Broker-Dealer M&A Transactions: Toward a More Accommodating Regulatory Process

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M&A transactions involving regulated broker-dealers often require Financial Industry Regulatory Authority (FINRA) approval under NASD Rule 1017. Such approval is required for any direct or indirect acquisition by a broker-dealer of another broker-dealer,[1] change in control of a broker-dealer or "material change in business operations" of a broker-dealer.

Rule 1017 has gained prominence in light of recent consolidation within the independent broker-dealer industry, which experienced a decrease in broker-dealers registered as members of FINRA from 4,905 in 2008 to 4,105 as of October 2014.[2] The consolidation has been driven by low interest rates (which have harmed independent broker-dealers by decreasing revenues from lending on margin) and difficult business conditions following the credit crisis. At the same time, the requirements of Dodd-Frank and other new regulations have imposed additional compliance costs on independent broker-dealers.

The timing and ultimate outcome of the Rule 1017 process are often critical factors in broker-dealer M&A transactions. Participants in broker-dealer M&A transactions may be unable, without FINRA assistance, to determine whether a transaction requires approval under Rule 1017. If Rule 1017 approval is required, uncertainties as to the likely timing for approval may further complicate the transaction.

Scope of Rule 1017 in the Context of M&A Transactions

A FINRA member broker-dealer that undergoes any of the changes described in Rule 1017 is required to file an application for FINRA's approval under the rule. Some common examples of transactions requiring Rule 1017 approval include:

- acquisition or disposition of a controlling block of the equity securities of a broker-dealer, or of an equity interest that represents less than a controlling interest but 25 percent or more of the outstanding equity securities of the broker-dealer;
- acquisition or disposition of an asset management firm that includes a broker-dealer subsidiary or affiliate (such as a hedge fund management firm that uses a broker-dealer subsidiary to trade securities and/or raise capital for its funds and other products); and
- acquisition or disposition of assets that will materially change the business operations of the acquiring and/or disposing broker-dealer, such as may be encountered in the acquisition of a material amount of revenues attributable to sales of securities (e.g., mutual funds).

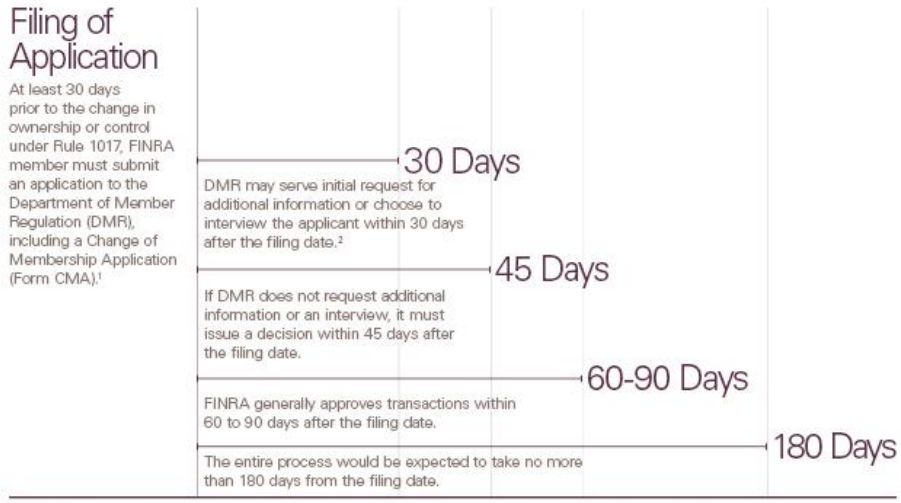
FINRA approval is required as a condition to closing each of the foregoing types of transactions and, in many cases, requires a longer period of time than any other closing condition — thus becoming the "critical path" to completing the deal.

Uncertainties in the Rule 1017 Process

Participants in M&A transactions involving FINRA members face uncertainty regarding the timing of the Rule 1017 process, from initial consultations, through the formal application process, to the effective date of FINRA approval. Moreover, the facts and structure of many

transactions present no clear answer to the threshold question of whether FINRA approval is necessary.

Rule 1017 Timeline



[1] *NASD Notice to Members 12-33* (2012), *available at* https://www.finra.org/Industry/Regulation/Notices/2012/P131267.

[2] DMR also may interview applicant within 30 days after the date of any request for more information. If DMR requests additional information or membership interview, it must issue a decision within 30 days after the later of the filing of the requested information or the conclusion of the interview.

For example, deal participants may be unable, without FINRA assistance, to determine whether a transaction will result in a "material change in business operations" of a broker-dealer for the purposes of Rule 1017. FINRA defines a material change in business operations as removing or modifying a membership agreement restriction; market making, underwriting or acting as a dealer for the first time; or adding business activities that require a higher minimum net capital. However, this definition is not all-inclusive. FINRA has further provided that whether any particular business expansion is material will depend on the following factors:[3]

- the nature of the proposed expansion;
- the relationship, if any, between the proposed new business line and the firm's existing business;
- the effect the proposed expansion is likely to 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 proposed expansion or addition.

A limited safe harbor exists for firms that do not have a membership agreement, firms with restrictions in their membership agreements that would conflict with the expansions allowed under the safe harbor, and firms that do not have a disciplinary history. Firms that can invoke the safe harbor can expand — up to prescribed numbers — the number of Associated Persons involved in sales, the number of offices or the number of markets made without triggering a material change in business operations. Exceeding the prescribed numbers may or may not constitute a material change in business operations.

Toward a More Efficient Process

Efficient execution of mergers and acquisitions involving registered broker-dealers may be compromised by lengthy processes to obtain the consent (or advice as to the requirement for such consent) of regulators, such as FINRA. FINRA staff members have been willing to conduct "materiality consultations" regarding whether a transaction will result in a material change in business operations of a broker-dealer.[4] In practice, however, at least prior to the developments of this past year, the response by FINRA to a materiality consultation could be lengthy enough to discourage transacting parties from using the process and instead opt to simply submit the Rule 1017 application.

Recent developments indicate that the FINRA staff is taking steps to expedite its responses to requests for materiality consultations in connection with a potential "material change in the business operations" of a broker-dealer under Rule 1017, including adding staff dedicated to materiality consultations. Participants in broker-dealer M&A transactions can be expected to welcome any endeavors by FINRA to expedite the materiality consultation process and to increase the transparency and formality of that process. To that end, written procedures — including prescribed time periods for FINRA responses — could be particularly helpful.

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[1] NASD Rule 1017(a)(2), (a)(4), (a)(5) (2014).

[2] Fin. Indus. Regulatory Auth., *FINRA Statistics & Data*, FINRA, http://www.finra.org/Newsroom/Statistics/ (last visited Nov. 25, 2014).

[3] NASD Rule 1011(k) (2014); NASD IM-1011-1 (2006); National Ass'n of Sec. Dealers, *NASD Notice to Members* 00-73 (2000), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003977.pdf. A FINRA Hearing Panel applied some of these factors to find that a firm in the general retail securities business had made a material change in business operations by selling four types of financial products that were not contemplated by its membership agreement and the nature of which was found by the Hearing Panel to be materially different from ordinary equities that the firm was allowed to sell, both "in terms of the sale of the products and the supervision of the sales." *Dep't of Enforcement v. Merrimac Corporate Sec., Inc.*, Complaint No. 2007007151101, 2010 FINRA Discip. LEXIS 41 (Dec. 8, 2010), *aff'd*, 2012 FINRA Discip. LEXIS 43 (May 2, 2012).

[4] Nat'l Ass'n of Sec. Dealers, *NASD Notice to Members* 13-11 (2013), available at https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p217586.pdf; *Continuing Membership Guide: CMA Requirements*, http://www.finra.org/Industry/Compliance/Registration/MemberApplicationProgram/CMGuide/P009723 (last visited Jan. 16, 2015).

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