

**FINRA AMENDS ITS MEMBERSHIP APPLICATION PROGRAM
TO INCENTIVIZE PAYMENT OF ARBITRATION AWARDS**

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FINRA has amended the rules governing its Membership Application Program (MAP) to address pending arbitration claims and to incentivize the payment of unpaid arbitration awards and settlements.¹ The MAP rules govern FINRA’s review of new membership applications (NMA) and continuing membership applications (CMA) and are designed to promote investor protection through uniform admission standards and for the review of member firms’ changes to ownership, control, or business operations.² Generally, these rules require applicants to demonstrate the ability to comply with applicable federal securities laws and FINRA rules, including adherence to “high standards of commercial honor and just and equitable principles of trade.”³ Under the amended rules, FINRA must also consider whether “an [a]pplicant or Associated Person is the subject of a pending arbitration claim.”⁴

The amendments to FINRA’s MAP rules are designed to address concerns 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 the payment of the claims should they go to award or result in a settlement by shifting assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.”⁵ These amendments focus on four key changes to the MAP rules:

- (1) mandatory materiality consultations for certain changes to ownership, control, or business operations of a member firm, involving a “covered pending arbitration award” or unpaid arbitration awards or settlements;
- (2) rebuttable presumption to deny an NMA where the applicant or associated person is subject to a pending arbitration claim;
- (3) demonstration of the applicant’s ability to satisfy pending arbitration claims, unpaid arbitration awards or

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arbitration settlements, or other adjudicated customer awards; and

- (4) notification of pending arbitration claims and unpaid arbitration awards or settlements.

Mandatory Materiality Consultations

FINRA Rule 1017 identifies instances where proposed changes to a member's ownership, control, or business operations require that member to file a CMA and to obtain FINRA's approval of those changes. However, FINRA IM-1011-1 provides "safe harbor" guidance on the types of incremental business expansions that are not considered to be material and therefore do not require the filing of a CMA. In some cases, where a proposed change does not fit clearly within one of the Rule 1017 categories, the member firm may request a materiality consultation with FINRA to determine whether the member needs to file a CMA.

Prior to the amended MAP rules, this materiality consultation was exclusively voluntary. Under the amended rules, however, to incentivize the payment of arbitration awards and settlements, a member is required to seek a materiality consultation in two distinct situations involving pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements (where the member is not otherwise required to file a CMA). These two situations include a member's contemplated addition of one or more associated persons involved with sales and a member's acquisition or transfer of a

member's assets, business, or line of operations. These new rules allow FINRA to better assess, among other things, the anticipated activities of the additional principals or registered representatives; the associated impact of the applicant's supervisory and compliance systems and finances; and the impact on protections for customers by adding the new personnel. The rules also permit FINRA to address the sufficiency of the applicant's plans to satisfy pending arbitration claims or unpaid arbitration awards or settlements.

Mandatory Consultations for Business Expansion to Add One or More Associated Persons Involved in Sales

Under the new Rule 1017(a)(6)(B), a member is required to request a materiality consultation with FINRA if it wants to add one or more associated persons involved in sales⁶ who has a "covered pending arbitration claim,"⁷ an unpaid arbitration award, or unpaid arbitration settlement, and the member is not otherwise required to file a CMA. As part of this materiality consultation, FINRA will determine whether the member is required to file a CMA. Under this scenario, the member firm cannot avail itself of the safe harbor provisions in IM-1011.1, as instructed by the new IM-1011-2.⁸

Mandatory Consultations for Acquisition or Transfer of Member's Assets

Similarly, under new Rule 1017(a)(6)(A), a member must request a materiality consultation with FINRA if it contemplates "any direct or indirect acquisition or transfer of a member's assets or any asset, business, or line of operations where the transferring

member or an Associated Person of the transferring member has a Covered Pending Arbitration Claim.”⁹ As noted above, this consultation is mandatory only where the member is not otherwise required to file a CMA. During this mandatory consultation, FINRA will determine whether the member needs to file a CMA.

Rebuttable Presumption to Deny an NMA

Rule 1014(b)(1) requires FINRA to consider the 14 standards under Rule 1014(a)(1)-(14) when granting or denying an NMA or a CMA. Under Rule 1014(a)(3) (Standard 3), FINRA must determine whether an applicant and its associated persons are capable of compliance with federal securities laws, related rules and regulations, and FINRA rules. Under the amended rules for Standard 3, FINRA also will be required to consider whether the “[a]pplicant or Associated Person is the subject of a pending arbitration claim.”¹⁰ Where there is such a claim involving an NMA, amended Rule 1014(b)(1) creates a presumption to deny the NMA.¹¹ This particular presumption does not apply to CMAs. The applicant for new membership can overcome this presumption by showing it can meet each of the 14 standards in Rule 1014(a), including satisfaction of any pending arbitration claim that goes to award or settlement.

This presumption of denial aids FINRA in addressing concerns related to NMAs where the applicant expects to hire principals and registered persons with pending arbitration claims. The applicant is required to demonstrate its ability to pay those claims if they go to award or result in settlement and to show how it will effectively supervise

individuals with a history of noncompliance. In the NMA process, this presumption shifts the burden to the applicant and promotes investor protection by heightening the scrutiny of certain prospective member firms. In the end, however, FINRA expects this presumption to have relatively little adverse impact on NMAs.¹²

Demonstration of Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Customer Awards or Arbitration Settlements, or Pending Arbitration Claims

Where a presumption of denial exists with respect to an NMA or a CMA, Rule 1014(b)(1) permits the applicant to rebut the presumption by demonstrating that it can nonetheless satisfy each of the standards in Rule 1014(a). As noted above, the presumption of denial concerning pending arbitration claims does not apply to CMAs. For CMAs, as it does today, FINRA would consider any pending arbitration claims when assessing whether the applicant or its associated persons can comply with relevant federal securities laws, rules, and regulations and FINRA rules.¹³

With new IM-1014-1, FINRA clarifies the various ways an NMA or CMA applicant can show its ability to satisfy “unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements or . . . pending arbitration claims.” Applicants can meet this standard through, among other things, “an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund or the retention of proceeds from an asset transfer.” In addition, the applicant can

provide the written opinion of legal counsel concerning the value of a pending arbitration claim. However, to overcome a presumption of denial for an NMA or a CMA, the applicant must guarantee that any funds used by the applicant to demonstrate its ability to satisfy a claim, award, or settlement will be used for that purpose. FINRA will use a reasonableness standard in assessing an applicant's ability to satisfy these outstanding obligations.

Notification of Pending Arbitrations or Unpaid Arbitration Awards or Arbitration Settlements

FINRA has added Rules 1013(c) (for NMAs) and 1017(h) (for CMAs) to require applicants to promptly notify FINRA, in writing, of any arbitration claim involving the applicant or its associated persons "that is filed, awarded or becomes unpaid before" FINRA's final decision on an application. As a result, according to FINRA, any such unpaid arbitration award, other adjudicated customer award, unpaid arbitration settlement, or (for NMAs only) pending arbitration claim arising during a pending application will allow FINRA to presumptively deny the application as provided by amended Rule 1014(b)(1).¹⁴ The applicant will then have an opportunity to demonstrate its ability to satisfy the obligation as provided in Rule 1014(b)(1) and discussed in IM-1014-1. This notification requirement provides FINRA with the opportunity to review any pending

arbitration claims or unpaid arbitration awards or settlements to determine whether an applicant is able to satisfy its outstanding obligations.

Impact of MAP Amendments

FINRA's amendments are designed to strengthen the MAP rules, to enhance review of membership applications, and to provide additional protections to investors. In essence, FINRA's amendments to the MAP rules shift the burden of an unpaid customer arbitration award from the associated person to the member firm. The amendments also increase the regulatory burden and economic costs to member firms that have, or that seek to hire, associated persons with pending arbitration claims, or unpaid arbitration awards or settlements.

However, there are limits to the amended MAP rules. For example, FINRA's amendment to the MAP rules specifically targets customer-initiated arbitrations and awards, but does not appear to be applicable to arbitrations initiated by, nor to awards obtained by, a member firm (e.g., an arbitration or award for repayment of a promissory note). Additionally, the amended MAP rules may have little impact on associated persons moving among larger member firms, as mandatory materiality consultations are triggered only if the amount of the pending arbitration claim exceeds the hiring member's excess net capital.

¹ These amendments are effective September 14, 2020. FINRA’s related Notice to Members 20-15 (2020) is located here <https://www.finra.org/rules-guidance/notices/20-15>. The text of the new rules and related interpretive materials are attached to the Notice as Attachment A.

² FINRA, Notice to Member 18-06 at 9 (February 8, 2020).

³ FINRA Rule 1014(a)(3)(A)-(H) (identifies those factors that FINRA must consider in determining whether the applicant can demonstrate this compliance).

⁴ FINRA Rule 1014(a)(3)(E). The amendments also remove “pending arbitration” from Rule 1014(3)(B)’s factors, leaving consideration of an applicant’s or associated person’s sales practice history and any pending civil action under that subsection.

⁵ FINRA, Notice to Members 20-15 (May 21, 2020).

⁶ The safe harbor in IM-1011-1 defines an “associated person involved sales” as “all Associated Persons, whether or not registered, who are involved in sales activities with public customers, including sales associates and cold callers, but excludes clerical, back office, and trading personnel who are not involved in sales activities.”

⁷ A “covered pending arbitration claim” for purposes of Rule 1017(a)(6)(B) means “[a]n investment-related, consumer initiated claim filed against the Associated Person in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the hiring member’s excess net capital.” According to FINRA, the claim amount would be limited to compensatory losses and would not include damages related to pain and suffering, punitive damages, or attorney’s fees. In addition, the claim 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, Notice to Members, 20-15 n.15.

⁸ FINRA IM-1011-2 provides:

The safe harbor for business expansions in IM-1011-1 is not available to any member that is seeking to add one or more Associated Persons involved in sales and one or more of those Associated Persons has a Covered Pending Arbitration Claim (as defined in Rule 1011(c)(1)), an unpaid arbitration award or unpaid settlement related to an arbitration; in such circumstances, if the member is not otherwise required to file a Form CMA in accordance with Rule 1017, the member must comply with the requirements of Rule 1017(a)(6)(B).

⁹ For purposes of this provision, a “covered pending arbitration claim” is governed by the definition in Rule 1011(c)(2), which provides that such a claim includes “[a]n investment-related, consumer initiated claim filed against the transferring member or its Associated Persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member’s excess net capital.” The amount of “covered pending arbitration claims” under Rule 1017(a)(6)(A) are limited to compensatory losses and the other restrictions applicable to these claims under Rule 1017(a)(6)(B). *See supra* n. 6.

¹⁰ FINRA Rule 1014(a)(3)(E).

¹¹ There are other factors that can create a presumption of denial under Rule 1014(b)(1) for both NMAs and CMAs. We address only the changes under the new rules here.

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¹² See Securities and Exchange Commission Release No. 34-88482, n. 60 (March 26, 2020) (FINRA denied 13 out of 317 NMAs for a roughly two-year period where applicant or associated persons had pending arbitration claim at time of application).

¹³ FINRA, Notice to Members 20-15 at 6.

¹⁴ FINRA, Notice to Members 20-15 at 7.

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