "schedule" the required personnel examinations within 30 days after filing of an NMA or CMA. I believe it would be more appropriate to require the filing of a Form U4 to open a window for such examinations within that 30-day limit. Appointments for exams that are "scheduled" can be cancelled and rescheduled. I believe that the requirement in paragraphs (1)(D)(ii) and (1)(E)(ii) that necessary personnel have passed the appropriate examinations within 120 days after the filing of the NMA or CMA is a sufficient deterrent of delay. In any event, it should be made clear that the requirement to pass necessary exams within a 120-day time span is limited to personnel who are essential to the proposed business. This would include the CEO, the CCO, the FINOP, and the supervisor of any line of business included in an NMA or a CMA.

Rule 1120 - New Member Application and Department Decision

(a) Filing of Application.

Paragraph (1) contains several provisions expanding the scope of material that must be submitted as part of an NMA. Most of the new language in this paragraph describes information that is already required in Form NMA and/or has customarily been required by FINRA staff for some time. I do not consider these new requirements to be inappropriate or unduly burdensome. However, some of the requirements of new sub-paragraph (a)(1)(G)(v) might benefit from clarification. For example, a person "on which the Applicant or its customers rely for operational support or services that are used in connection with the Applicant's securities, investment banking, or investment advisory business" could be understood to be persons that provide "mission critical" services and that are so identified in the Applicant's Business Continuity Plan. Without some standard of materiality of the level of "operational support or services" every minor vendor or service provider could be deemed to be a necessary disclosure item in the NMA.

Paragraph (3) continues the requirement of the NASD rules that the Department must serve an initial request for any additional information within 30 days after filing of the NMA. This is a requirement that has not always been satisfied by FINRA, and more likely than not the initial request from FINRA will arrive about 29 ½ days after the filing

of the NMA. I realize that this is consistent with the rules, and that sometimes Applicants use the full allotted time to respond to FINRA requests. However, what is stated to be the maximum time for FINRA staff action is typically the normal time. Anything that can be done to lower that time span would be very beneficial to Applicants.

Paragraph (4) authorizes FINRA to reject an NMA that it determines, within 30 days of receipt, not to be substantially complete. This should be extremely rare as the use of the electronic Form NMA prevents submission of an NMA that is lacking any of the essential answers. However, it is possible that an Applicant could submit an NMA with attached Written Supervisory Procedures that are manifestly insufficient for the proposed business, or there could be other filings that can pass the entry requirements of Form NMA that are, in fact, substantially incomplete. The $350 fee for reviewing and returning a substantially incomplete application was established when the NASD 1010 Rules were originally adopted in 1997, based on an estimate of the cost of time for an experienced examiner to review a file and determine that it was substantially incomplete. On an inflation-adjusted basis, the increase of this fee to $500 does not appear unreasonable, although use of the electronic Form NMA filing process may reduce the actual time it takes for an experienced examiner to make this determination. FINRA should be able to present a rationale for the new, higher fee level.

Paragraph (5) will require the Form NMA to be submitted within 180 days of the date the Applicant files its Form BD. This is not unreasonable, and may be required by current SEC policy to purge Form BD applications that are not followed by filing of a Form NMA within an even shorter time than 180 days.

(d) Decision

Paragraph (1) of this section requires the Department to issue a written decision on an NMA within 30 days after the membership interview or after the Applicant's final filing of additional information or documents, whichever is later. Frequently, FINRA staff will request additional information at the membership interview or shortly thereafter. The post-membership interview written request is generally preceded by an oral notification at the membership interview that the written request will be forthcoming. So long as this pattern is followed the timing provisions of paragraph (1) are reasonable and workable. However, there have been more than a few instances when the FINRA staff makes a series of requests for additional information, each of which is characterized as "just one more thing." Sometimes there can be a regular stream of just-one-more-things. It is my perception that this results from the examiner presenting a proposed decision to his or her supervisor who then returns the draft to the examiner for further work. It might be appropriate to limit the number of post-membership interview requests from FINRA staff. This would not be designed to deprive FINRA of any necessary or appropriate information but to impose greater discipline on how the application is reviewed and how the response is coordinated.

Paragraph (2) would require the FINRA staff to provide a detailed statement of the reason(s) for denial of an NMA. Although I can't speak from personal experience on this point, it is my belief that this has been the staff practice. In any event, it is essential to

enable the Applicant to formulate an appeal, if that is the Applicant's chosen course of action.

Rule 1130 - Basis for Department Decision

(a) Membership Standards. Most of the provisions of this proposed rule are consistent with long-standing practice and appear to be reasonable and appropriate. However, some paragraphs contain ambiguous or extremely subjective terms that should be clarified.

Paragraph (3) requires FINRA to determine that an Applicant's sources of funding are "not objectionable." What does this mean?

Paragraph (4)(G) authorizes FINRA to deny an application if it has information that "indicates that the Applicant may seek to circumvent, evade or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or FINRA rules." Not only is this criterion entirely subjective, there is no element of materiality and no indication of who has the burden of proof that the "indication" warrants denial of membership.

I am personally familiar with a case in which an NASD member in good standing, with an immaculate compliance record, healthy capital, numerous branches, dozens of associated persons and hundreds, if not thousands, of customers, was required to withdraw from NASD membership because an individual who was under investigation for money laundering (but not formally accused) became the 30% owner of the publicly-traded parent of the NASD member. There was no evidence that this individual had any intentions of influencing the activities of the NASD member or even of the parent company of which the individual was a direct owner. The presence of this individual as a more-than-25% indirect owner of the member firm resulted in denial of a CMA for change of ownership.

This case was reviewed by senior staff in the NASD Department of Member Firms but the only relief available was to allow the member firm additional time to attempt to remove the objectionable shareholder from its corporate structure, or at least to reduce that individual's ownership to less that 25% of the parent. The NASD member and its parent were unable to negotiate a buy-out or other transaction that would reduce the ownership level of the objectionable individual and a perfectly healthy NASD member was put out of business. If this has happened before, it could happen again. FINRA staff should be required to bear the burden of demonstrating the risk that their fears actually present a meaningful risk to customers or to the marketplace.

Paragraph (8)(B) retains the language of the analogous provision of NASD Rule 1014(a)(7)(B) that the Applicant should have enough excess net capital to survive its first 12 months of operation, giving effect to a reliable projection of expenses *net of revenues*. The requirement to view the Applicant from a 12-month perspective is echoed in **paragraph (8)(F)** of proposed Rule 1130(a). The management of FINRA should be aware that frequently - indeed in virtually all NMAs - the staff focuses on expenses for the first six months *without taking into consideration reasonably projected revenues.*

There is absolutely no basis in the existing rule for this policy and the new rule would not provide such a basis. However, in light of the routine adoption by FINRA staff of an unwritten policy that is materially different from the written rule, either the new rule, or the Regulatory Notice accompanying its adoption, or both, should make it clear that FINRA staff is not authorized to revise these requirements unilaterally and without any formal authorization.

Rule 1160 - Continuing Membership Application for Approval of Change in Ownership, Control, or Business Operations

(b) Filing and Content of Application. Many of my comments on the NMA process are equally applicable to CMAs, especially those that relate to the scope of information that can be requested by FINRA. In particular, I wish to re-emphasize that, both under current NASD rules and under the proposed new FINRA rules, the Department is not authorized to demand information such as names, addresses, and Social Security numbers of minority, non-controlling passive investors in entities that, through a series of subsidiaries, seek to create a FINRA member or to acquire ownership of an existing member. Other specific comments on this section are as follows.

Paragraph (1) requires the CMA to be filed "in the manner prescribed by FINRA." The manner is not specified. I understand that FINRA is working on the possibility of an electronic filing of CMAs, analogous to the electronic filing of Form NMA, and I do not seek to inhibit that effort. However, FINRA members may have no opportunity for input or approval of a significant change in the manner of filing and this provision is not only vague, it is subject to any kind of change that might seem to suit the preferences of FINRA.

Paragraph (3) states that FINRA may waive the requirement to file a CMA if the member firm is planning to cease doing business and to file Form BDW, provided the member firm and its Associated Persons is not subject to various kinds of unsatisfied claims. I understand the interest of FINRA in preventing members from evading their obligations on exiting the business, but it seems inapposite, if not oxymoronic, to do this under the guise of waiving the requirement to file a CMA. A firm that is planning to file Form BDW is not a candidate for a CMA - the "C" stands for "continuing." This legitimate concern can and should be dealt with without distorting the meaning and purpose of a CMA.

Paragraph (4) permits FINRA to waive the requirement of a CMA when a proposed change in a member will not result in any direct or indirect change in ownership, control, or business, management, supervision, assets, liabilities or ultimate ownership of the member. This sounds like an event that would be eligible for registration of a successor to an SEC-registered broker-dealer pursuant to Securities Exchange Act Rule 15b1-3(b). This rule authorizes a successor that differs from its predecessor only in terms of legal structure (e.g., partnership vs. corporation), or place of formation (e.g., Delaware vs. New York) to achieve registration merely by filing an amendment of the Form BD of the predecessor. This "old wine in new bottles" approach in the Securities Exchange Act rules was respected and followed by NASD for many years until very recently when,

pursuant to an internal change of policy that was not announced to its membership, FINRA decided that any such succession required a CMA. The proposed new rule is evidently a compromise, in that it permits FINRA to waive the requirement of a CMA under these circumstances. I question whether this kind of succession should ever require a CMA. The basis for FINRA's proposed new approach is not articulated in the proposal. In my view, a more appropriate process, if any process is required at all, would be to have the predecessor file a notice with FINRA of the terms of the proposed succession and for the burden on FINRA to make an affirmative determination within a very short time (say, five business days) that a CMA is required.

Supplementary Material:

.01 **Safe Harbor from Application in Limited Circumstances.** I do not object to any changes in the text of this safe harbor (currently IM-1011-1), other than the inclusion of "any felony" as a ground for depriving a member of the right to use the safe harbor. (See the discussion of this point in the comments on proposed Rule 1111(n), the definition of "sales practice event.") However I strongly object to the interpretation of IM-1011-1 that if a membership agreement contains a restriction relating to any of the three kinds of events for which the safe harbor is available, namely number of Associated Persons engaged in sales-related activities, number of markets, and number of branches, the safe harbor is unavailable for expansion in all of these areas. I don't see the relevance of a restriction on the number of markets that a firm can make to the number of branch offices or Associated Persons that it can have. In my view this interpretation is not authorized by IM-1011-1 and the language of proposed Supplementary Material .01 does not purport to introduce such a cross-restriction. The language of Supplementary Material .01 <u>and</u> the Regulatory Notice accompanying the promulgation of the new rules should expressly negate this unauthorized and irrational interpretation.

<u>Rule 1170 - Notice of Certain Member Changes and Continuous Access to Affiliate Information</u>

(a) The need for the kinds of advance notice of some of the events specified in this section has not been substantiated.

Paragraph (1) relates to acquisition of 10% or more (but less than 25%) of a member's business or assets. It is not clear why advance notice is required and on what basis this could be deemed to be a material change, in light of the specific requirements of Rule 1160(a)(3) that establish a 25% bright-line test for materiality of this type of event.

Paragraph (2) relates to transfers or acquisitions of 10% or more (but less than 25%) of the member's equity interests, notwithstanding the bright-line 25% test for materiality in proposed Rule 1160(a)(4). The supposition in Regulatory Notice 10-01 that a person could acquire 20% of the ownership of a member at a price that represents 100% of its value seems extremely unlikely. However, if it were to occur, the 20% owner would not have any more control than a 20% owner who paid 20% of the value of the firm for his stake.

Paragraph (9) relates to the listing of the member on a facility or medium that is designed to solicit offers for possible purchase of the member, in whole or in part. This also seems unnecessary. Leaving aside my extreme skepticism as to whether buying a FINRA "shell" is faster, less expensive, or in any way more advantageous that starting a new firm, the mere fact that a member arranges or allows its availability for purchase to be published on such a facility or medium does not call for a regulatory response. It is clear that no actual transaction can take place without a CMA. I see no reason for a member to disclose to FINRA what may be an extremely tentative step, subject to revision, and incapable of accomplishment without formal FINRA approval.

(b) This section deals with the procedure for notification and, to a limited extent, the obligations of FINRA in response to such a notice. The drafting is unclear. For example, as drafted it appears that events covered by paragraphs (a)(5), (6), (7), (8), or (10) could actually lead to FINRA determining that the proposed change is material and requiring a CMA. What about paragraphs (a)(1), (2), (3), (4), or (9)? What are the consequences to the member or the obligations and powers of FINRA if notice is given of any of those impending events? Moreover, there is no express time limit for FINRA to respond to what is currently considered a request for non-materiality determination. The member must "promptly" respond to any request from FINRA for further information but there is no deadline, or even a guideline such as "promptly," for FINRA to communicate its position to the member.

0-0-0-0-0

I appreciate the opportunity to share my views on the proposed adoption of FINRA Rules 1110-1180 to replace NASD 1010 Rules. As noted in this letter some of my concerns relate to the letter of the rules and some to the manner in which they are used or ignored in practice. Since there is no alternative to FINRA membership for companies and individuals who wish to engage in the securities business in the United States, FINRA has a special responsibility not to abuse its unique power. Very few Applicants - either proposed members or existing members seeking to change or grow their businesses - are in a position to say "no" to FINRA or to undergo the costly and time-consuming process of appealing from Membership Application Department staff determinations to the FINRA National Adjudicatory Council, the FINRA Board, or the SEC. In light of this extreme inequality in power, it is incumbent on FINRA to apply its rules in a manner consistent with their letter and spirit and to refrain from reinterpretations of rules or changes of policy without opportunity for members to participate in the decision process.

Finally, I recognize that there can be a wide range of difference in the quality of NMAs and CMAs as initially submitted. This can be due to a variety of factors, including the Applicant's uncertainty about its eventual business plan; uncertainty about the ability to recruit enough appropriate representatives and principals to conduct the business especially when there is no certainty whether or when the firm will receive authorization to conduct that business; changes in plans with respect to ownership or capitalization of the firm; lack of experience or skill on the part of the people assisting the Applicant to plan, prepare, and file the application; and many other weaknesses that I am sure that FINRA staff have observed and can document.

On the other hand, from the perspective of a person assisting Applicants, it seems to me and several of my colleagues that FINRA staff could benefit from better education and training in securities laws, regulations, and business practices. To mention only one example, we are aware of at least one NMA and one CMA in which the Applicant proposed to act as a "chaperone" for a foreign broker-dealer under Securities Exchange Act Rule 15a-6(a)(3). In each instance a substantial amount of the 180-day review period (and a correspondingly large amount of the cost to the Applicant) was devoted to educating FINRA staff about the meaning of this particular rule.

In sum, however well designed the NMA and CMA rules may be it requires intelligence, skill, and effort on the part of Applicants, their lawyers and their consultants, and the staff of FINRA to make these processes, understandable, efficient and fair.

Respectfully submitted,

Faith Colish

FC:df