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April 17, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE.
Washington, D.C. 20549-1090

Re: SR-FINRA-2008-067

Dear Ms. Murphy:

We submit this letter in response to a request by the Securities Exchange Commission ("SEC") in Release No. 34-59273 (the "Proposing Release")[1] for comments concerning the proposed consolidated Financial Industry Regulatory Authority, Inc. ("FINRA") rules governing financial responsibility. Our comments are limited to proposed FINRA rule 4110(c) (the "Proposed Rule"). The Proposed Rule would prohibit a member from withdrawing equity capital for a period of one year, unless otherwise permitted by FINRA in writing. We appreciate the opportunity to comment on the Proposed Rule.

I. Background

Since the early 1970s, the SEC has expressed concern over broker-dealers whose equity capital structure is not "sufficiently permanent."[2] When the SEC revised rule 15c3-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") to impose notification requirements and to authorize the SEC to limit withdrawals of excess net capital, the SEC addressed the topic directly. According to the SEC in its adopting release (the "Adopting Release"):[3]

> "[T]he net capital maintained in a broker-dealer should be permanent capital and not merely a temporary infusion of funds from an affiliate or other sources. For example, there are instances where a broker-dealer receives funds from an affiliate in an

[1] 74 Fed. Reg. 4992 (Jan. 28, 2009).

[2] *See* Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 231, 92nd Cong., 1st Sess. (December 28, 1971) (identifying the "impermanence of capital" as one of the major structural weaknesses giving rise to the Securities Investor Protection Act of 1970); Letter from Nelson Kibler (Assistant Director, SEC Division of Market Regulation) to John Pinto, Sept. 8, 1980.

[3] Exchange Act Release No. 34-28927 (Feb. 28, 1991).

> amount that would enable the broker-dealer to engage in a transaction that it would otherwise be prohibited from doing because of minimum net capital requirements. If the funds are transferred back to the affiliate within a relatively short period of time after the transaction, the [SEC] questions whether the funds transferred into the broker-dealer entity could properly be characterized as capital of the firm. Instead, the transaction could be viewed as a loan by the affiliate to the broker-dealer, with the result that the broker-dealer would have to treat the transaction as a liability. Moreover, the [SEC] does not believe it is appropriate for holding companies to temporarily transfer funds into their broker-dealer subsidiaries for reporting or other purposes."[4]

Quite clearly, the SEC was concerned about infusions of equity capital that are intended to be temporary and that are effected for the purpose of increasing a broker-dealer's regulatory net capital to effect a transaction requiring such an increase, or to report increased net capital. In both of the situations described by the SEC, the broker-dealer receives equity capital that it (i) knows to be temporary, (ii) knows to be intended for a specific purpose, and (iii) knows will be returned to its original source. Under these circumstances, the infusion does bear some resemblance to a loan. The broker-dealer is given equity capital temporarily, for a specific purpose, and must give it back.

In subsequent years, FINRA's predecessor organization, the National Association of Securities Dealers, Inc. ("NASD"), significantly expanded the plain meaning of the language used by the SEC in the Adopting Release. In 1998, the NASD announced that the SEC must have intended for equity capital to be "permanent capital" when it is held by the broker-dealer for at least one year. According to the NASD:

> "The SEC has emphasized that the net capital maintained in a member should be permanent capital and not a temporary infusion of funds. Permanency of capital has been deemed to be a minimum of one year duration. The SEC Division of Market Regulation has taken the position that funds temporarily deposited into a member entity and withdrawn shortly thereafter should be regarded as a loan and considered a liability of the member."[5]

This interpretation of "permanent capital" — requiring a one-year duration — had no written SEC precedent at all. In 2000, the SEC Staff engaged in an interpretive expansion of its own (albeit a more limited one). In an interpretive letter to the New York Stock Exchange, Inc. ("NYSE") and NASD Regulation, Inc. ("NASD Regulation"), the Staff of the Division of Market Regulation expressed the view that a capital contribution received by a broker-dealer

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[4] Adopting Release, at 4-5.
[5] 1998 Regulatory & Compliance Alerts, Vol. 12, No. 4.

from an individual investor that is withdrawn within one year cannot be included in the net capital computations of the broker-dealer. Specifically:

> "It is the view of the Division that, for net capital purposes, if an individual investor contributes capital to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the individual investor, the contribution of the individual investor may not be included in the firm's net capital computation and must be re-characterized as a liability. Any withdrawal of capital as to that investor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of [r]ule 15c3-1, shall be presumed to have been contemplated at the time of the contribution."[6]

Here again, the SEC Staff expressed concern about infusions of equity capital that the broker-dealer knows (or should know) will be temporary, intended for a specific purpose, and then returned to their original source. When an individual investor contributes equity capital to a broker-dealer for proprietary trading and then seeks its return within a year, the transaction bears some of the characteristics of a loan. The broker-dealer has received equity capital temporarily, for a specific purpose, and is obligated to return the capital to the original source. These are narrow circumstances. The SEC Staff did not express concerns about infusions of equity capital that the broker-dealer does not know (or should not know) would be temporary. The SEC Staff did not express concerns about infusions of equity capital that are received by the broker-dealer from one equity investor and then, for legitimate business reasons, directed somewhere else.

FINRA ignored these subtleties. In its initial proposal, FINRA proposed that:

> "[a]ny equity capital contributed by a member may not be withdrawn for a period of one year, unless otherwise permitted by FINRA in writing."[7]

FINRA received critical comments from interested parties.[8] FINRA responded by adding a sentence to its one-year prohibition, clarifying that it would not preclude the withdrawal of "profits earned." According to the Proposed Rule:

> "Any equity capital contributed by a member may not be withdrawn for a period of

[6] Interpretive letter from Michael A. Macchiaroli (Associate Director, SEC Division of Market Regulation) to Raymond J. Hennessy (Vice President, NYSE) and Susan DeMando (Vice President, NASD Regulation) (the "Interpretive Letter"), Feb. 23, 2000, at 2 (footnote omitted).

[7] FINRA Regulatory Notice 08-23, at 12 (May 9, 2008).

[8] *See, e.g.*, comment letter from Northwestern Mutual Investment Services, LLC (June 13, 2008); comment letter from Financial Services Institute (June 13, 2008).

> one year, unless otherwise permitted by FINRA in writing. Subject to the requirement of paragraph (c)(2) of this [r]ule, this paragraph shall not preclude a member from withdrawing profits earned."[9]

Like the initial proposal, the Proposed Rule broadly prohibits withdrawals of equity capital that are made within one year of the broker-dealer having received an equity capital contribution. This is a much broader prohibition than the SEC had ever approved. While the SEC targeted specific types of capital withdrawals that warrant concern, FINRA has proposed a blanket prohibition. Under the Proposed Rule, it makes no difference whether the broker-dealer knows (or should know) that the infusion will be temporary. It makes no difference whether the broker-dealer knows (or should know) if the equity capital will be returned to its original source or some other source. All such scenarios are prohibited.

For all of the reasons discussed below, we urge the SEC to reject the Proposed Rule. Alternatively, we urge the SEC to direct FINRA to revise the Proposed Rule so that it is consistent with relevant SEC interpretations and prohibits only infusions of equity capital that the broker-dealer knows will be temporary, intended for specific purpose, and then returned to their original source.

II. Discussion

The Proposed Rule is vastly overbroad. Taken literally, it prohibits a broker-dealer from withdrawing any equity capital that was contributed within a year, regardless of source, intent, purpose, or anything else. The Proposed Rule makes no attempt to distinguish between those types of equity capital infusions that have raised concerns with the SEC, and those that have not. It simply ignores them.

Indeed, the SEC has raised concerns only with respect to narrow categories of equity capital infusions. Specifically, the SEC has raised concerns about temporary infusions of equity capital from an affiliate that enable the broker-dealer to engage in a transaction requiring additional net capital or to report additional net capital.[10] The SEC has also raised concerns about infusions of equity capital from individual investors that are withdrawn within the same year.[11] In each instance, the broker-dealer knows (or should know) that the infusion of equity capital will be temporary, intended for a specific purpose, and then returned to its original source. Each bears some characteristics of a loan.

There are many scenarios involving infusions of equity capital that raise none of the concerns

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[9] Proposing Release, at 5000.
[10] *See* Adopting Release, at 4-5.
[11] *See* Interpretive Letter, at 2.

identified by the SEC. Some are not known by the broker-dealer to be temporary. Some are not intended for a specific purpose. Some do not involve equity capital that is returned to its original source. Set forth below are examples of a few such scenarios, each of which would be prohibited by the Proposed Rule:

1. *The Partnership Scenario*:

Partners A and B are equity partners in a broker-dealer. Each contributed $1,000,000 in equity capital on January 1, 1990. On January 1, 2008, Partner C joins as an equity partner and contributes $1,000,000 in equity capital. In December of 2008, for reasons having nothing at all to do with Partner C, Partner A leaves the partnership and wishes to withdraw the full amount of his capital account. The broker-dealer would violate the Proposed Rule in this scenario because it has withdrawn equity capital that was contributed in the same year, regardless of the amount of the broker-dealer's excess net capital.

This scenario raises none of the concerns identified by the SEC. The broker-dealer had no reason at all to believe that the infusion of equity capital from Partner C would be temporary (nor was it intended to be temporary). The broker-dealer did not seek equity capital from Partner C for any specific transaction requiring additional capital, or for reporting purposes. Nor did the broker-dealer return the equity capital to its original source, Partner C. It went to Partner A, for unrelated reasons. Partner A's own equity capital contribution was anything but temporary — it remained invested with the broker-dealer for eighteen years. This scenario bears no resemblance to a loan. The withdrawal of equity capital was completely unrelated to the infusion of equity capital that the broker-dealer received earlier in the year. There is no legitimate reason to exclude this equity capital from the net capital computations of the broker-dealer.

2. *The Acquisition Scenario:*

On January 1, a broker-dealer receives a $100,000,000 infusion of equity capital from its parent, which is intended to be permanent capital. In September of that same year, instead of expanding its brokerage operations, the parent decides to sell the broker-dealer to another financial institution. For tax reasons, the parent wishes to distribute to itself $50,000,000 prior to closing, reducing the proposed purchase price by the same amount. The broker-dealer would have substantial excess net capital both prior to and following the proposed distribution. The broker-dealer would violate the Proposed Rule in this scenario because it has withdrawn equity capital that was contributed in the same year.

Here again, this scenario raises none of the concerns identified by the SEC. The broker-dealer had no reason at all to believe that the infusion of equity capital from its parent would be temporary (nor was it intended to be temporary). The broker-dealer did not seek the equity capital for any specific transaction requiring additional capital, or for reporting purposes. This scenario, too, bears no resemblance to a loan. The withdrawal of equity capital was completely unrelated to the infusion of equity capital that the broker-dealer received earlier in the year. There is no legitimate reason to exclude this equity capital from the net capital computations of the broker-dealer.

3. *<u>The Truncated or Terminated Growth-Plan Scenario</u>*

> *On January 1, a broker-dealer receives a $100,000,000 infusion of equity capital from its parent, which is intended to permit the broker-dealer to fund a plan to expand into certain new business lines. In September of that same year, due to radically changed market conditions, the broker-dealer believes that embarking on its plan to expand into certain additional business lines no longer represents a good use of its capital and scales back its plans. The broker-dealer is now substantially over-capitalized for its current brokerage activities and seeks to return $50,000,000 of the $100,000,000 previously contributed by its parent. The broker-dealer would violate the Proposed Rule in this scenario because it has withdrawn equity capital that was contributed in the same year.*

Here again, this scenario raises none of the concerns identified by the SEC. The broker-dealer had no reason at all to believe that the infusion of equity capital from its parent would be temporary (nor was it intended to be temporary). The broker-dealer did not seek the equity capital for any specific transaction requiring additional capital, or for reporting purposes. It intended to implement growth plans that it subsequently decided not to pursue. This scenario, too, bears no resemblance to a loan.

4. *<u>The Joint Back-Office Scenario</u>:*

> *On January 1, Introducing Broker A enters into a joint back-office ("JBO") arrangement with Clearing Broker. In order to be eligible for JBO treatment under the laws and rules, Introducing Broker A makes an equity capital contribution of $1,000,000 to Clearing Broker. Clearing Broker has JBO arrangements with other introducing brokers, including Introducing Broker B, which made an equity capital contribution of $1,000,000 a number of years ago when Introducing Broker B first began clearing through Clearing Broker. In December of that same year, for reasons having nothing at all to do with Introducing Broker A, Introducing Broker B terminates its JBO arrangement with Clearing Broker and begins clearing through*

> *another clearing broker. Introducing Broker B seeks to withdraw its $1,000,000 in equity capital to use as a clearing deposit with its new clearing broker. Clearing Broker would violate the Proposed Rule in this scenario because it has permitted a withdrawal of equity capital within one year of having received an equity capital contribution.*

Like all of the others, this scenario raises none of the concerns identified by the SEC. Clearing Broker had no reason at all to believe that the infusion of equity capital from Introducing Broker A would be temporary (nor was it intended to be temporary). Clearing Broker did not seek equity capital from Introducing Broker A for any specific transaction requiring additional capital, or for reporting purposes. Nor did Clearing Broker return the equity capital to its original source, Introducing Broker A. It went to Introducing Broker B for unrelated reasons. This scenario bears no resemblance to a loan. The withdrawal of equity capital by Introducing Broker B — which had been part of the capital of Clearing broker for years — was completely unrelated to the infusion of equity capital that the Clearing Broker received earlier in the year. There is no legitimate reason to exclude this equity capital from the net capital computations of Clearing Broker.

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Respectfully, FINRA underestimates the number of legitimate capital withdrawal scenarios that bear no resemblance to a loan and that would be prohibited by the Proposed Rule. None of the above scenarios raises any of the concerns identified by the SEC. Some are not known by the broker-dealer to be temporary or sought for any specific purpose, and do not involve equity capital that is returned to its original source. Others are the result of unsolicited or unanticipated events. The Proposed Rule is vastly overbroad and ignores all of these important distinctions.[12]

As the SEC Staff is aware, the SEC has considered and rejected "blanket prohibitions" on withdrawals of equity capital in the past. FINRA now proposes just that. The SEC should not adopt a standard that it has previously considered and rejected. Adopting such a standard is, in effect, approving an SRO's attempt to do what the SEC itself has refused to do. Were it to adopt a standard that it has previously considered and rejected, the SEC should at least

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[12] The FINRA Staff may believe that, by giving itself the ability to grant permission in writing, it can make exceptions in appropriate cases. Respectfully, this is a misguided approach. There are so many types of "temporary" infusions of equity capital that raise none of the concerns identified by the SEC that the exception could easily swallow the rule. Forcing every broker-dealer to get written permission from the FINRA Staff in all of these instances would be a significant burden with uncertain results. The FINRA Staff, meanwhile, would have vast discretion to distinguish between appropriate and inappropriate scenarios, with little guidance or accountability. We believe that the inevitable result would be a vague standard that is applied inconsistently among broker-dealers.

have a compelling justification. FINRA has not articulated a compelling justification. Indeed, FINRA offers no specific rationale in support of the Proposed Rule, only the unsubstantiated comment that it furthers "the goal of financial stability."[13] By imposing serious restrictions on the ability of owners of broker-dealers to withdraw excess capital, however, it may well do the opposite, ensuring that owners of broker-dealers do not contribute capital to a broker-dealer until it is desperately needed.

III. Conclusion

For all of the foregoing reasons, we urge the SEC to reject the Proposed Rule. Alternatively, we urge the SEC to direct FINRA to revise the Proposed Rule so that it is consistent with relevant SEC interpretations and prohibits only infusions of equity capital that the broker-dealer knows will be temporary, intended for a specific purpose, and then returned to their original source.

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We thank the SEC for its serious consideration of our comments. If the SEC has any questions about this comment letter, or needs any additional information, please feel free to contact me at 212.508.6142, or my colleague, Bob Frenchman, at 212.508.6184.

Very truly yours,

Julian Rainero
Bracewell & Giuliani LLP

cc: Mary L. Schapiro, Chairman, SEC
Kathleen L. Casey, Commissioner, SEC
Elisse B. Walter, Commissioner, SEC
Luis A. Aguilar, Commissioner, SEC
Troy A. Paredes, Commissioner, SEC
Erik Sirri, Director, Division of Trading and Markets, SEC
Marc Menchel, Executive Vice President and General Counsel, FINRA
Susan M. DeMando, Associate Vice President, FINRA

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[13] *See* Proposing Release at 4994; FINRA Regulatory Notice at 3.