



March 7, 2014

FINRA Announces Proposed Rules for Limited Corporate Financing Brokers

Overview

In late February, the Financial Industry Regulatory Authority (“FINRA”) released Regulatory Release 14-09, and requested public comment on the proposed rules (the “LCFB Rule Set”) for a new category of broker-dealer called the Limited Corporate Financing Brokers (“LCFB”). The LCFB Rule set will be comprised of new FINRA rules 010 to 1000. The comment period ends April 28, 2014.

The proposed registration category and LCFB Rule Set appears to be FINRA’s response to the perception that FINRA applies a one-size fits all set of rules to broker-dealers. This includes firms that provide corporate financing, mergers and acquisitions advice, advising issuers on raising debt and equity capital in private placements with institutional investors, or advisory services on a consulting basis, analyzing strategic and financial alternatives. This regulatory approach has created excessive regulatory costs and structure that does not address broker-dealers that are only registered with FINRA so that they can receive transaction-based compensation as part of their services.

There are many broker-dealers that do not engage in the types of activities typically associated with traditional broker-dealers. To that end, they do not maintain customer accounts, handle customer funds or securities, accept orders to purchase or sell securities either as principal or agent for the customer, exercise investment discretion on behalf of any customer, or engage in proprietary trading of securities or market-making activities, but because they receive transaction-based compensation as part of their services, they are FINRA member firms.

While some still perceive a disconnection between FINRA’s vision of regulatory oversight, the proposed legislation for M&A activities and the SEC’s current position on M&A Brokers, it is clear that FINRA is attempting to simplify the rules for LCFB’s. Under the proposed LCFB Rule Set, FINRA is proposing to relax a number of regulatory requirements for LCFB’s. This should result in lower regulatory costs in terms of money and resources for LCFB firms. While the LCFB Rule Set still imposes obligations on these limited brokers that appear to not be relevant to their business, this also represents a significant shift that will be welcomed by the member firms engaged in the limited corporate finance business.

LCFB Business Activities

For purposes of the LCFB Rule Set, a “limited corporate financing broker” is defined as any broker that solely engages in one or more of the following activities:

- advising an issuer, including a private fund, concerning its securities offerings or other capital raising activities;
- advising a company regarding its purchase or sale of a business or assets or regarding its corporate restructuring, including a going-private transaction, divestiture or merger;
- advising a company regarding its selection of an investment banker;
- assisting in the preparation of offering materials on behalf of an issuer;
- providing fairness opinions; and
- qualifying, identifying or soliciting potential institutional investors.

A firm would be permitted to register as, or change its status to an LCFB, only if the firm solely engages in one or more of these activities.

The term “limited corporate financing broker” would not include any broker or dealer that:

- carries or maintains customer accounts;
- holds or handles customers’ funds or securities;
- accepts orders from customers to purchase or sell securities either as principal or as agent for the customer;
- possesses investment discretion on behalf of any customer; or
- engages in proprietary trading of securities or market-making activities.

Application with FINRA as a LCFB

The member application process for LCFB’s generally follows the current NASD Rule 1017 procedures for membership, with a few modifications included the LCFB Rule Set. First, an applicant for membership that seeks to qualify as an LCFB would have to state in its application that it intends to operate as such. Second, in reviewing an application for membership as an LCFB, the FINRA Member Regulation Department would consider, in addition to the standards for admission set forth in NASD Rule 1014, whether the applicant’s proposed activities are consistent with the limitations imposed on an LCFB under LCFB Rule Set.

The LCFB Rule Set allows for an existing member firm that is already approved to engage in the activities of an LCFB, to not be required to file either a New Member Application (“NMA”) or a Change in Membership Application (“CMA”), where the firm does not intend to change its existing ownership, control or business operations. Instead, such a firm would be required to file a request to amend its membership agreement or obtain a membership agreement (if none exists currently) to provide that: (i) the firm’s activities will be limited to those permitted for an LCFB, and (ii) the firm agrees to comply with the LCFB Rules. Finally, the LCFB Rule Set allows for an existing LCFB to terminate its status as such and continue as a FINRA firm. Such a firm would be required to file a CMA with the FINRA Member Regulation Department, and to amend its membership agreement to provide that the firm agrees to comply with all FINRA Rules.

Registration and Qualification

LCFB firm principals and representatives would generally be subject to the same registration and qualification examination requirements as principals and representatives of other FINRA firms. However, LCFB firm principals and representatives would be eligible for fewer registration categories. LCFB principals would be eligible to register as a general securities principal (Series 24), limited principal-financial and operations (Series 27), limited principal-introducing broker-dealer financial and operations (Series 28), and limited principal-general securities sales supervisor (Series 9 and 10). LCFB associated persons would be eligible to register as a general securities representative (Series 7), limited representative-corporate securities (Series 62), limited representative-private securities offerings (Series 82), limited representative-investment banking (Series 79) and operations professional (Series 99).

Areas of Relaxed Regulatory Oversight

FINRA has reduced some of its regulatory requirements for LCFB's, including:

Anti-Money Laundering (“AML”) Examinations. While LCFB's are required to have an AML Program, they will only have to provide for independent testing every two years.

Annual Compliance Meetings. LCFB's would not be required to have annual compliance meetings for all covered representatives and principals where matters relevant to the activities of the representatives and principals are discussed.

Communication with the Public. An abbreviated version of FINRA Rule 2210 has been proposed which essentially prohibits false and misleading statements and requires that communications be based on principles of fair dealing and good faith, must be fair and balanced and provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.

Continuing Education. Under the LCFB Rule Set, LCFB's would not be subject to the regulatory element of FINRA's continuing education requirements. However, FINRA would impose annual firm element requirements for any person registered with an LCFB, who has direct contact with customers in the conduct of the firm's corporate financing activities, and to their immediate supervisors. Additionally, FINRA would have the right to require an LCFB to provide special training to its covered persons in such areas as FINRA deems appropriate.

Customer Information. Because an LCFB would not carry or maintain customer accounts, it would have more limited customer information requirements than is imposed under FINRA Rule 4512. It is anticipated that a LCFB would maintain the clients name and residence, whether the customer is of legal age (if applicable), and the names of any persons authorized to transact business on behalf of the customer.

Know Your Customer (“KYC”) Obligations. Every LCFB would be required to use reasonable diligence to know the essential facts concerning every customer and the authority of each person acting on behalf of such customer. The facts “essential” to KYC are those required to: (a) effectively service the customer, (b) understand the authority of each person acting on behalf of the customer, and (c) comply with applicable laws, regulations and rules

Internal Inspections. LCFB’s would not be required to conduct a review annually of the businesses in which it engages and all Office of Supervisory Jurisdiction’s and or internal inspections of branch offices pursuant to FINRA Rule 3110 (c).

3012 Review of Supervisory Controls Systems and Annual Verification. LCFB’s would not be subject to FINRA Rule 3012 and would not have to establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the member's supervisory procedures are reasonably designed to comply with applicable securities laws and FINRA rules, nor would the Chief Executive Officer be required to certify them annually.

Regulatory Regulation Common to all Brokers

A number of the LCFB Rule Set are incorporated by reference to existing FINRA rules or subject to new limited rules. The following sets forth a few of the significant regulatory rules that will be included, and should be given special considered when reviewing and or commenting the FINRA Rule Set:

Financial and Operational Rules. An undercurrent in this next generation of securities regulations is a recognition by the regulators and the legislators that extensive financial reporting requirements are not critical for customer protection purposes, especially where the target investor is an “institutional” investor. This issue is of substantial importance because it is one of the largest, single costs that the small, limited broker faces. That being said, the LCFB Rule Set does require an LCFB to comply with the applicable net capital requirements set forth in SEA Rule 15c3-1, the requirement to maintain a FINOP, to have an annual Public Company Oversight Accounting Board (“PCOAB”) financial audit and to maintain a fidelity bond.

Purchasers Limited to Institutional Investor. An LCFB would not be permitted to qualify, identify or solicit potential purchasers of securities, unless the purchaser meets the definition of “institutional investor”. However, an LCFB would be allowed to serve clients (such as individuals or entities seeking advice on securities offerings or sale of businesses), who do not meet the “institutional investor” definition. The term “institutional investor” would have the same meaning as that term has under FINRA Rule 2210 (Communications with the Public). The term would include any: bank, savings and loan association, insurance company or registered investment company; governmental entity or subdivision thereof; or employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but does not include any participant of such plans, other person (whether a natural person, corporation, partnership, trust, family office or otherwise) with total assets of at least \$50 million; and any person acting solely on behalf of any such institutional investor.

Due Diligence on Investors. While the KYC Rules are being amended, a LCFB firm will have to have a reasonable basis to believe that a recommended transaction or investment strategy is suitable for the institutional customer. To this end, a customer's investment profile includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose in connection with a

recommendation. The limited corporate financing broker or associated person may not disclaim any responsibilities under this Rule.

Other Rules Common to all Dealers. In addition to the LCFB Rules discussed above, the proposed LCFB Rules include a number of rules that are common to all brokers. A number of these are set forth below, and are implemented by either incorporation by reference or by the proposed rules.

- Proposed LCFB Rule 324 (Borrowing from or Lending to Customers);
- Proposed LCFB Rule 327 (Outside Business Activities of Registered Persons);
- Proposed LCFB Rule 313 (Designation of Chief Compliance Officer);
- FINRA and NASD Rule 1150 (Executive Representative);
- NASD Rule 1160 (Contact Information Requirements);
- FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade);
- FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices);
- FINRA Rule 2070 (Transactions Involving FINRA Employees);
- FINRA Rule 2080 (Obtaining an Order of Expungement of Customer Dispute);
- FINRA Rule 2263 (Arbitration Disclosure to Associated Persons);
- FINRA Rule 2268 (Requirements When Using Pre-Dispute Arbitration Agreements);
- NASD Rule 2420 (Dealing with Non-Members);
- IM-2420-1 (Transactions Between Members and Non-Members);
- FINRA Rules 3220 (Influencing or Rewarding Employees of Others);
- FINRA Rule 3110 (with respect to the supervision of offices, personnel, customer complaints, correspondence and internal communications);
- FINRA Rules 4150 (Guarantees by, or Flow through Benefits for, Members);
- FINRA Rule 4160 (Verification of Assets);
- FINRA Rule 4511 (Books and Records – General Requirements);
- FINRA Rule 4513 (Records of Written Customer Complaints)
- FINRA Rule 4530 (Reporting Requirements)
- FINRA Rule 4570 (Custodian of Books and Records);
- NASD Rule 3170 (Mandatory Electronic Filing Requirements).
- FINRA Rule 8000 series governing investigations and sanctions of firms (other than FINRA Rules 8110, 8211 and 8213);
- FINRA Rule 9000 series governing disciplinary and other proceedings involving firms (other than Procedures on Grievances Concerning the Automated Systems).
- FINRA Rule 10000 – 14000 series (Code of Arbitration Procedure, Code of Arbitration Procedure for Industry Disputes and the Code of Mediation Procedure)

Summary

While FINRA's proposal represents a major shift from their historical position it is still significantly more intrusive than the regulatory position of the SEC, legislative branch and state regulators. The proposed LCFB Rule Set should provide a substantial reduction in the costs borne by an LCFB in its regulatory compliance obligations as a FINRA member firm. With that said, if your firm qualifies as an LCFB, you have an opportunity to help shape the final LCFB rules that are implemented by forwarding your comments to FINRA by April 28, 2014.

We hope that this information has been helpful to you. Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail or phone, at 281-367-2454, or consult with your legal counsel or compliance consultant. This legal update has been provided to you courtesy of The LeGaye Law Firm, P.C., 2002 Timberloch Drive, Suite 200, The Woodlands, Texas 77380. Visit our web site at www.legayelaw.com.

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http://www.finra.org/Industry/Regulation/Notices/2014/P449587?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+FinraNotices+%28FINRA+Notices%29

Rule Set

<https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p448158.pdf>

Applicable Net Capital

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