SIFMA®
Securities Industry and
Financial Markets Association

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VIA ELECTRONIC DELIVERY (pubcom@finra.org)

Marcia E. Asquith
Senior Vice President and Corporate Secretary
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1500

Re: FINRA Regulatory Notice 10-01; Membership Application Proceedings

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to comment on FINRA Regulatory Notice 10-01 (the "Notice"), through which FINRA solicits public comment on a proposal to transfer the existing NASD membership rules into the Consolidated FINRA Rulebook as the FINRA Rule 1100 Series, with significant substantive changes based, in part, on existing NYSE membership rules (the "Proposal"). The Proposal would require substantially greater information and disclosures than what is required under existing NASD rules for New Membership Applications ("NMAs") and would expand the categories of business change events that would trigger a Continuing Membership Application ("CMA"). FINRA also proposes an entirely new rule that would impose an advance written notification requirement for broad categories of business events that do not currently trigger a CMA or other notice to the FINRA staff.

Although SIFMA agrees in principle with FINRA's stated goals of streamlining the standards of review for NMAs and CMAs, clarifying certain administrative aspects of the Membership Application Process ("MAP"), and updating or eliminating outdated terminology, SIFMA is seriously concerned about the business impact of the new

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). For more information, visit www.sifma.org.

advance notification requirements found in proposed FINRA Rule 1170. SIFMA also is troubled by the apparent breadth of two new evaluation standards for FINRA NMAs and CMAs. One such standard would require FINRA staff to determine that an applicant's funding sources are "not objectionable" and the other would require FINRA staff to consider the disciplinary histories for all of an applicant's affiliates in evaluating whether the applicant is capable of complying with the laws and rules governing member firms, not just those affiliates that control the applicant.[2] Finally, SIFMA is concerned about the ability of new applicants for FINRA membership, as well as existing FINRA member firms, to comply with a FINRA request for the books and records of certain non-member affiliates when such affiliates are not under the control of the applicant or member firm.

I. Proposed FINRA Rule 1170 – Notice of Certain Member Changes and Continuous Access to Affiliate Information

Proposed FINRA Rule 1170 creates an entirely new requirement that members provide FINRA with written notice of certain business change events 30 days prior to the event's occurrence (or as soon as possible if circumstances make it impracticable to meet the 30-day time period), notwithstanding that such changes may not trigger a CMA filing.[3] Proposed Rule 1170(a) enumerates ten events requiring such prior written notice. These events, which are varied in nature and likely would impact many different organizational and business units, are as follows:

- Direct or indirect acquisitions or divestitures of 10% or more of the member's assets or any asset, business, or line of operation that generates revenues comprising 10% or more of the member's aggregate revenues (measured on a rolling 36-month basis);
- Direct or indirect acquisitions or divestitures of 10% or more of the member's shares, partnership interests, or other ownership interests;
- Changes in business relationships with certain affiliates;[4]

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[2] Proposed FINRA Rules 1130(a)(3) and 1130(a)(4), respectfully.

[3] Proposed Rule 1170(c) also requires that, upon request by FINRA, each member firm promptly provide "any information" concerning its affiliates that the member firm otherwise would be required to provide under FINRA's membership rules (the 1100 Series). Even though this affiliate information requirement is based on NYSE Rule 416 and its related supplementary material, it represents a significant expansion of the type of information that FINRA is expressly authorized to request, especially with respect to firms that are not NYSE members. SIFMA also has concerns with this aspect of the proposal, which are addressed in Section II, B "Requests for Books and Records of a Covered Affiliate," below.

[4] The affiliates covered by this requirement are the same affiliates for which disclosure is required pursuant to Proposed FINRA Rule 1121(a)(1)(G)(v)a. through h., to wit, any affiliate: (1) whose financial information is consolidated with that of the applicant; (2) whose liabilities have been guaranteed by the applicant; (3) that is a source of flow-through capital to the applicant; (4) that provides certain operational support or services to the applicant; (5) that has the ability to withdraw capital from the applicant; (6) that has a "mutually dependent financial relationship" with the applicant, such as having an expense-sharing

- Changes or loss of a member's key personnel (such as the CEO, CFO, COO or CCO);
- Changes in a member's service bureau, certain clearance activities or method of bookkeeping or record keeping;
- Expansions of business requiring certain minimum capital infusions or licenses;
- Adding certain new products or services;
- Certain expansions in sales personnel, office locations or markets, beyond the safe harbor provisions of proposed FINRA Rule 1160;
- Listing the member firm "on any facility or medium that is designed to solicit offers or inquiry with respect to the possible purchase" of all or part of the member or the member's assets; or
- Discovery of any condition that the firm believes could lead to capital, liquidity or operational problems or impairment of recordkeeping, clearance or control functions.

A. General Concerns

Before turning to our comments on the specific events requiring advance written notification, SIFMA emphasizes as a threshold matter that, if adopted, this Rule would require member firms to undertake a comprehensive review of nearly all of their business operations and governance structures and establish tracking and reporting procedures in each affected area to enable them to comply with the requirements of the Rule. In light of the breadth of activities enumerated in the Rule, the areas of member firms potentially impacted by the Rule range from business units launching new products and services, to operational areas, to corporate boards of directors or boards of managers. In addition, personnel in some of the affected departments or business units likely would require comprehensive training on these new requirements for regulatory notification and approval. Accordingly, SIFMA believes that the Rule would create significant compliance challenges for member firms.

In addition, depending on how the proposed advance notice requirement is enforced in practice, members may be forced to delay corporate actions or potential transactions, and even more routine business matters such as launching new products or services. SIFMA notes that proposed FINRA Rule 1170(b) provides FINRA staff with the discretion, for certain of the enumerated events, to require a full CMA if, upon receiving notice of the proposed event, FINRA determines that the event will "substantively affect the business or resources of the member." This effectively provides FINRA with an opportunity to challenge certain business decisions by forcing the decision into a FINRA approval process. Moreover, because the standard for requiring a CMA is very broad and subject

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arrangement; (6) that has a "financial and/or marketing relationship" with the applicant; or (7) that provides certain products or services as part of the applicant's operations that FINRA rules would require to be supervised by the applicant (collectively, "Covered Affiliates").

to varying interpretations, SIFMA is concerned about inconsistent application of this requirement to different member firms by different FINRA staff.

Finally, we note that the description of triggering events in proposed FINRA Rule 1170(a) is, in some instances, overly broad and vague, raising the risk of inconsistent application and noncompliance based on good faith differences in interpretation.

In light of the above concerns, SIFMA believes that FINRA should reconsider adopting proposed Rule 1170, specifically taking into account the perceived benefits of the Rule in comparison with the compliance costs that will be incurred by member firms.[5] SIFMA notes that, although FINRA has not provided a rationale for all of the events enumerated in the Rule, FINRA states that knowledge of certain transactions that occur below the 25 percent threshold for a CMA is "useful for maintaining effective oversight of member firms by identifying potential regulatory issues."[6] FINRA also notes that certain business expansions are "often material events in the sense that they may have an impact on a firm's supervisory and compliance infrastructure and/or finances."[7] SIFMA appreciates these points, but questions the need for advance notification in all cases and suggests that notification contemporaneous with the event's occurrence should be adequate for these purposes.[8]

B. Comments on Specific Event Notification Requirements

As discussed above, SIFMA believes that FINRA should reconsider adopting proposed Rule 1170 in its entirety. However, should FINRA determine to pursue approval of the Rule by the Securities and Exchange Commission ("SEC"), we urge FINRA to delete the following events from list of events triggering notification in proposed Rule 1170(a) or, at a minimum, revise them to provide greater clarity:

1. Changes to Affiliate Relationships

Proposed FINRA Rule 1170(a)(3) appears to require 30 days' advance written notice of the "addition, removal, or substantial modification of a business relationship" between a member and its Covered Affiliates.[9] SIMFA is concerned that this requirement is overly broad and that it will be very difficult for firms to monitor for compliance purposes. FINRA member firms often have extensive inter-company arrangements in place with their affiliates covering myriad routine business activities. For example, as currently

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5 SIFMA would be pleased to coordinate with its member firms to help FINRA estimate the costs associated with building a compliance infrastructure to support this new notification requirement.

6 *See* Notice at Page 17.

7 *Id*.

8 SIFMA also notes that FINRA's existing supervision rules require member firms to address any compliance and supervision issues implicated by these business events.

9 *See* note 4, *supra*, for a definition of Covered Affiliates.

drafted, the proposed Rule would appear to require 30 days' advance notice to FINRA before the member firm could enter into an arrangement to sell securities issued by a Covered Affiliate. Similarly, a minor change to a cost allocation formula in one of the member firm's expense sharing arrangements arguably would require advance notification under this provision. At a minimum, SIMFA believes the Rule should include a clear materiality standard.[10] Assuming FINRA intends the standard to be the "addition, removal, or ***substantial*** modification of a business relationship" (emphasis ours), SIFMA urges FINRA to consider providing examples of what kinds of changes FINRA would view as "substantial."

2. Changes in Key Personnel

Proposed FINRA Rule 1170(a)(4) would require 30 days' advance written notice of the "change or loss of the member's key personnel, such as its Chief Executive Officer, Chief Financial Officer, Chief Operations Officer, Chief Compliance Officer, or any individual with similar status or functions." In some cases, changes to key personnel at member firms are made within a relatively short time period (i.e., less than 30 days). SIFMA assumes that FINRA would permit firms to provide less than 30 days' notice in these circumstances, consistent with the definition of "timely" in Proposed FINRA Rule 1170(a), which acknowledges circumstances where 30 days' notice is impracticable. However, in order to ensure that member firms have the necessary flexibility in this regard, SIFMA requests confirmation of this point, should FINRA determine to move forward with adopting Proposed Rule 1170.[11]

3. New Products and Services

Proposed FINRA Rule 1170(a)(7) would require 30 days' advance notification if a member firm were to expand its business to add "products or services that are new in terms of the types of investments, transactions, or risks" since the time of the last approval of a membership application. SIFMA believes that this requirement is overly broad and will be very difficult to monitor. As with any competitive marketplace, member firms routinely offer new products and services to their customers and imposing a 30-day advance notice requirement will hamper significantly the ability of firms to quickly respond to market developments and customer demand. Moreover, SIFMA notes that many of its member firms have adopted comprehensive procedures for developing

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[10] In this regard, we note that the Notice describes the event triggering notification as the "addition, removal, or ***subsequent*** modification of a business relationship. . ." (*See* Notice at Page 18, emphasis ours.) The proposed rule text itself, however, describes the triggering event as the "addition, removal, or ***substantial*** modification of a business relationship. . ." (*See* Attachment A at Page 61, emphasis ours.) SIFMA seeks clarification on which standard FINRA intends to adopt, as this is a critical distinction.

[11] We also note that member firms are required to update their Forms BD promptly to reflect changes in key personnel, thus keeping FINRA informed of such changes.

and vetting new products, in keeping with regulatory guidance on this topic,[12] and SIFMA believes that such internal procedures obviate the need to provide advance notification to FINRA.

4. Solicitation of Corporate Transactions

Proposed FINRA Rule 1170(a)(9) would require 30 days' advance notification before listing the member firm "on any facility or medium that is designed to solicit offers or inquiry with respect to the possible purchase" of all or part of the member or the member's assets. SIFMA respectfully submits that notifying FINRA at this stage of a potential transaction is significantly premature. We note that the decision to solicit bids for a potential transaction involving a member firm is typically made by the most senior management at the member firm or even at the holding company level (for firms that are part of a holding company structure) and that this information is highly confidential and is typically only known by a handful of individual managers or board members and their advisers. SIFMA, therefore, respectfully requests that this requirement be eliminated from the proposed Rule.

5. Discovery of Problematic Conditions

Proposed Rule 1170(a)(10) requiring the reporting of "the discovery of any existing or impending condition(s) which the member reasonably believes could lead to capital, liquidity or operational problems or impairment of recordkeeping, clearance or control functions" is overly broad in SIFMA's view. There is no basis for a member firm interpreting the proposed Rule to measure what constitutes a "condition" that could lead to a "problem" or an "impairment" that requires notice under the Rule. The standard does not include a clear materiality threshold. "Conditions," "problems" or "impairments" at one member firm may be considered more routine for another. In our view, notice requirements should be framed by certain, objective standards. In addition, with respect to capital or liquidity matters, such standards already exist. The SEC's net capital rule sets out a clear, precise system of "early warning" notice requirements and FINRA is already privy to this information.

II. Additional SIFMA Concerns with the Proposal

A. New Application Evaluation Standards

As noted above, SIFMA has two principal concerns with the new application evaluation standards found in Proposed FINRA Rule 1130 and believes FINRA should reconsider these new standards.

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[12] *See* NASD Notice to Member 05-26, "New Products" (April 2005), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf

1. Information on Funding Sources

Proposed FINRA Rule 1130(a)(3) includes a new application evaluation standard that requires an applicant to fully disclose through documentation satisfactory to FINRA all of the applicant's "funding sources" and requires FINRA staff to determine whether "such sources of funding are not objectionable." SIFMA notes that the proposal fails to provide any rationale for this new requirement and seeks clarification on what is meant by "objectionable" funding sources. SIFMA believes that, provided applicants have adequate financing to ensure they can meet applicable net capital requirements, FINRA's regulatory purposes should be satisfied. Imposing a requirement that a funding source not be "objectionable" seems to suggest that FINRA will engage in a subjective review of the character of the funding source, which seems beyond FINRA's regulatory mandate and SIFMA questions the regulatory purpose that is served by requiring this information.

2. Affiliate Disciplinary History

Proposed FINRA Rule 1130(a)(4) would for the first time require FINRA staff to review and consider the disciplinary histories of the applicant's "affiliates" in evaluating whether the applicant meets the standard requiring it to be capable of complying with the federal securities laws, rules and regulations and FINRA rules. In light of FINRA's proposed "affiliate" definition, which includes an entity that is controlled by, or is under common control with, an applicant, SIMFA believes that this requirement also is overbroad. We understand that FINRA may have a legitimate concern in those cases where an affiliate has control over the applicant (e.g., the affiliate is the applicant's parent company), but we believe that considering the disciplinary histories of all an applicant's affiliates is outside of FINRA's mandate and is irrelevant to determining whether the applicant is capable of complying with applicable laws and rules governing FINRA member firms.

B. Requests for Books and Records of a Covered Affiliate

Proposed FINRA Rule 1121 requires new member applicants to submit "detailed and comprehensive" summaries of their business relationships with Covered Affiliates.[13] The proposed Rule also requires the applicant, at FINRA's discretion, to provide "evidence of, and information regarding" any disclosed business relationship with a Covered Affiliate "from the books and records of the Applicant and/or the books and records of the [Covered Affiliate]." Moreover, as noted above, proposed FINRA Rule 1170(c) would provide FINRA with the authority to request this same information from existing member firms, at any time.

SIFMA is concerned about the ability of new member applicants and FINRA member firms (collectively, "Impacted Firms") to comply with a FINRA request for the books and records of a non-member Covered Affiliate when such entity is a third party not under the

[13] *See* Note 4, *supra*, for a definition of Covered Affiliates.

control of the Impacted Firm. SIFMA respectfully submits that, in these circumstances, neither FINRA nor the Impacted Firm would have the legal authority to compel the non-member Covered Affiliate to produce such books and records. As a policy matter, SIFMA believes it is reasonable for FINRA to have access to certain basic information about the existence of material arrangements between an Impacted Firm and a Covered Affiliate when such arrangements are related to the securities business of the Impacted Firm. However, we also believe that FINRA does not have, and should not expect to obtain through this Proposal, authority to make information requests that relate to non-member books and records merely because an entity is under common ownership with an Impacted Firm. We request that FINRA reconsider this aspect of the Proposal.

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We appreciate this opportunity to submit our comments on FINRA's proposal, and we would welcome the opportunity to meet with FINRA staff to understand FINRA's objectives better and explain our views more fully. If you should have any questions or would like to discuss our comments, please do not hesitate to contact me at 202-962-7386 or jmchale@sifma.org.

Sincerely,

James T. McHale
Managing Director and Associate General Counsel
SIFMA

cc: Steve Kasprzak
Ann-Marie Mason