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FINRA Continuing Membership Applications Checklist

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The Financial Industry Regulatory Authority (FINRA) Rule 1017 requires broker-dealers to file continuing membership applications (CMAs) if they plan to embark on certain enumerated events such as changes in ownership, control, or business operations. The process is time-consuming and may impose a significant obstacle to promising business opportunities. Having sufficient knowledge of the particulars of the CMA process is vital in ensuring that major business transitions proceed in a seamless manner. The checklist below provides a short overview of the CMA process and issues that arise during the process.

Triggering Events: FINRA Rule 1017(a) sets forth five events that will trigger the requirement to file a CMA. Triggering events fall into one of two broad categories: (1) changes in ownership, or (2) a material changes in business.

Changes in Ownership: There are four types of ownership changes that implicate Rule 1017(a):

- A merger with another member unless both are members of the New York Stock Exchange (NYSE) or the surviving entity will continue to be a member of the NYSE.
- A direct or indirect acquisition by one member of another member unless the acquiring members is a member of the NYSE.
- Direct or indirect acquisitions or transfers of: (1) 25 % or more of the member's assets, or (2) any asset, business or line of operations that generates revenues comprising 25% or more of the member's earnings as measured on a rolling 36-month basis. An exception to both types of transfers arises if both the seller and acquirer are members of the NYSE.
- A change in the equity ownership or partnership capital that results in one person/entity directly or indirectly owning or controlling 25% or more of the equity or partnership capital.

Material Change in Business: Whether a change is material depends upon the facts and circumstances of each case. The individual firm has the obligation to determine materiality, although they may consult with FINRA in making that determination. Relevant considerations include, but are not limited to, the nature of the proposed expansion, and the relationship, if any, between the proposed new business activity or expansion and the firm's existing business. If the new activity comprises a substantial part of the business, then it is most likely material. Other relevant considerations include the effect the expansion will have on the firm's capital, the qualifications of the firm's personnel, and the degree to which the firm's existing internal systems may accommodate the proposed expansion. Additionally, Rule 1017(a)(5) states that the following events listed in Rule 1011(k) are material business changes:

- Removing or modifying a membership agreement restriction
- Market making, underwriting, or acting as a dealer for the first time
- Adding business activities that require a higher minimum net capital under the United States Securities and Exchange Commission (SEC) Rule 15c3-1

Timing and Approval: The CMA process is lengthy and must be completed by FINRA within 180 days. For pure changes in equity ownership or control, FINRA requires 30-day advance notice, but, once the 30-day period lapses, the change may take effect prior to FINRA approval. However, FINRA may also impose interim conditions until the application is decided and in any case, their review remains open after the 30-day period, meaning they could ultimately deny the application or advise the firm to withdraw the application.

For the other four triggering events – a material change in business, mergers, acquisitions, or sales of 25% or more of assets – the change may not take effect until FINRA has approved the application. See FINRA Continuing Membership Guide, available at: *http://www.finra.org/industry/continuing-membership-guide-cma-requirements-0315*. Customer protection is one of the primary concerns driving the requirement of prior approval for these events. For example, these four events can be utilized to avoid liabilities and leave customers who have valid judgments or arbitration claims without recourse. See FINRA Notice to Members 04-10.

For any CMA, FINRA may require a membership interview during the initial 30-day review period. In the interview, FINRA may provide the applicant with information it received from outside sources, which may provide a potential basis for its decision.

Rule 1017 requires FINRA to issue a written decision for CMAs within 30 days after:

- Conclusion of the membership interview or
- Filing of additional information or documents, whichever is later

If FINRA does not require a membership interview or request additional information or documents, they must deliver their written decision within 45 days after the filing of the application. Overall, FINRA is required to complete the CMA review process within 180 days after the filing of a CMA.

Filing Process: The CMA must be filed by the seller and managed by a member firm's authorized person through FINRA Firm Gateway. Oddly, the seller—not the buyer—is in control of the application process. The seller initiates the process by submitting the application to FINRA through the Department of Member Regulation.

Form Filings: In addition to the CMA itself, applicants must submit all necessary firm form filings for the surviving entity. For example, if ownership or control information of the surviving entity changes, then such entity must submit an amendment to Form BD (Uniform Application for Broker-Dealer Registration). Similarly, if a predecessor firm will not survive the change—and is thus withdrawing from the industry— it must file a Form BDW (Uniform Request for Broker-Dealer Withdrawal). Finally, if the applicant does not qualify for a Mass Transfer (discussed below), and the representatives of an original firm will, in effect, be moved to the surviving entity, then the applicant must submit Form U4 (Uniform Application for Securities Industry Registration or Transfer) filings and fingerprint cards to register those persons with the new firm, while Form U5 (Uniform Termination Notice for Securities Industry Registration) filings need to be submitted to terminate those persons from the original firm.

Mass Transfer: The Mass Transfer Program applies where: (1) the firm has at least 50 individuals; and (2) the organizational change is an acquisition (successor), asset purchase, consolidation, merger, and/or succession. If qualified for the Mass Transfer Program, then the applicable representatives will be systematically registered with the surviving entity, and terminated from their original firm, without the need for Form U4 and U5 filings or fingerprint cards. The Mass Transfer Program is time and cost effective in comparison to the normal process.

Material Considerations on Review: While FINRA's review is comprehensive, there are certain issues that are often targeted during review. As a result, applicants need to be prepared for such issues to avoid delays in the CMA review.

- *Management and Supervision:* If existing officers (e.g., CEO, CFO, etc.) are leaving the organization during an ownership change, FINRA may restrict parts or all of the firm's business while the proposed new officers are considered.
- *Contracts:* FINRA will review any ownership change to determine if important contracts and agreements will remain in effect. Third-party agreements that FINRA considers integral to a firm's business operations will need to be assigned or re-executed. Such agreements include: (1) a firm's clearing agreement; (2) systems contracts; (3) audit agreement; (4) fidelity bond; (5) lease; (6) insurance; (7) vendor; and (8) expense sharing or service agreements. Absent valid agreements, FINRA will most likely restrict certain business lines or the ownership change itself.
- *Money:* FINRA considers three months of bank statements from the purchasing party, the source of those funds, and any other funding sources.
- *Qualifications:* The applicant must ensure that all of its employees are sufficiently registered. Thus, qualification examinations should be scheduled as soon as the material change is contemplated.

Regulatory History: Buyers inherit the selling firm's regulatory history and potential FINRA restrictions. Broker-dealers should be prepared for FINRA to restrict a firm's business or ability to complete the ownership change as originally contemplated if the firm has a negative regulatory history.

Safe Harbor: If applicable, the safe harbor applies to create a presumption that a business expansion is not a material change in business operations, and therefore does not require a CMA. To be eligible for a safe harbor, the firm must: (1) not have a membership agreement; or (2) have a membership agreement that does not contain a restriction on one or more of the factors considered in the safe harbor (i.e., number of associated persons involved in sales, number of offices or number of markets) or contain expansion plans. Additionally, the safe harbor is not available to any member that has a disciplinary history. See FINRA IM-1011-1. Safe Harbor for Business Expansions (FINRA NASD Rule IM-1011-1). The Safe Harbor provision applies to three types of business expansions: (1) increases in the number of associated persons involved in sales; (2) increases in the number of offices; and (3) increases in the number of markets. The safe harbor presumes the following types of expansions are not material changes, measured on a rolling 12-month basis. The tables below set forth the applicable expansions permitted under the safe harbor.

Number of Associated Persons Involved in Sales	*Safe Harbor-Increase Permitted Within a One Year Period Without CMA*
1-10	10 persons
11 or more	10 persons or a 30% increase, whichever is greater.

Number of Offices (registered or unregistered)	*Safe Harbor-Increase Permitted Within a One Year Period Without CMA*
1-5	3 offices
6 or more	3 offices or a 30% increase, whichever is greater

Number of Markets Made	*Safe Harbor-Increase Permitted Within a One Year Period Without CMA*
1-10	10 markets
11 or more	10 markets or a 30% increase, whichever is greater

Appeal: Upon reaching a decision, FINRA's Department of Member Regulation will serve its decision on the applicant by first class mail. Upon service, an applicant may file a written request for review of the decision with the National Adjudicatory Council. The request must be made within 25 days from the date of review, and must state with specificity the errors in the decision. Simultaneously with making the request for review, the applicant must file by first-class mail a copy of the request with the district office where the applicant filed its application. If a hearing is requested or directed, it will be held within 45 days after the filing of the request for review. The National Adjudicatory Council will serve a proposed written decision on the FINRA Board, which has discretion to conduct further review. If they decline review, then the decision of the Council will become final. Thereafter, the applicant can seek review from the SEC pursuant to Rule 19d-3 (17 CFR 240.19d-3) under the Exchange Act.

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