

to make available publicly. All submissions should refer to File Number SR–EMERALD–2019–038 and should be submitted on or before January 21, 2020.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>12</sup>

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[FR Doc. 2019–28086 Filed 12–27–19; 8:45 am]

BILLING CODE 8011–01–P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–87810; File No. SR–FINRA–2019–030]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Amend the Membership Application Program (“MAP”) Rules To Address the Issue of Pending Arbitration Claims

December 20, 2019.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) <sup>1</sup> and Rule 19b–4 thereunder, <sup>2</sup> notice is hereby given that on December 13, 2019, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend the Membership Application Program (“MAP”) rules to help further address the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms.<sup>3</sup>

Specifically, the proposed rule change would: (1) Amend Rule 1014 (Department Decision) to: (a) Create a rebuttable presumption that an application for new membership should be denied if the applicant or its associated persons are subject to a pending arbitration claim, and (b) permit an applicant to overcome a presumption of denial by demonstrating its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement or pending arbitration claim; (2) adopt a new requirement for a member, that is not otherwise required to submit an application for continuing membership for a specified change in ownership, control or business operations, including business expansion, to seek a materiality consultation if the member or its associated persons have a defined “covered pending arbitration claim,” unpaid arbitration award, or an unpaid arbitration settlement; (3) amend Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations) to require a member to demonstrate its ability to satisfy an unpaid arbitration award or unpaid settlement related to an arbitration before effecting the proposed change thereunder; (4) amend Rule 1013 (New Member Application and Interview) and Rule 1017 to require an applicant to provide prompt written notification of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before a decision on an application constituting final action on FINRA is served on the applicant; and (5) make other non-substantive and technical changes in the specified MAP rules due to the proposed amendments.<sup>4</sup>

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

#### II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the

proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

#### A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

##### 1. Purpose

##### Background

The MAP rules govern the way in which FINRA reviews a new membership application (“NMA”) and a continuing membership application (“CMA”).<sup>5</sup> These rules require an applicant to demonstrate its ability to comply with applicable securities laws and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. FINRA evaluates an applicant’s financial, operational, supervisory and compliance systems to ensure that the applicant meets the standards set forth in the MAP rules. Among other factors, the MAP rules require FINRA to consider whether persons associated with an applicant have material disciplinary actions taken against them by industry authorities, customer complaints, adverse arbitrations, pending arbitration claims, unpaid arbitration awards, pending or unadjudicated matters, civil actions, remedial actions imposed or other industry-related matters that could pose a threat to public investors.<sup>6</sup>

FINRA is proposing to amend the MAP rules in several ways. First, FINRA is proposing to amend one standard for admission and the corresponding factors therein relating to the presumption to deny an application for new or continuing membership. Second, FINRA is proposing to clarify the various ways in which an applicant for new or continuing membership may demonstrate its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or a pending arbitration claim during the application review process, and to preclude an applicant from effecting any contemplated change in ownership, control or business operations until such demonstration is made and FINRA approves the application. Third, FINRA

<sup>12</sup> 17 CFR 200.30–3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b–4.

<sup>3</sup> Effective May 8, 2019, FINRA adopted the NASD Rule 1010 Series (Membership Proceedings), among other rules, in the consolidated FINRA rulebook, without substantive change. The MAP rules now reside under the FINRA Rule 1000 Series (Member Application and Associated Person Registration) as FINRA Rules 1011 through 1019. See Securities Exchange Act Release No. 85589 (April 10, 2019), 84 FR 15646 (April 16, 2019) (Notice of Filing and Immediate Effectiveness of File No. SR–FINRA–2019–009). For purposes of this filing, all references to the MAP rules are to the FINRA Rule 1000 Series. The proposed rule change

would also update cross-references and make other non-substantive, technical changes, and make corresponding changes to the Forms NMA and CMA. FINRA is separately developing changes to the MAP rules in connection with the retrospective review of this rule set. See *Regulatory Notice* 18–23 (July 2018) (“*Notice* 18–23”) (requesting comment on a proposal regarding the MAP rules).

<sup>4</sup> For example, the proposed rule change would require the renumbering of some paragraphs in Rules 1011 and 1014 and the updating of cross-references.

<sup>5</sup> Unless otherwise specified, the term “application” refers to either an NMA (or Form NMA) or CMA (or Form CMA), depending on context.

<sup>6</sup> See generally Rules 1014(a)(3) and 1014(a)(10).

is proposing to mandate a member firm to seek a materiality consultation in two situations in which specified pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements are involved. Finally, FINRA is proposing to require an applicant for new or continuing membership to notify FINRA of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before FINRA renders a decision on the application.

FINRA believes that these proposed amendments to select portions of the MAP rules would enable FINRA to take a stronger approach to addressing the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms, in connection with the application review process. In addition, the proposed amendments would enable FINRA to consider the adequacy of the supervision of individuals with pending arbitration claims. As described below, the proposed amendments are intended to address concerns regarding situations where: (1) A FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and concerns about the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

The proposed rule change would impact members that have elected to be treated as capital acquisition brokers (“CABs”) and are subject to CAB rules. CAB Rules 111 through 118 incorporate by reference several MAP rules, including Rules 1011, 1013, 1014 and 1017.<sup>7</sup> The proposed amendments would make conforming changes to CAB Rules 111 through 118, as applicable.

#### Proposed Rule Change

##### A. Rule 1014(a)(3)—Compliance with Industry Rules, Regulations, and Laws

Rule 1014(a) sets forth 14 standards for admission FINRA must consider in

determining whether to approve an application. Currently, Rule 1014(a)(3) (“Standard 3”) requires FINRA to determine whether an applicant for new or continuing membership and its associated persons “are capable of complying with” the federal securities laws, the rules and regulations thereunder, and FINRA rules. Standard 3 sets forth six factors that FINRA must consider in making that determination.<sup>8</sup> One factor, set forth under Rule 1014(a)(3)(B), requires FINRA to consider whether an applicant’s or its associated person’s record reflects a sales practice event, a pending arbitration, or a pending private civil action. Another factor appears under Rule 1014(a)(3)(C) and requires FINRA to consider, among other regulatory history, whether an applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant’s net capital, and any other member with respect to which these persons were a controlling person or a five percent lender of its net capital, is subject to unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.

Further, under Rule 1014(b)(1), where an applicant or its associated person is subject to certain regulatory history enumerated in Standard 3, “a presumption exists that the application should be denied.”<sup>9</sup> Rule 1014(a)(3)(C) is one of several factors that trigger the presumption. The existence of such an event “[raises] a question of capacity to comply with the federal securities laws and the rules of [FINRA],” which should result in a rebuttable presumption to deny the application.<sup>10</sup> However, the existence of a record of a pending arbitration, as set forth in Rule 1014(a)(3)(B), is currently not among the enumerated factors that trigger the presumption to deny an application.

##### 1. Rebuttable Presumption to Deny an NMA (Proposed Rule 1014(b)(1))

FINRA is concerned about prospective applicants for new membership hiring principals and registered persons with pending arbitration claims without having to demonstrate how those claims would be paid if they go to award or result in a settlement. In addition, FINRA is concerned about a new member’s supervision of such individuals who may have a history of noncompliance.

Accordingly, FINRA is proposing to amend Rule 1014(b)(1) to specify that a presumption of denial would exist if a new member applicant or its associated persons are the subject of a pending arbitration claim. Creating a presumption of denial in connection with a pending arbitration claim for an NMA would shift the burden to the new member applicant to demonstrate how its pending arbitration claims would be paid should they go to award or result in a settlement. In addition, the proposed amendment would spotlight the firm’s supervision of individuals with pending arbitration claims. This presumption of denial for a pending arbitration claim would not apply to an existing member firm filing a CMA. Instead, consistent with today’s practice, FINRA would continue to consider whether an applicant’s or its associated persons are the subject of a pending arbitration claim in determining whether the applicant for continuing membership is “capable of complying with” applicable federal securities laws and FINRA rules.<sup>11</sup>

##### 2. Evidence of Ability To Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements, or for New Member Applications, Pending Arbitration Claims (Proposed IM-1014-1)

Proposed IM-1014-1 would provide that an applicant may demonstrate its ability to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement or a pending arbitration claim, through an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms of documentation that FINRA may determine to be acceptable.<sup>12</sup> In addition, under the proposed interpretive material, an applicant may

<sup>11</sup> For purposes of determining whether an applicant meets Standard 3, FINRA’s consideration of an applicant’s or associated person’s pending arbitration claim would be separated from Rule 1014(a)(3)(B) and moved to proposed Rule 1014(a)(3)(E).

<sup>12</sup> FINRA expects to make conforming amendments to Forms NMA and CMA. FINRA notes that Form CMA currently instructs the applicant to provide supporting documentation to show that such applicant is able to meet Standard 3. Specifically, if the CMA involves a transfer of assets with no corresponding transfer of associated liabilities, and there are pending arbitration claims or closed or settled arbitration matters, Form CMA requires the applicant to provide a written “Arbitration Plan,” explaining, among other things, how the applicant will handle the arbitrations and awards that may result. An applicant may show that it has a reserve fund or will retain the proceeds of the asset transfer to satisfy the award. See Form CMA, Standard 3, Question 2.d. (within the section titled, “Provide supporting documents”).

<sup>7</sup> See generally CAB Rule 111 (Membership Proceedings) (referencing Rule 1011), CAB Rule 112 (New Member Application and Interview) (referencing Rule 1013), CAB Rule 113 (Department Decision) (referencing Rule 1014), and CAB Rule 116 (Application for Approval of Change in Ownership, Control, or Business Operations) (referencing Rule 1017).

<sup>8</sup> See Rule 1014(a)(3)(A)–(F).

<sup>9</sup> See also Rule 1017(h)(1), which pertains to CMAs and contains language identical to Rule 1014(b)(1). FINRA would make conforming changes to Rule 1017(h)(1).

<sup>10</sup> See Notice to Members 04–10 (February 2004).

provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable in the area as to the value of the arbitration claims (which might be zero). Proposed IM-1014-1 would also provide that to overcome the presumption to deny the application, the applicant must guarantee that any funds used to evidence the applicant's ability to satisfy any awards, settlements, or claims will be used for that purpose. Any demonstration by an applicant of its ability to satisfy these outstanding obligations would be subject to a reasonableness assessment by FINRA.

#### B. Materiality Consultation

A member is required to file a CMA when it plans to undergo an event specified under Rule 1017 (e.g., acquisition or transfer of the member's assets, or a business expansion). In some cases, a change contemplated by a firm may not clearly fall within one of the events described in Rule 1017, and so before taking steps to prepare a CMA, a member has the option of seeking guidance, or a materiality consultation, from FINRA on whether such proposed event would require a CMA.<sup>13</sup> The materiality consultation process is voluntary, and FINRA has published guidelines about this process on *FINRA.org*.<sup>14</sup> A request for a materiality consultation, for which there is no fee, is a written request from a member firm for FINRA's determination on whether a contemplated change in business operations or activities is material and would therefore require a CMA or whether the contemplated change can fit within the framework of the firm's current activities and structure without the need to file a CMA for FINRA's approval. The characterization of a contemplated change as material depends on an assessment of all the relevant facts and circumstances, including, among others, the nature of the contemplated change, the effect the contemplated change may have on the firm's capital, the qualifications and experience of the firm's personnel, and the degree to which the firm's existing

financial, operational, supervisory and compliance systems can accommodate the contemplated change.<sup>15</sup> Through this consultation, FINRA may communicate with the member to obtain further documents and information regarding the contemplated change and its anticipated impact on the member. Where FINRA determines that a contemplated change is material, FINRA will instruct the member to file a CMA if it intends to proceed with such change. Ultimately, the member is responsible for compliance with Rule 1017. If FINRA determines during the materiality consultation that the contemplated business change is material, then the member potentially could be subject to disciplinary action for failure to file a CMA under Rule 1017.<sup>16</sup>

To help further incentivize payment of arbitration awards and settlements, FINRA is proposing to preclude a member from effecting specified changes in ownership, control, or business operations, including business expansions involving a "covered pending arbitration claim" (as defined under proposed Rule 1011(c)), unpaid arbitration award, or unpaid settlement related to an arbitration without first seeking a materiality consultation from FINRA as described below.<sup>17</sup>

#### 1. Mandatory Materiality Consultation for Business Expansion To Add One or More Associated Persons Involved in Sales (Proposed IM-1011-2 and Proposed Rules 1011(c)(1) and 1017(a)(6)(B))

Rule 1017 specifies the changes in a member's ownership, control, or business operations that require a CMA and FINRA's approval.<sup>18</sup> Among the

events that require a CMA are a "material change in business operations," which is defined to include, but is not limited to: (1) Removing or modifying a membership agreement restriction; (2) market making, underwriting or acting as a dealer for the first time; and (3) adding business activities that require a higher minimum net capital under SEA Rule 15c3-1.<sup>19</sup> In addition, a CMA is required for business expansions to increase the number of associated persons involved in sales, offices, or markets made that are a material change in business operations.<sup>20</sup> However, IM-1011-1 (Safe Harbor for Business Expansions) creates a safe harbor for incremental increases in these three categories of business expansions that will be presumed not to be material. Under this safe harbor provision, a member, subject to specified conditions and thresholds, may undergo such business expansions without filing a CMA.<sup>21</sup>

FINRA is concerned that the changes in a member firm's ownership, control, or business operations as currently described in Rule 1017, and the availability of the safe harbor for a business expansion to increase the number of associated persons involved in sales could allow a member to, for example, hire principals and registered representatives with substantial pending arbitration claims without giving consideration to how the firm would supervise such individual or the potential financial impact on the firm if the individual, while employed at the hiring firm, engages in additional potential misconduct that results in a customer arbitration. Accordingly, FINRA is proposing to add new interpretive material, IM-1011-2 (Business Expansions and Covered Pending Arbitration Claims), to provide that if a member is contemplating to add one or more associated persons involved in sales and one or more of those associated persons has a "covered

unless both the seller and acquirer are members of the NYSE; (4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or (5) a material change in business operations as defined in Rule 1011(k).

<sup>19</sup> See Rule 1011(k).

<sup>20</sup> See Rule 1017(b)(2)(C) (stating, "If the application requests approval of an increase in Associated Persons involved in sales, offices, or markets made, the application shall set forth the increases in such areas during the preceding 12 months.").

<sup>21</sup> The safe harbor is unavailable to a member that has a membership agreement that contains a specific restriction as to one or more of the three areas of expansion or to a member that has a "disciplinary history" as defined in IM-1011-1.

<sup>13</sup> See IM-1011-1 (stating, "[f]or any expansion beyond these [safe harbor] limits, a member should contact its district office prior to implementing the change to determine whether the proposed expansion requires an application under Rule 1017."); see also *Notice to Members* 00-73 (October 2000) ("Notice 00-73") (stating, whether, based upon all the facts and circumstances, a change and expansion that falls outside of the safe harbor provisions are material, "[a] member may, but is not required to, contact the District Office to obtain guidance on this issue.").

<sup>14</sup> See The Materiality Consultation Process for Continuing Membership Applications, <https://www.finra.org/rules-guidance/guidance/materiality-consultation-process>.

<sup>15</sup> See *Notice* 00-73.

<sup>16</sup> See *Notice* 00-73.

<sup>17</sup> In a separate proposal, FINRA is proposing to mandate materiality consultations under other circumstances. See *Notice* 18-23 (seeking comment on a proposal to the MAP rules that would, among other things, codify the materiality consultation process and mandate a consultation under specified circumstances such as where an applicant seeks to engage in, for the first time, retail foreign currency exchange activities, variable life settlement sales to retail customers, options activities, or municipal securities activities).

<sup>18</sup> See Rule 1017(a). The events that require a member to file a CMA for approval before effecting the proposed event are: (1) a merger of the member with another member, unless both members are members of the New York Stock Exchange, Inc. ("NYSE") or the surviving entity will continue to be a member of the NYSE; (2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE; (3) direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis,

pending arbitration claim” (as that term is defined under proposed Rule 1011(c)(1)), an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, the member may not effect the contemplated business expansion unless the member complies with the requirements in proposed Rule 1017(a)(6)(B).

Proposed Rule 1017(a)(6)(B) would require a member firm to file a CMA for approval of the business expansion described in proposed IM-1011-2 unless the member first submits a written request to FINRA seeking a materiality consultation for the contemplated business expansion. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, FINRA would consider the written request and other information or documents the member provides to determine in the public interest and the protection of investors that either: (1) The member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated business expansion; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated business expansion unless FINRA approves the CMA.

A materiality consultation for this type of business expansion would allow FINRA to, among other things, assess the nature of the anticipated activities of the principals and registered representatives with arbitration claims, unpaid arbitration awards or arbitration settlements; the impact on the firm’s supervisory and compliance structure, personnel and finances; and any other impact on investor protection raised by adding such individuals. If FINRA determines that a member must file a CMA, it would be subject to the application review process set forth under the MAP rules, including a review of any record of a pending arbitration claim and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements.

For purposes of a business expansion to add one or more associated persons involved in sales, FINRA is proposing to define, under proposed Rule 1011(c)(1), a “covered pending arbitration claim” as: (1) An investment-related, consumer-initiated claim filed against the associated person in any arbitration forum that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the hiring member’s excess net

capital. For purposes of this definition, the claim would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees, and shall be the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

FINRA believes that the definition of a “covered pending arbitration claim” for purposes of a business expansion as described in proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) is appropriate because if an individual has substantial arbitration claims, those claims could be an indication that the individual may engage in future potential misconduct that could result in additional arbitration claims.<sup>22</sup> Under such circumstances, if the customer names the hiring member firm in any such additional arbitration claims, FINRA is concerned whether a hiring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims including a customer award or settlement. By requiring a materiality consultation if a member firm is contemplating hiring an individual with a “covered pending arbitration claim,” FINRA would be able to assess, among other things, the adequacy of any supervisory plan the member firm has in place for the individual. In addition, the materiality consultation would allow FINRA to discuss with the member firm the potential impact on its finances if the member firm hires the individual and the individual engages in future potential misconduct while employed at the member firm that results in an arbitration claim against the member firm.

If the SEC approves the proposed rule change, FINRA will reassess the definition of “covered pending arbitration claim” for purposes of proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) after FINRA has had experience with the application of the rule to determine its impact and if the definition requires modification. In

<sup>22</sup> Recent academic studies provide evidence that the past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events. See Hammad Qureshi and Jonathan Sokobin, Do Investors Have Valuable Information About Brokers? (FINRA Office of the Chief Economist Working Paper, August 2015). See also Mark Egan, Gregor Matvos, and Amit Seru, The Market for Financial Adviser Misconduct, *J. Pol. Econ.* 127, No. 1 (February 2019): 233–295.

addition, FINRA invites comment on the proposed definition.

## 2. Mandatory Materiality Consultation for Any Acquisition or Transfer of Member’s Assets (Proposed Rule 1017(a)(6)(A) and Proposed Rule 1011(c)(2))

Rule 1017(a) requires a member to file a CMA for direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member’s assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member’s earnings measured on a rolling 36-month basis, unless both the seller and acquirer are NYSE members.<sup>23</sup>

FINRA is concerned that this 25 percent threshold could permit a firm with pending arbitration claims that ultimately produce awards or settlements to avoid satisfying those awards or settlements by transferring assets without encumbrance and then closing down. Accordingly, FINRA is proposing to amend Rule 1017(a) to add new subparagraph (6)(A) to provide that if a member is contemplating any direct or indirect acquisition or transfer of a member’s assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim (as that term is defined under proposed Rule 1011(c)(2)), an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, the member may not effect the contemplated transaction unless the member first submits a written request to FINRA seeking a materiality consultation for the contemplated acquisition or transfer. Similar to proposed subparagraph (6)(B) in Rule 1017(a), the written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, FINRA would consider the written request and other information or documents provided by the member to determine in the public interest and the protection of investors that either: (1) The member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated acquisition or transfer; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated business acquisition or transfer unless FINRA approves the CMA.

<sup>23</sup> See *supra* note 18.

During the course of this consultation, FINRA would consider, among other relevant facts and circumstances, whether the contemplated acquisition or transfer could result in non-payment of an arbitration claim should it go to award or result in a settlement, or the continued non-payment of such arbitration award or settlement. If FINRA determines that a member must file a CMA, it would be subject to the application review process set forth under the MAP rules, including a review of any record of a pending arbitration claim and the presumption of denial with respect to any unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements.

For purposes of this proposed amendment, FINRA is proposing to define, under proposed Rule 1011(c)(2), a “covered pending arbitration claim” as: (1) An investment-related, consumer-initiated claim filed against the transferring member or its associated persons in any arbitration forum that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member’s excess net capital. For purposes of this definition, the claim amount would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees, and shall be the maximum amount for which the associated person is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

FINRA believes that the definition of a “covered pending arbitration claim” for purposes of a direct or indirect acquisition or transfer as described in proposed Rule 1017(a)(6)(A) is an appropriate measure because a member with substantial arbitration claims that is seeking to transfer its assets could be an indication of attempts to insulate itself from responsibility for the payment of pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements particularly when there is no corresponding transfer of liabilities. Under such circumstances, FINRA is concerned whether a transferring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims, including a customer award or settlement. By requiring a materiality consultation where a member firm is contemplating

any direct or indirect acquisition or transfer involving a “covered pending arbitration claim,” FINRA would be able to assess, among other things, the adequacy of any plan the member firm has in place to satisfy pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements.

As noted above, FINRA invites comment on the proposed definition and if the SEC approves the proposed rule change, FINRA will reassess the definition of “covered pending arbitration claim” for purposes of proposed Rule 1017(a)(6)(A) after FINRA has had experience with the application of the rule to determine its impact and if the definition requires modification.

### C. Other Proposed Amendments

#### 1. Notification of Changes

Rule 1013(a) sets forth a detailed list of items that must be submitted with an NMA.<sup>24</sup> Rule 1017(b) sets forth the documents or information required to accompany a CMA, depending on the nature of the CMA. FINRA is proposing to amend Rules 1013 and 1017 to add new paragraphs that would appear as proposed Rules 1013(c) and 1017(h), to require an applicant to provide prompt notification, in writing, of any pending arbitration claim involving the applicant or its associated persons that is filed, awarded, settled or becomes unpaid before a decision on the application constituting final action of FINRA is served on the applicant.<sup>25</sup> Thus, any such unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or pending arbitration claim (for a new member applicant only) that comes to light in this manner during the application review process would result in FINRA being able to presumptively deny the application under the applicable factors set forth in Standard 3 and the ability of the applicant to overcome such presumption by demonstrating its ability to satisfy the obligation, as discussed above.

<sup>24</sup> The list of items set forth under Rule 1013(a) includes, among other things, documentation of disciplinary history and certain regulatory, civil, and criminal actions, arbitrations, and customer complaints for the applicant and its associated persons.

<sup>25</sup> FINRA expects to make conforming changes to Forms NMA and CMA, but notes that Form CMA currently requires the applicant seeking approval of an asset transfer to promptly update the information provided regarding arbitration claims. Such update should include new arbitrations filed, settlements made and awards granted against the applicant. See Form CMA, Standard 3, Question 4.b.

#### 2. Timing and Conditions for Effecting Change Under Rule 1017

Rule 1017(c) describes the timing and conditions for effecting a change under Rule 1017.<sup>26</sup> Rule 1017(c)(1) requires a member to file a CMA for approval of a change in ownership or control at least 30 days before the change is expected to occur. While a member may effect the change prior to the conclusion of FINRA’s review of the CMA, FINRA may place interim restrictions on the member based upon the standards in Rule 1014 pending a final determination.<sup>27</sup> Under Rule 1017(c)(2), a member may file a CMA to remove or modify a membership agreement restriction at any time, but any such existing restriction shall remain in effect during the pendency of the proceeding. Finally, Rule 1017(c)(3) permits a member to file a CMA for approval of a material change in business operations at any time, but the member may not effect such change until the conclusion of the proceeding, unless FINRA and the member otherwise agree.

FINRA is proposing to amend Rule 1017(c) by adding new subparagraph (4) to provide that, notwithstanding the existing timing and conditions for effecting a change as described under Rule 1017(c)(1) through (3), where a member or an associated person has an unpaid arbitration award or unpaid settlement related to an arbitration at the time of filing a CMA, the member may not effect such change until demonstrating that it has the ability to satisfy such obligations in accordance with Rule 1014 and proposed IM-1014-1, as discussed above, and obtaining approval of the CMA.<sup>28</sup>

<sup>26</sup> In a separate proposal, FINRA is considering whether to eliminate the timing considerations for filing a CMA depending upon the type of contemplated change or event to require that any change specified under Rule 1017 should not be permitted until such time as the CMA has been approved by FINRA. See Notice 18-23 (seeking comment on a proposal to the MAP rules that would, among other things, delete Rule 1017(c) in its entirety).

<sup>27</sup> Interim restrictions are meant for the protection of investors and ordinarily would not prevent a transaction from moving forward. However, there may be some instances where the protection of investors will require that interim restrictions will prohibit or delay a transaction from closing. See Notice to Members 02-54 (August 2002).

<sup>28</sup> FINRA expects to make conforming changes to Forms NMA and CMA. FINRA notes that where an applicant is seeking FINRA’s approval of a CMA to transfer assets with no corresponding transfer of associated liabilities, and there is an unpaid arbitration award, Form CMA currently requires the applicant to provide proof that the award was satisfied in full and in the case of an unpaid award, the applicant must pay the award in full before closing the transaction. See Form CMA, Standard 3, Question 2.a. (within the section titled, “Provide supporting documents”).

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a *Regulatory Notice* to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following publication of the *Regulatory Notice* announcing Commission approval of the proposed rule change.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>29</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change will allow FINRA to better take into account the issue of pending arbitration claims, as well as arbitration awards and settlement agreements related to arbitrations that have not been paid in full in accordance with their terms, in connection with the NMA or CMA processes. FINRA believes that the proposed amendments will strengthen FINRA's ability to consider the adequacy of the supervision of individuals with pending arbitration claims and, therefore, who may have a history of noncompliance, and how a member firm will address the payment of an existing or potential arbitration claim should it go to award or result in a settlement. In addition, FINRA believes that the proposed amendments will give FINRA the authority to carefully assess, at an earlier stage of a member's contemplated business transaction or expansion, the relevant facts and circumstances surrounding pending arbitration claims.

Among other things, the proposed amendments will help address concerns regarding situations where: (1) A FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the adequacy of the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.

## B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### 1. Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet its regulatory objectives.

### 2. Regulatory Need

The MAP rules are intended to promote investor protection by applying uniform standards for admission and by reviewing changes to ownership, control, or business operations. While the current MAP rules give FINRA the ability to review pending arbitration claims, unpaid arbitration awards, and unpaid arbitration settlements in determining whether to grant or deny an application, the proposed amendments would strengthen the MAP rules when claimants may need additional protections. Currently, claimants may be at risk if the individuals or firms responsible actively maneuver to avoid payment of awards (e.g., by joining or transferring assets to a different member firm).<sup>30</sup>

### 3. Economic Baseline

The economic baseline for the proposed amendments is the current set of MAP rules and related guidance, and FINRA practices. The current rules include unpaid arbitration awards and settlements, but not pending arbitration claims, in the presumption of denial; the definition of a material change in business operations and the availability of a safe harbor for some business expansions; and the requirements for a member firm to file a CMA relating to asset acquisitions or transfers. The proposed amendments would affect prospective and existing member firms,

<sup>30</sup> FINRA identified five customer arbitration claims that (a) closed between 2015 and 2017 and resulted in an award that went unpaid and (b) the associated persons responsible for the unpaid awards transitioned from one member firm to another while the claim was pending. The total amount of unpaid awards relating to the five customer claims was \$2.5 million. Three of the four associated persons relating to the unpaid awards were suspended or barred from the industry by FINRA. The fourth associated person declared bankruptcy but was no longer registered as a broker.

and associated persons. The proposed amendments would also affect the current and future customers of prospective and existing member firms including those that have brought or may bring claims against member firms and associated persons.

### A. NMAs

In order to get a better understanding of the potential scope of the proposed amendments, FINRA reviewed 317 NMAs that it received from January 2015 through December 2017.<sup>31</sup> Among these applications, FINRA identified few new member applicants or their associated persons as having a pending arbitration claim at the time of FINRA's receipt of the NMA.<sup>32</sup> Among the 317 NMAs, FINRA identified 13 NMAs (or four percent) where the new member applicant or its associated persons had a pending arbitration claim at the time of receipt of the application.<sup>33</sup> Under the proposed amendments, FINRA could have presumptively denied these NMAs. FINRA also identified one NMA as relating to a customer claim that resulted in an award that went unpaid.<sup>34</sup>

### B. CMAs

FINRA also reviewed 1,051 CMAs that it received from January 2015 through December 2017.<sup>35</sup> This sample of CMAs only provides a potential indication of the member firms that

<sup>31</sup> These NMAs were either approved in whole or with restrictions, denied, withdrawn, rejected, or lapsed.

<sup>32</sup> The statistics on pending arbitration claims in this discussion relate only to claims in the arbitration forum administered by FINRA. The proposed amendments also would apply to claims in other venues. Information describing claims in other arbitration forums, however, is generally not available. FINRA's estimates of the number of firms that may be impacted by the proposed amendments are therefore likely lower than the true number. Further, FINRA is not able to estimate the total amount of monetary compensation claimants received from the arbitration cases discussed because information that identifies the settlement amount relating to a particular case is not available.

<sup>33</sup> Among these 13 NMAs, there were seven pending customer arbitration claims filed against associated persons prior to FINRA's receipt of the application, and among these seven customer claims, three resulted in a settlement, one closed by hearing, and three were withdrawn. The total amount of compensatory damages sought by customers was over \$1.9 million (including the claims that resulted in a settlement). In the case closed by hearing, the customer was awarded compensatory damages of approximately \$76,000.

<sup>34</sup> The firm withdrew the NMA. The customer arbitration claim resulted in an award prior to FINRA's receipt of the NMA. The amount of the damages that went unpaid is approximately \$250,000. The associated person who failed to pay the awarded damages has been suspended by FINRA.

<sup>35</sup> The CMAs were either approved in whole or with restrictions, denied, withdrawn, rejected, or lapsed.

<sup>29</sup> 15 U.S.C. 78o-3(b)(6).

could be impacted by the proposed amendments. A member firm may elect to proceed with effecting a change in business operations because it independently determines, without seeking guidance from FINRA through a materiality consultation, that such contemplated change falls within the safe harbor parameters or that such transaction does not represent a material change in business operations that would require a CMA. In these cases, a member firm is not obligated to proactively notify FINRA of the independent determination.<sup>36</sup> Thus, the number of member firms that potentially may be subject to the proposed amendments, including those that effect an increase in the number of associated persons involved in sales under the safe harbor or effect some other change in business operations that is, in the member firm's view, not material, may be different than the member firms that filed a CMA and are part of the sample.

Of the 1,051 CMAs, 65 involved the hiring of associated persons. FINRA identified four of the 65 CMAs where the associated person being hired had a pending customer arbitration claim. Under the proposed amendments, the pending customer arbitration claims for all four of the CMAs would have been considered covered pending arbitration claims.<sup>37</sup> An additional 154 of the 1,051 CMAs were identified as relating to asset acquisitions (17) or transfers (137). FINRA identified 44 CMAs (29 percent of 154) where the transferring member or an associated person of the transferring member had a pending customer arbitration claim at the time of the filing.<sup>38</sup> Under the proposed

amendments, the pending customer arbitration claims for 25 of the 44 CMAs would have been considered covered pending arbitration claims. FINRA also identified five of the CMAs as relating to six customer claims that resulted in an award that went unpaid.<sup>39</sup>

#### 4. Economic Impact

FINRA believes that the proposed amendments to the MAP rules would enhance the review of applications by strengthening the MAP rules in relation to pending arbitration claims and unpaid arbitration awards and settlements.

The proposed amendments would benefit claimants and potential claimants by decreasing the risk that firms are avoiding the payment of awards or settlements by transferring their assets, including capital and customer accounts, to another firm. Firms can shift their assets to another firm by starting a new firm, or by selling or transferring assets to an existing firm. A decrease in the ability of firms to avoid satisfying their arbitration awards or settlements in this manner may result in a higher likelihood that they are paid in full in accordance with their terms. The proposed amendments could also benefit the current and future customers of new member applicants and member firms that seek a materiality consultation by increasing FINRA's ability to assess, among other things, the adequacy of the supervisory plan the member firm has in place for the associated persons who may have a history of non-compliance.

#### A. Rebuttable Presumption To Deny an NMA

Proposed Rule 1014(b)(1) would specify that a presumption of denial would exist if a new member applicant or its associated persons are subject to

the 300 pending arbitration claims, 184 resulted in a settlement, 48 closed by hearing or on the papers, 52 closed by other means including 32 that were withdrawn, and 16 remained open. Customers requested a total of \$311.3 million in compensatory relief (including the claims that resulted in a settlement); and in the claims resulting in an arbitration award in favor of customers, customers were awarded approximately \$9.9 million in compensatory damages.

<sup>39</sup> Three of the CMAs were withdrawn, and two were approved. Three of the six customer claims were closed prior to the filing of the CMA, whereas the other three were still pending. For the two approved CMAs, the cases which resulted in an unpaid customer award closed at least one year after the decision was served. Five of the six customer awards went unpaid by a member firm, whereas the other went unpaid by an associated person. The total amount of damages that went unpaid is approximately \$3.4 million. The member firms have either cancelled their membership or were expelled by FINRA, and the associated person has been suspended by FINRA.

a pending arbitration claim. By establishing a presumption of denial, the proposed rule change would shift the burden to the new member applicant to demonstrate how pending arbitration claims would be paid if they go to an award. Proposed Rule 1014(b)(1) would impose both direct and indirect costs on new member applicants.

New member applicants with pending arbitration claims would incur direct costs. The costs include the time and expense of firm staff and outside experts to demonstrate the ability to satisfy the claims. The costs would be in addition to the costs new member applicants incur to demonstrate their ability to meet the 14 standards for admission under Rule 1014(a). In addition, new member applicants and their associated persons may incur the opportunity costs associated with setting aside funds that may otherwise be used for new business. A new member applicant may incur more opportunity costs than is necessary if it sets aside more capital than the actual amount of the award.

New member applicants may also incur indirect costs if the rebuttal process delays the applicant's ability to begin earning revenues or otherwise negatively impacts the business. The magnitude of these costs is related to the ability of the new member applicant and FINRA to adequately gauge the likelihood and size of an award or settlement. However, as noted above, FINRA estimates that few associated persons related to new member applicants will have pending arbitration claims at the time of the filing.<sup>40</sup> The majority of new member applicants are therefore unlikely to be affected by the proposed amendments.

#### B. Materiality Consultations

The proposed amendments would also mandate a member firm to seek a materiality consultation for specified business changes—hiring an associated person involved in sales, or any direct or indirect acquisition or transfer of assets—where the member firm or associated person, as applicable, has an unpaid arbitration award or settlement related to an arbitration, or a defined covered pending arbitration claim, unless the member firm is otherwise required to file a CMA. FINRA believes that an unpaid arbitration award or settlement poses a severe risk to claimants that would warrant a materiality consultation under any circumstances. FINRA also believes that the proposed definition of a covered pending arbitration claim, which

<sup>36</sup> Under IM-1011-1, a firm would remain obligated to keep records of increases in personnel, offices, and markets made to determine whether they are within the safe harbor.

<sup>37</sup> From January 2015 to December 2017, among all member firms, 480 associated persons were hired with a pending arbitration claim at the time of hiring. These pending claims would have been considered "covered pending arbitration claims" under the proposed amendments for 186 of the associated persons (39 percent of 480) and would not have been considered covered pending arbitration claims for the remaining 294 associated persons (or 61 percent of 480). FINRA does not know how many of the associated persons were involved in sales. This estimate, therefore, provides an upper bound for the number of materiality consultations member firms would have been required to seek under the proposed amendments. See *supra* note 30 for a discussion of the unpaid awards relating to associated persons who transitioned from one member firm to another while the claim was pending.

<sup>38</sup> Thirty-four of the CMAs were approved, and 10 were withdrawn or not substantially completed and therefore rejected. There were 300 pending customer arbitration claims as of the receipt of the CMAs. The pending claims included claims made against the applicant or its associated persons. Of

<sup>40</sup> See *supra* note 33 and accompanying text.



focuses on investment-related, consumer-initiated claims (individually or, if there is more than one claim, in the aggregate) that exceed the excess net capital of the transferring or hiring member firm (as applicable), represents an objective benchmark that would provide FINRA the opportunity to review the specified business changes to assess whether they may adversely affect former, current or future customers in a material way.

For a member firm transferring assets, FINRA believes that the relative size of covered pending arbitration claims may signal that the firm may be attempting to avoid the payment of awards or settlements by transferring assets, including capital and customer accounts, to another firm. For member firms adding one or more associated persons involved in sales, the relative size of the covered pending arbitration claims may foreshadow future potential misconduct by such individuals that could result in additional arbitration claims.<sup>41</sup> Under such circumstances, if the customer names the hiring member firm in any such additional arbitration claims, FINRA is concerned whether a hiring member firm with low excess net capital would be able to satisfy any obligation that may result from the arbitration claims, including a customer award or settlement.

Member firms that would be required to seek a materiality consultation would incur direct costs. Similar to the additional direct costs associated with NMAs, the costs may include the time and expense of firm staff and outside experts to provide information and documents that demonstrate the ability to satisfy the unpaid awards or settlements, or covered pending arbitration claims. Member firms that would be required to seek a materiality consultation and their associated persons may also incur the opportunity costs associated with setting aside funds that may otherwise be used for new business.

Member firms that seek a materiality consultation may also incur costs relating to a delay in effecting the contemplated expansion or transaction. A delay may negatively impact the value of the expansion or transaction and may lead to a loss of business opportunities. Given the experience of FINRA, this delay is anticipated to be small as the time for a materiality consultation has recently averaged 12 days; this time period, however, may lengthen depending on the complexity of the contemplated expansion or transaction.

Business activities that decrease the amount of excess net capital available may increase the likelihood that member firms would be required to seek a materiality consultation. In response, member firms may constrain business activities to maintain a level of excess net capital in order to demonstrate their ability to pay pending arbitration claims (or pay unpaid awards or settlements) in the event a materiality consultation is required. As described in the Economic Baseline, a number of CMAs relate to the hiring of an associated person with a covered pending arbitration claim or the acquisition or transfer of a member's assets where the transferring member or an associated person of the transferring member had a covered pending arbitration claim.<sup>42</sup>

FINRA may require member firms that seek a materiality consultation to file a CMA. FINRA would then consider whether the member firm meets each of the 14 standards under Rule 1014. These members would therefore incur costs in addition to the costs to seek a materiality consultation. This includes the fees associated with a CMA, time of firm staff, and submission of additional documentation. The filing of a CMA would also cause an additional delay to effectuate the contemplated expansion or transaction. This may cause member firms, associated persons and the customers of member firms to lose the benefits associated with the business opportunities. A determination that a CMA must be filed, however, would indicate that the risks to claimants, and therefore the potential benefits of a closer examination, are high. An examination may include the regulatory history of a member to determine whether it is able to satisfy any pending arbitration claims should they go to award, as well as the adequacy of any supervisory plan for an individual with a pending arbitration claim that the firm is contemplating hiring.<sup>43</sup> If the actual

risks to claimants are low (*e.g.*, the amount settled or eventually awarded is a small percentage of the amount claimed), then the greater costs to member firms to file a CMA would not also result in a similar increase in customer protections.

The proposed amendments are not designed to impose disproportionate costs based on firm size. Instead, the costs the proposed amendments would impose are dependent on the compensatory loss amounts of pending customer arbitration claims, or the presence of an unpaid arbitration award or an unpaid settlement related to an arbitration, and the financial capacity of the member firm. In addition, the costs member firms may incur to seek a materiality consultation (and potentially file a CMA) as a result of the proposed amendments, including any burden on competition, are borne at their discretion, in their decision to hire or acquire or transfer the member's assets. Member firms would incur the additional costs if they choose to hire an associated person involved in sales who has a covered pending arbitration claim, or where the transferring member or an associated person of the transferring member has a covered pending arbitration claim.

The member firms that would be required to seek a materiality consultation (and potentially file a CMA) as a result of the proposed amendments may range in size.<sup>44</sup> For example, as described in the Economic Baseline, FINRA identified four member firms that filed a CMA relating to the hiring of an associated person with a covered pending arbitration claim. All four member firms were small.<sup>45</sup> Similarly, FINRA identified 25 CMAs as relating to the asset acquisitions or transfers of 26 member firms where the transferring members had covered pending customer arbitration claims. Among the 26 transferring members, 13 members were small, nine members

<sup>42</sup> See the discussion in the Economic Baseline. Customers may have an incentive to file an arbitration claim for the sole purpose of disrupting a contemplated transaction. This incentive could increase the number of member firms that would be required to seek a materiality consultation and potentially file a CMA and incur the associated costs. FINRA has no reasonable basis on which to predict the frequency of this occurring if the proposed amendments are adopted. SIFMA suggested that the definition of a covered pending arbitration claim should be limited to claims filed prior to the public announcement of the contemplated transaction. FINRA would review customer claims as part of a materiality consultation and consider the facts and circumstances of the case as well as its timing. The potential disruption to contemplated transactions from these claims, therefore, is expected to be limited.

<sup>43</sup> Individuals with pending arbitration claims may engage in future potential misconduct that

could result in additional arbitration claims, including claims that name the hiring member. See *supra* note 22.

<sup>44</sup> The definition of firm size is based on Article I of the FINRA By-Laws. A firm is defined as "small" if it has at least one and no more than 150 registered persons, "mid-size" if it has at least 151 and no more than 499 registered persons, and "large" if it has 500 or more registered persons.

<sup>45</sup> During the sample period and among all member firms, FINRA also identified 186 associated persons who were hired with a covered pending arbitration claim at the time of the hiring. See *supra* note 37. The percentage of small member firms that hired the 186 associated persons (90 percent) is similar to the proportion of small member firms industry-wide as of year-end 2017 (90 percent). See 2018 FINRA Industry Snapshot, [https://www.finra.org/sites/default/files/2018\\_finra\\_industry\\_snapshot.pdf](https://www.finra.org/sites/default/files/2018_finra_industry_snapshot.pdf).

<sup>41</sup> See *supra* note 22.



were mid-size, and four members were large.<sup>46</sup>

An associated person, as a respondent to a pending claim, may also incur costs as a result of the proposed amendments. New member applicants and existing member firms may be less likely to hire associated persons with a pending claim in order to avoid the costs associated with the proposed amendments. An associated person, as a respondent to a pending claim, may therefore experience fewer career opportunities within the brokerage industry.

### C. Other Proposed Amendments

Two other proposed amendments would have additional economic effects. First, the proposed amendments would require applicants to provide prompt notification of a pending arbitration claim that is filed, awarded, settled, or becomes unpaid before a decision on the application is served. These notifications would further improve the ability of FINRA to oversee and review the pending arbitrations of applicants to ensure that arbitration awards and settlements are paid in full in accordance with their terms. Applicants that provide notification would incur additional costs including the time of firm staff and the expense to submit additional documentation.

A number of the applicants for new membership or member firms that filed a CMA during the sample period would have been required to promptly notify FINRA of changes to pending arbitration claims. FINRA identified 13 of the 317 NMAs (or four percent) from January 2015 through December 2017 as having changes in the status of a pending arbitration claim involving the applicant or its associated persons before a decision constituting final action was served on the applicant (or the application was otherwise withdrawn),<sup>47</sup> and 156 of the 1,051 CMAs (or 15 percent) as also having

similar changes to the status of a pending arbitration claim.<sup>48</sup>

Second, the proposed amendments would clarify the manner in which an applicant may demonstrate its ability to satisfy pending arbitration claims or unpaid arbitration awards or settlements. The clarification would improve the efficiency of the MAP process by increasing the ability of applicants to anticipate the information necessary to demonstrate their ability to satisfy outstanding obligations, and reduce the need for applicants to submit additional information after the initial filing.

### 5. Alternatives Considered

FINRA considered a range of suggestions in developing the proposed amendments as set forth in *Regulatory Notice* 18–06. The proposed amendments reflect the changes that FINRA believes at this time to be the most appropriate for the reasons discussed herein.

An alternative to the proposed amendments includes a rebuttable presumption of denial for a CMA if the applicant or its associated persons are the subject of a pending arbitration claim. This alternative would increase the costs to member firms that file a CMA, including member firms that initially sought a materiality consultation under the proposed amendments. Member firms may incur costs to demonstrate their ability to satisfy the claims. This includes the opportunity costs associated with setting aside funds that may otherwise be used for other business opportunities.

A presumption of denial would reduce the risks associated with firms avoiding the payment of claims should they go to award. As part of a materiality consultation, however,

FINRA would examine the regulatory history of a member firm to determine whether it is able to satisfy pending arbitration claims should they go to award, as well as the adequacy of any supervisory plan for an individual with a pending arbitration claim that the firm is contemplating hiring.<sup>49</sup> The additional protections from extending a presumption of denial for pending arbitration claims to CMAs, therefore, may not justify the additional costs to member firms.<sup>50</sup>

Other alternatives to the proposed amendments include expanding or narrowing the conditions for member firms to seek a materiality consultation or file a CMA.<sup>51</sup> Expanding (narrowing) the requirements for member firms to seek a materiality consultation or to file a CMA may decrease (increase) the ability of firms to avoid satisfying their outstanding obligations by transferring their assets to another firm. By expanding (narrowing) the requirements, however, additional (fewer) member firms would incur the associated costs. FINRA believes that the requirements under the proposed amendments for member firms to seek a materiality consultation provide for the additional investor protections but minimize the costs when the risk of members not satisfying their outstanding obligations is low.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

The proposed rule change was published for comment in *Regulatory Notice* 18–06 (February 2018) (“*Notice*”). FINRA received nine comment letters in response to the

<sup>49</sup> See *supra* note 22.

<sup>50</sup> Several commenters suggested alternatives to the proposed amendments that would require a presumption of denial when pending arbitration claims exceed certain thresholds. See GSU, PIABA, and UNLV. Although member firms with pending arbitration claims that exceed the thresholds may be at higher risk of nonpayment, FINRA believes that it would still be able to adequately assess these firms' ability to pay the claims should they go to award without the presumption of denial.

<sup>51</sup> For example, commenters suggested expanding the requirement to seek materiality consultations for business expansions. Suggestions include omitting the qualifying term “involved in sales” (NASAA) and expanding to principals, control persons, or officers (GSU). Another commenter, however, suggested excluding business expansions from the requirement to seek a materiality consultation if the expansion is in connection with another corporate event such as a merger, acquisition, or asset transfer (FSI). Commenters also suggested narrowing the requirement to seek materiality consultations for asset acquisitions or transfers. Suggestions include permitting smaller acquisitions or transfers to proceed without a materiality consultation (GSU) or excluding covered pending arbitration claims altogether (FSI).

<sup>46</sup> As a result of the safe harbor provision, the member firms that would have been subject to the proposed amendments during the sample period may be different than the member firms that filed a CMA. The number and composition of member firms that would have been required to file a materiality consultation under the proposed rule change is therefore not known.

<sup>47</sup> The arbitration claims consisted of 11 customer claims and one intra-industry claim. Among the 11 customer claims, three resulted in a settlement, three closed by hearing, four were withdrawn, and one remained open. The total amount of compensatory damages sought by customers was \$5.8 million (including the cases closed by settlement). In the cases closed by hearing, the customers were awarded compensatory damages of approximately \$146,000. None of the awarded damages went unpaid.

<sup>48</sup> The arbitration claims consisted of 913 customer claims of which 497 resulted in a settlement, 184 closed by hearing or on the papers, 174 were closed by other means including 95 that were withdrawn, and 58 remained open. The total amount of compensatory damages sought by customers was \$856.0 million. In the cases closed by hearing or on the papers, the customer was awarded compensatory damages of approximately \$20.5 million. Two of the customer cases resulted in an award that went unpaid. One of the cases is referred to above in the discussion in the Economic Baseline. The other case relates to two associated persons who left the applicant before a decision constituting final action was served. The amount of the awarded damages that went unpaid is approximately \$70,000. The associated persons who failed to pay the awarded damages have been suspended or barred by FINRA. The CMA was approved with restrictions. For applicants with changes to a pending arbitration claim before a decision constituting final action was served (or the application was otherwise withdrawn), the median number of changes is two.

*Notice*. A copy of the *Notice* is attached as Exhibit [sic] 2a. A list of the comment letters received in response to the *Notice* is attached as Exhibit [sic] 2b.<sup>52</sup> Copies of the comment letters received in response to the *Notice* are attached as Exhibit [sic] 2c.

Eight commenters supported the proposal as set forth in the *Notice* either absolutely or with some qualifications.<sup>53</sup> One commenter raised concerns outside the scope of the *Notice*.<sup>54</sup> A summary of the comments and FINRA's responses are discussed below.<sup>55</sup>

#### 1. Rebuttable Presumption to Deny an NMA

FINRA is proposing to amend Standard 3 to create a rebuttable presumption to deny an NMA where the applicant or its associated person is subject to a pending arbitration claim. Three commenters expressly supported the proposed amendment.<sup>56</sup> No commenters opposed this proposed amendment.

#### 2. Rebuttable Presumption to Deny a CMA

In the *Notice*, FINRA requested comment on whether the presumption of denial in connection with a pending arbitration claim should be applied to a CMA as well. Six commenters responded with three expressing opposition to this approach.<sup>57</sup> In general, these three commenters noted that a CMA already requires an applicant to provide information pertaining to pending arbitration claims and how an applicant will handle the arbitrations and the awards that may result. NASAA further expressed the belief that creating a presumption to deny a CMA may disincentivize a firm from taking on potential liability through an acquisition, which could result in more unpaid arbitration awards.

The other three commenters supported extending the presumption to deny an application with pending arbitration claims to a CMA but recommended various conditions on when the presumption should apply.<sup>58</sup>

GSU recommended that the presumption to deny a CMA should be

triggered when the applicant or its associated person has a pending arbitration claim or unpaid settlement for an amount exceeding \$15,000, contending that such dollar limit would provide some balance to the proposed rule change by tying the presumption to CMAs with claims that are required to be reported to FINRA. PIABA recommended that two preconditions for the presumption to deny a CMA should apply—one for the associated person and the other for the member firm. With respect to the associated person, PIABA stated that the presumption to deny a CMA should be triggered when more than five claims are pending against any control person, principal, registered representative, or other associated person of the member, as such number of claims may signal problems within the member and may be an indicator of potential future investor harm. If the member can overcome the presumptive denial of a CMA, and it still desires to hire or continue the employment of individuals with five or more pending arbitration claims, PIABA recommended that those individuals with such claims pending against them should be subject to heightened supervision and not be permitted to serve in a supervisory capacity until all pending arbitration claims against them have in fact been resolved, and the corresponding awards or settlements, if any, have been paid in full. PIABA further stated that following the conclusion of such proceedings, the decision related to an individual's supervision or supervisory capacity should rest with the member, and recommended that FINRA's rules should be modified to ensure that such individual is not permitted to move from one firm to another without regard to problems that occurred at the former firm.

As for the member firm, PIABA stated that the presumption should be applied based upon the aggregate amount of damages pleaded in all pending arbitration claims, taking the nature and quality of those claims into account, compared to the value of cash assets and insurance held by the member firm. If this ratio indicates a substantial risk of insolvency or presents the inability to pay all pending legitimate claims in full, then the presumption should apply. PIABA further stated that FINRA should be permitted to look beyond the damages described in a statement of claim, and discuss the issues related to damages directly with investors, their representative and FINRA members and their counsel, in confidential sessions, prior to applying a presumptive CMA

denial. UNLV recommended that the presumption apply to a CMA where there is a covered pending arbitration claim.

The existence of a specified regulatory history currently enumerated under Standard 3 that triggers the presumption to deny an application is intended to encourage compliance with unpaid arbitration awards, other unpaid adjudicated customer awards and unpaid arbitration settlements, and their existence raise the question of an applicant's capacity to comply with applicable securities laws and regulations, and with applicable FINRA rules.<sup>59</sup> Standard 3, as proposed, would not diminish FINRA's ability to assess whether the applicant and its associated persons are able to meet this standard. FINRA would continue to consider an applicant's or its associated person's pending arbitration claims, among other regulatory history, in determining whether an applicant for continuing membership is "capable of complying with" the federal securities laws and FINRA rules. Accordingly, while FINRA appreciates the commenters' recommendations, FINRA has determined, at this time, not to apply the presumption of denial for pending arbitration claims to a CMA.

#### 3. Evidence of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements, or Pending Arbitration Claims

##### A. Types of Evidence

Proposed IM-1014-1 would provide that an applicant may demonstrate, in a variety of ways, that it has the financial resources to satisfy an unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or a pending arbitration claim. Some examples include an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer.

With the exception of SIFMA, none of the commenters expressed views on the types of documentation an applicant may present to evidence the ability to satisfy an award, settlement or claim. SIFMA expressed concern about proposed IM-1014-1 requiring an

<sup>52</sup> All references to commenters are to the comment letters as listed in Exhibit [sic] 2b.

<sup>53</sup> See Colorado, Cornell, GSU, FSI, NASAA, PIABA, SIFMA, and UNLV.

<sup>54</sup> See IBN.

<sup>55</sup> Comments that speak to the economic impacts of the proposed rule change are addressed in Item B above.

<sup>56</sup> See SIFMA, Cornell, and GSU.

<sup>57</sup> See Cornell, NASAA, and SIFMA.

<sup>58</sup> See GSU, PIABA, and UNLV.

<sup>59</sup> See Rule 1014(a)(3)(C) (providing, in part, that a presumption of denial applies if the applicant, its control persons, principals, registered representatives, other associated persons, any lender of five percent or more of the applicant's net capital, and any other member with respect to which these persons were a control person or a five percent lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements).

applicant to show proof of insurance coverage, asserting that having insurance coverage does not necessarily correspond to having the ability to pay the award, settlement or claim. FINRA notes that the supporting documentation listed in the proposed interpretive material are examples of what an applicant may produce to FINRA to evidence the ability to satisfy the award, settlement or claim, and is not intended to be an exhaustive list by which a member can show its financial resources.<sup>60</sup>

#### B. Guarantee

In the *Notice*, FINRA requested comment on whether an applicant, if it designates a clearing deposit or the proceeds from an asset transfer for purposes of showing the ability to satisfy a pending arbitration claim, should be required to provide some form of guarantee that such funds will be used to satisfy the award, settlement or claim. Three commenters expressed their general support for a guarantee,<sup>61</sup> with two of these commenters making additional recommendations.<sup>62</sup>

Emphasizing the need to secure funds or to prevent them from being depleted for other purposes, PIABA recommended that applicants hold the funds in an escrow account with clear instructions to the third party escrow agent (unaffiliated with the member firm) to disburse the funds under specified circumstances.<sup>63</sup> PIABA also suggested strict penalties in the event of a breach of that guarantee, such as the immediate suspension of a member's broker-dealer license. NASAA noted that circumstances sometimes change during the pendency of a planned business transaction and that an applicant may need to reallocate the prior designated funds. To account for potentially changing business circumstances and given the fungibility of money, NASAA stated that an applicant should not be duty bound to satisfy an arbitration award or settlement from the funds they may have initially identified. Instead,

FINRA's rules should allow an applicant the flexibility to amend its application and designate a different source of available funds to satisfy pending claims or unpaid arbitration awards or settlements if necessary.

In light of the comments received, FINRA has modified proposed IM-1014-1 to provide that to overcome the presumption to deny the application, the applicant must guarantee that any funds used to evidence the applicant's ability to satisfy any awards, settlements, or claims, will be used for that purpose. As proposed, IM-1014-1 would not preclude an applicant from designating a different source of funds to satisfy an award, settlement or claim, provided the source of funds is acceptable to FINRA. Moreover, Section 1(c) of Article IV of the FINRA By-Laws already requires an applicant to keep its application current by submitting supplementary amendments as necessary.<sup>64</sup> A change in source of available funds to satisfy pending arbitration claims or unpaid arbitration awards or settlements would require the application to be updated in accordance with the FINRA By-Laws.

#### C. Valuation of Claim Through Independent Legal Counsel

Proposed IM-1014-1 would also permit an applicant to provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable as to the value of the arbitration claim in an effort to lend support to the applicant's ability to demonstrate that it has the financial resources to satisfy the claim, award or settlement. Two commenters suggested that the proposed provision should not require that counsel be "independent."<sup>65</sup> FSI stated that a firm should be able to rely on the opinion of in-house counsel as such counsel would be more familiar with the firm and its risk profile, adding that obtaining an opinion from external legal counsel could be costly and would not increase the regulatory value of the opinion offered. NASAA stated that it did not believe that the expert opinion necessarily needed to be from an "independent" source and instead, FINRA should have the authority to assess the veracity and reasonableness of an offered expert opinion on a case-by-case basis and to require such qualifications and degree of independence from the applicant as FINRA reasonably believes warranted in each instance. In addition, NASAA recommended that proposed IM-1014-

1 should compel an applicant to obtain a written opinion of a legal or financial expert to support the applicant's assertion that it can satisfy an unpaid award or settlement obligation it intends to assume, rather than giving the applicant the discretion to provide such opinion.

FINRA believes that it would be appropriate and consistent with current FINRA Rules to provide a member with the option to derive support for the valuation of an arbitration claim through a legal opinion from an independent, reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claim.<sup>66</sup>

#### 4. Materiality Consultations

##### A. The Process

Proposed IM-1011-2 and proposed Rule 1017(a)(6) would require a member to seek a materiality consultation under specified circumstances. FSI, while not expressly opposed to the underlying concept of mandating materiality consultations, stated that the proposed rules do not set forth clear parameters around the process, such as the time in which FINRA must issue a decision and the remedy a member firm has if it does not agree with FINRA's decision on the materiality consultation. FINRA notes that the materiality consultation process is well established, and a description of the process and the information that should be included in a request for a materiality consultation, among other information, is detailed on *FINRA.org*.<sup>67</sup> In addition, FINRA notes that if this proposed rule change is approved by the Commission, FINRA will update the materiality consultation process as detailed on its website as necessary.

##### B. Mandatory Materiality Consultation for Business Expansion To Add One or More Associated Persons Involved in Sales With Covered Pending Arbitration Claims

As set forth in the *Notice*, proposed IM-1011-2 would require a member to seek a materiality consultation before effecting a business expansion that would involve adding one or more associated persons involved in sales with a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an

<sup>60</sup> FINRA notes that similar examples appear in other FINRA rules. See, e.g., Section 4(i)(3) of Schedule A to the FINRA By-Laws (describing the circumstances under which a CMA for an acquisition or transfer of 25 percent or more of the member's assets may qualify for a fee waiver where the applicant can demonstrate in the CMA the ability to satisfy in full any unpaid customer-related claim (e.g., sufficient capital or escrow funds, proof of adequate insurance for customer related claims)). Form CMA also includes various examples. See *supra* note 12.

<sup>61</sup> See NASAA, PIABA, and UNLV.

<sup>62</sup> See NASAA and PIABA.

<sup>63</sup> PIABA's other recommendation was to have the guarantee secured by a lien in favor of FINRA or the investor.

<sup>64</sup> See Section 1(c) of Article IV of the FINRA By-Laws.

<sup>65</sup> See FSI and NASAA.

<sup>66</sup> See, e.g., FINRA Rule 2040 (Payments to Unregistered Persons) (providing in supplementary material that a member, if uncertain about whether an unregistered person may be required to be registered under SEA Section 15(a), can derive support from the member's determination by, among other things, a legal opinion from independent, reputable U.S. licensed counsel knowledgeable in the area).

<sup>67</sup> See *supra* note 14 and accompanying text.

arbitration.<sup>68</sup> Thus, a member would not be permitted to effect the contemplated business expansion until FINRA determined whether or not a CMA would be required for such contemplated business expansion.

Four commenters expressed support for this proposed requirement,<sup>69</sup> with some commenters suggesting modifications. For example, NASAA recommended omitting the qualifying term “involved in sales” so that the proposed rule would apply to any associated person, irrespective of the nature of his or her employment at the member firm, who is subject to a claim, award or settlement, explaining that firms may assign an associated person with pending claims or unpaid awards to administrative, non-sales roles in order to circumvent a materiality consultation. GSU suggested that proposed IM-1011-2 should be expanded to apply to principals, control persons or officers as occasionally, associated persons from problematic firms may move on to become officers at larger firms.<sup>70</sup> If a materiality consultation results in the requirement to file a CMA, Cornell recommended that proposed IM-1011-2 should require the member to file the CMA within a specified timeframe (e.g., 30 days after FINRA’s finding of materiality).<sup>71</sup>

FSI raised a concern that proposed IM-1011-2 could require a member to undergo a materiality consultation to add a single registered person with a pending arbitration claim. FSI recommended that proposed IM-1011-2 should exclude such a business expansion when adding associated persons involved in sales to a member’s roster if done in connection with another corporate event such as a merger, acquisition, asset transfer or some other business expansion. FSI also recommended that the proposed rule exclude pending arbitration claims, explaining that a member should not be

potentially compelled to undergo an application review process so that FINRA can assess the member’s decision to hire one registered person with a pending arbitration claim, particularly when the claim is unsubstantiated. FSI noted that the proposed provision would have a negative impact on a member’s recruiting efforts by overreaching into a member’s routine hiring decisions.

As noted above, proposed IM-1011-2 is intended to address situations in which a member wants to hire an associated person who engages in sales with the public and has a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration and, therefore, may have a history of noncompliance. In the *Notice*, proposed IM-1011-2 also included a description of the possible outcomes of FINRA’s determination on a materiality consultation; that is, either a member firm would not be required to file a CMA in accordance with Rule 1017 and may effect the contemplated business expansion or the member must file a CMA in accordance with Rule 1017 and would not be permitted to effect the contemplated business expansion without FINRA’s approval of the CMA.

For clarity, FINRA has modified the language in proposed IM-1011-2 in two ways. First, proposed IM-1011-2 expressly states that the safe harbor for business expansions in IM-1011-1 is not available if a member firm is seeking to add one or more associated persons involved in sales with a covered pending arbitration claim (as defined in proposed Rule 1011(c)(1)), unpaid arbitration award, or unpaid settlement related to an arbitration. Second, proposed IM-1011-2, as modified, directs member firms to proposed Rule 1017(a)(6)(B) under which the description of the possible outcomes of FINRA’s determination on a materiality consultation now resides. Proposed IM-1011-2, as modified, and proposed Rule 1017(a)(6)(B) are intended to clarify that a member firm, before it considers hiring one or more associated persons involved in sales with a covered pending arbitration claim (as defined in proposed Rule 1011(c)(1)), unpaid arbitration award, or unpaid settlement related to an arbitration, must first seek a materiality consultation from FINRA.

Requiring a materiality consultation in this situation would give FINRA the opportunity to assess, among other things, the adequacy of any supervisory plan the member firm has in place for the individual, and to discuss with the member firm the potential impact on its finances if the member firm hires the

individual and the individual engages in future potential misconduct while employed at the member firm that results in an arbitration claim against the member firm. FINRA notes that, in general, materiality consultations are not lengthy processes, taking on average 12 days.

In addition, FINRA notes that with respect to pending arbitration claims, a materiality consultation would only be required if those claims individually or in the aggregate are substantial, i.e., exceed the hiring firm’s excess net capital. As described above, mandating a materiality consultation where a member is seeking to increase the number of associated persons involved in sales with covered pending arbitration claims, unpaid arbitration awards or unpaid settlements is to provide FINRA the opportunity to assess the relevant facts and circumstances of hiring such individuals and the impact, if any, on the member’s supervisory and compliance structure, among other considerations.

#### C. Mandatory Materiality Consultation for Any Acquisition or Transfer of Member’s Assets (Proposed Rule 1017(a)(6)(A))

Proposed Rule 1017(a)(6)(A) would require a member to seek a materiality consultation before effecting any direct or indirect acquisition or transfer of a member’s assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim, unpaid arbitration award, or unpaid settlement related to an arbitration.<sup>72</sup> The proposed rule would require a member to wait for FINRA’s determination on whether or not a CMA would be required for the contemplated acquisition or transfer.

Several commenters supported proposed Rule 1017(a)(6)(A) either unequivocally or with a minor qualification.<sup>73</sup> GSU expressed its support for the proposed provision insofar as it would prevent a member from acquiring or transferring a large amount of assets without first undergoing a materiality consultation in situations involving covered pending arbitration claims, unpaid arbitration awards or settlements, but recommended that smaller acquisitions or transfers involving such claims, awards or settlements should be

<sup>68</sup> FINRA notes that the term, “associated person involved in sales” as used in proposed IM-1011-2 and proposed Rule 1017(a)(6)(B) is derived from the safe harbor provision under IM-1011-1.

<sup>69</sup> See SIFMA, NASAA, GSU, and Cornell.

<sup>70</sup> FINRA notes that the proposed amendments relating to requiring a materiality consultation for asset acquisitions or transfers would apply to principals, control persons or officers with covered pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements moving between firms.

<sup>71</sup> FINRA does not believe that it is necessary to require the applicant to file the CMA within a specified time period because if a CMA is required, the applicant would not be able to effect the transaction without FINRA’s approval of the CMA and, therefore, FINRA believes the applicant would be incentivized to file the CMA for approval as soon as possible.

<sup>72</sup> In the *Notice*, this provision previously appeared as proposed paragraph (a)(4) in Rule 1017. The proposed rule change would renumber this provision as paragraph (a)(6)(A) in Rule 1017.

<sup>73</sup> See, e.g., Cornell, GSU, NASAA, and SIFMA.

permitted to proceed without a materiality consultation or CMA. Specifically, GSU recommended that FINRA should set a threshold of 10 percent, explaining that this threshold would allow the “occasional transfer” of customer accounts from one firm to another, but not allow an associated person to move a “meaningful percentage of his accounts to another firm.”

FSI stated that proposed Rule 1017(a)(6)(A) should exclude covered pending arbitration claims, noting that asset transfers that do not require a CMA under the current MAP rules should not be required to undergo a materiality consultation solely because the member or its associated person has a pending arbitration claim. FSI stated that proposed Rule 1017(a)(6)(A) could be interpreted as requiring a member that transfers any asset, no matter how immaterial, to undergo a materiality consultation and then potentially, a CMA, where the member or any of its associated persons may be subject to unsubstantiated, pending, investor arbitration claims.

While FINRA appreciates the commenters’ recommendation and concerns, FINRA has determined not to modify the proposal. As noted above, FINRA believes that the definition of a covered pending arbitration claim is sufficiently narrowly tailored to limit the extent to which a member would have to seek a materiality consultation, but would also capture those transactions that could result in investors not being paid should the claims go to award.

In the *Notice*, FINRA requested comment on whether proposed Rule 1017(a)(6)(A) should be limited to asset acquisitions or transfers involving a principal, control person or officer who has a covered pending arbitration claim, unpaid arbitration award, or unpaid arbitration settlement. Two commenters responded, opposing such limitation because it may provide an opportunity for circumvention.<sup>74</sup> NASAA stated that narrowing the scope of the proposed provision could allow a member to make staffing changes by temporarily shifting its principals, control persons or officers into administrative or other positions that fall outside the proposed provision. PIABA stated that a member’s solvency may be jeopardized by an associated person who is not a principal, control person or officer, but who may be engaged in selling away activities or “running a large scheme” without the member’s knowledge.

FINRA has determined not to limit proposed Rule 1017(a)(6)(A) to asset acquisitions or transfers involving principals, control persons or officers. FINRA believes that to help further address the issue of unpaid arbitration awards, the proposal should apply more broadly.

#### D. Definition of “Covered Pending Arbitration Claim”

The *Notice* defined the term “covered pending arbitration claim” for business expansions, and asset acquisitions and transfers as: (1) An investment-related, consumer-initiated claim filed against the associated person (for business expansions), or filed against the transferring member or its associated persons (for asset acquisitions and transfers) that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member’s excess net capital. Under both circumstances, the definition provided that such claim amount would include only claimed compensatory loss amounts, not requests for pain and suffering, punitive damages or attorney’s fees.

Two commenters discussed this definition.<sup>75</sup> FSI stated that the nexus between an associated person’s pending arbitration claim and a firm’s excess net capital is unclear as the firm at which the misconduct occurred would be the one to cover the claim, not the firm that is obligated to file the materiality consultation. NASAA recommended that the definition should expressly state that it includes all investment-related arbitration claims filed in any arbitration forum (*e.g.*, FINRA arbitration forum, a private alternative dispute resolution forum) or judicial (state or federal) forum). In addition, NASAA stated that the “claim amount” was unclear as to its treatment of pending claims for which there may be joint liability between more than one person or for which an associated person reasonably expects to be indemnified, explaining that pending claims with joint liability should be assessed to each respondent maximally, as if no other person could be potentially liable.

In response to comments, FINRA has modified the definition to clarify that a covered pending arbitration claim would include those filed in any arbitration forum, and that a pending claim with joint liability would be assessed to each respondent, as if no other person could be potentially liable. In addition, FINRA emphasizes that the definition would be applied only for

purposes of determining whether a materiality consultation would be required or not. The term is not intended to speak to whether the member would be responsible for satisfying the covered pending arbitration claim.

In the *Notice*, FINRA requested comment on whether the definition of “covered pending arbitration claim” should be limited to claims filed prior to a specified time period or event such as a public announcement of the contemplated transaction. Two commenters addressed this question.<sup>76</sup> SIFMA stated that the definition should include only those pending arbitration claims filed prior to public announcement of the contemplated transaction. PIABA stated that the definition should be broad and not be limited to claims filed prior to a specific date, but if a date is specified, then FINRA should require that any funds received in consideration for the transaction be frozen or subject to a lien in favor of the investor, pending the resolution of all pending arbitration claims filed within a certain period following the transaction closing.

FINRA has determined not to limit the proposed definition to only those claims filed prior to a specified date. At this time, FINRA believes that the definition of a covered pending arbitration claim is sufficiently narrowly tailored without adding a time limitation relating to when the arbitration claims are filed.

#### 5. Written Notification of Any Pending Arbitration Claim That Is Filed, Awarded, Settled or Becomes Unpaid Before Final Action Is Served on Applicant

FINRA is proposing to add a new provision to the application review process to require an applicant to provide prompt notification, in writing, of any pending arbitration claim that is filed, awarded, settled or becomes unpaid before a decision constituting final action of FINRA is served on the applicant. Two commenters expressed their views on proposed Rules 1013(c) and 1017(h).<sup>77</sup>

Cornell noted that the proposed provisions would enhance FINRA’s ability to monitor when pending arbitration claims are filed or when awards become unpaid during the application review process. NASAA recommended moving the language from proposed Rule 1013(c) to Rule 1013(a)(1)(H), which currently provides that an NMA must include

<sup>74</sup> See NASAA and PIABA.

<sup>75</sup> See FSI and NASAA.

<sup>76</sup> See PIABA and SIFMA.

<sup>77</sup> See Cornell and NASAA.

documentation of disciplinary history and certain regulatory, civil, and criminal actions, arbitrations, and customer complaints for the applicant and its associated persons, unless such history has been reported to the Central Registration Depository (CRD®). At this time, FINRA intends to retain the language as a standalone provision under proposed Rule 1013(c) to maintain clear parity with the language appearing under proposed Rule 1017(h). However, FINRA will consider NASAA's recommendation in connection with its separate proposal to substantially restructure the MAP rules.<sup>78</sup>

#### 6. Other Comments

UNLV recommended that FINRA consider proposing a rule to protect investors when FINRA members try to convert themselves into another area of the securities industry while facing covered pending arbitration claims or outstanding unpaid arbitration awards. IBN expressed the view that “[a]rbitration has nothing to do with the law it is about feelings[,]” suggesting that there needs to be two sets of rulebooks, one for small firms and the other for large firms. While FINRA acknowledges the commenters' concerns, their recommendations are beyond the scope of this proposed rulemaking and, therefore, FINRA has not addressed them here.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) By order approve or disapprove such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2019-030 on the subject line.

#### Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2019-030. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2019-030 and should be submitted on or before January 21, 2020.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>79</sup>

**J. Matthew DeLesDernier,**

*Assistant Secretary.*

[FR Doc. 2019-28021 Filed 12-27-19; 8:45 am]

**BILLING CODE 8011-01-P**

### SMALL BUSINESS ADMINISTRATION

#### Interest Rates

The Small Business Administration publishes an interest rate called the optional “peg” rate (13 CFR 120.214) on a quarterly basis. This rate is a weighted average cost of money to the government for maturities similar to the average SBA direct loan. This rate may be used as a base rate for guaranteed fluctuating interest rate SBA loans. This rate will be 1.88 percent for the January–March quarter of FY 2020.

Pursuant to 13 CFR 120.921(b), the maximum legal interest rate for any third party lender's commercial loan which funds any portion of the cost of a 504 project (see 13 CFR 120.801) shall be 6% over the New York Prime rate or, if that exceeds the maximum interest rate permitted by the constitution or laws of a given State, the maximum interest rate will be the rate permitted by the constitution or laws of the given State.

**Dianna L. Seaborn,**

*Director, Office of Financial Assistance.*

[FR Doc. 2019-28188 Filed 12-27-19; 8:45 am]

**BILLING CODE 8025-01-P**

### DEPARTMENT OF STATE

[Public Notice: 10986]

#### 30 Day Notice of Proposed Information Collection: Adoptive Family Relief Act Refund Application

**ACTION:** Notice of request for public comment and submission to OMB of proposed collection of information.

**SUMMARY:** The Department of State is seeking Office of Management and Budget (OMB) approval for the information collection described below. In accordance with the Paperwork Reduction Act of 1995, we are requesting comments on this collection from all interested individuals and organizations. The purpose of this Notice is to allow 30 days for public comment.

**DATES:** Submit comments directly to the Office of Management and Budget (OMB) up to January 29, 2020.

**ADDRESSES:** Direct comments to the Department of State Desk Officer in the Office of Information and Regulatory Affairs at the Office of Management and Budget (OMB). You may submit comments by the following methods:

- *Email:* [oir-submission@omb.eop.gov](mailto:oir-submission@omb.eop.gov). You must include the DS form number, information collection

<sup>78</sup> See Notice 18–23.

<sup>79</sup> 17 CFR 200.30–3(a)(12).