

Regulatory Notice

14-09

Limited Corporate Financing Brokers

FINRA Requests Comment on a Proposed Rule Set for Limited Corporate Financing Brokers

Comment Period Expires: April 28, 2014

Executive Summary

FINRA is soliciting public comment on a proposed rule set for firms that meet the definition of “limited corporate financing broker” (LCFB). An LCFB is a firm that engages in a limited range of activities, essentially advising companies and private equity funds on capital raising and corporate restructuring. The rule set would not apply to firms that carry or maintain customer accounts, handle customers’ funds or securities, accept customers’ trading orders, or engage in proprietary trading or market-making.

The proposed rules are available as Attachment A at _____

Notice should be directed to Joseph P. Savage, Vice President and Counsel, Regulatory Policy, at (240) 386-4534.

Action Requested

FINRA encourages all interested parties to comment on the proposed rule set. Comments must be received by April 28, 2014.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to _____
- ▶ Mailing comments in hard copy to:
 - Marcia E. Asquith
 - Office of the Corporate Secretary
 - FINRA
 - 1735 K Street, NW
 - Washington, DC 20006-1506

February 2014

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Corporate Restructuring
- ▶ Limited Corporate Financing Brokers
- ▶ Mergers & Acquisitions
- ▶ Private Equity Funds

Referenced Rules & Notices

- ▶ FINRA Rule 1000 Series
- ▶ FINRA Rule 2000 Series
- ▶ FINRA Rule 3000 Series
- ▶ FINRA Rule 4000 Series
- ▶ FINRA Rule 5122
- ▶ FINRA Rule 8000 Series
- ▶ FINRA Rule 9000 Series
- ▶ FINRA Rule 10000 Series
- ▶ FINRA Rule 12000 Series
- ▶ FINRA Rule 13000 Series
- ▶ FINRA Rule 14000 Series
- ▶ NASD Rule 1000 Series
- ▶ NASD Rule 2000 Series
- ▶ NASD Rule 3170

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposed rule set.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, comments will be posted as they are received.¹

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).²

Background & Discussion

Some FINRA-regulated firms are solely corporate financing firms that advise companies on mergers and acquisitions, advise issuers on raising debt and equity capital in private placements with institutional investors, or provide advisory services on a consulting basis to companies that need assistance analyzing their strategic and financial alternatives. These firms often are registered as broker-dealers because they may receive transaction-based compensation as part of their services.

Nevertheless, these firms do not engage in many of the types of activities typically associated with traditional broker-dealers. For example, these firms 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.

FINRA is proposing to establish a separate rule set that would apply exclusively to firms that meet the definition of limited corporate financing broker. An LCFB would be subject to the FINRA By-Laws, as well as core FINRA rules that FINRA believes should apply to all firms. The rule set would include other FINRA rules that are tailored to address an LCFB's business activities.

General Standards (LCFB Rule 010 Series)

Proposed LCFB Rule 014 provides that an LCFB and persons associated with an LCFB will be subject to the FINRA By-Laws (including the schedules thereto), unless the context requires otherwise, and the Limited Corporate Financing Broker Rules. Proposed LCFB Rule 015 provides that the LCFB Rules do not apply to transactions in, and business activities relating to, municipal securities as that term is defined in the Exchange Act.

LCFB Rule 016 sets forth basic definitions modified as appropriate to apply to an LCFB. The proposed definitions of "limited corporate financing broker" is particularly important to the application of the rule set.

The term “limited corporate financing broker” would include 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.³

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.⁴

Member Application and Associated Person Registration (LCFB Rule 100 Series)

The proposed LCFB Rule 100 series sets forth the requirements for firms that wish to register as an LCFB. The proposed LCFB Rule 100 series generally incorporates by reference FINRA Rules 1010 (Electronic Filing Requirements for Uniform Forms), 1122 (Filing of Misleading Information as to Membership or Registration), and 1230(b)(6) (Operations Professional), and NASD Rules 1011 (Definitions), 1012 (General Provisions), 1013 (New Member Application and Review), 1014 (Department Decision), 1015 (Review by National Adjudicatory Council), 1016 (Discretionary Review by FINRA Board), 1017 (Application for Approval of Change in Ownership, Control, or Business Operations), 1019 (Application to Commission for Review), 1090 (Foreign Members), 1100 (Foreign Associates) and IM-1011-1 (Safe Harbor for Business Expansions). Accordingly, an LCFB applicant would follow the same procedures for membership as any other FINRA applicant, with four modifications.

- ▶ 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 016(g).
- ▶ Third, proposed LCFB Rule 116(b) sets forth the procedures for an existing FINRA firm to change its status to an LCFB. If an existing firm is already approved to engage in the activities of an LCFB, and the firm does not intend to change its existing ownership, control or business operations, it would not be required to file either a New Member Application (NMA) or a Change in Membership Application (CMA). 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 under LCFB Rule 016(g), and (ii) the firm agrees to comply with the LCFB Rules.⁵

Fourth, proposed LCFB Rule 116(c) sets forth the procedures 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.⁶

The proposed LCFB Rule 100 series also would govern the registration and qualification examinations of principals and representatives that are associated with an LCFB. These rules incorporate by reference NASD Rules 1021 (Registration Requirements – Principals), 1031 (Registration Requirements – Representatives), 1060 (Persons Exempt from Registration), 1070 (Qualification Examinations and Waiver of Requirements), and 1080 (Confidentiality of Examinations), and FINRA Rule 1230(b)(6) (Operations Professional). Accordingly, LCFB firm principals and representatives would 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.⁷ 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).

Proposed LCFB Rule 125 would subject an LCFB to continuing education requirements that are more streamlined than those imposed on other firms under FINRA Rule 1250. Proposed LCFB Rule 125 would not impose any Regulatory Element continuing education requirements on an LCFB, but would impose Firm Element requirements. The Firm Element requirements would apply to 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.

The proposed rule would require an LCFB to establish and implement Firm Element programs that are appropriate for the LCFB's business, to administer the program in accordance with its annual evaluation and written plan, and to maintain records documenting the program's content and completion by covered persons. The rule would require covered persons to take all appropriate and reasonable steps to participate in continuing education programs required by their firms. The rule also would authorize FINRA to require an LCFB to provide special training to its covered persons in such areas as FINRA deems appropriate.

Duties and Conflicts (LCFB Rule 200 Series)

The proposed LCFB Rule 200 series would establish a streamlined set of conduct rules. An LCFB would be subject to FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices), 2070 (Transactions Involving FINRA Employees), 2080 (Obtaining an Order of Expungement of Customer Dispute Information from the CRD System), 2263 (Arbitration Disclosure to Associated Persons Signing or Acknowledging Form U4), and 2268 (Requirements When Using Pre-dispute Arbitration Agreements for Customer Accounts), and NASD Rule 2420 (Dealing with Non-Members) and IM-2420-1 (Transactions Between Members and Non-Members).

LCFB Rules 209 and 211 would impose more streamlined know-your-customer and suitability obligations than are imposed under FINRA Rules 2090 and 2111.

Proposed LCFB Rule 221 is an abbreviated version of FINRA Rule 2210 (Communications with the Public), essentially prohibiting false and misleading statements.

Under proposed LCFB Rule 240, if an LCFB or associated person of an LCFB had engaged in activities that would require the LCFB to register as a broker or dealer under the Exchange Act, and that are inconsistent with the limitations imposed on an LCFB under LCFB Rule 016(g), FINRA could examine for and enforce all FINRA rules against the broker or associated person, including any rule that applies to a FINRA broker-dealer that is not an LCFB or to an associated person who is not associated with an LCFB.

Supervision and Responsibilities Related to Associated Persons (LCFB Rule 300 Series)

The proposed LCFB Rule 300 series would establish a limited set of supervisory rules for an LCFB. An LCFB would be subject to FINRA Rules 3220 (Influencing or Rewarding Employees of Others), 324 (Borrowing from or Lending to Customers), and 327 (Outside Business Activities of Registered Persons).

Proposed LCFB Rule 311 would subject an LCFB to some, but not all, of the requirements of FINRA Rule 3110 (Supervision) and, consistent with Rule 3110, is designed to permit an LCFB flexibility to tailor its supervisory systems to its business models. An LCFB would be subject to many of the provisions of Rule 3110 concerning the supervision of offices, personnel, customer complaints, correspondence and internal communications. However, an LCFB would not be subject to the provisions of Rule 3110 that require annual compliance meetings (paragraph (a)(7)), review and investigation of transactions (paragraphs (b)(2) and (d)), specific documentation and supervision procedures for supervisory personnel (paragraph (b)(6)), and internal inspections (paragraph (c)).

Proposed LCFB Rule 313 would require an LCFB to designate and identify one or more principals to serve as a firm's chief compliance officer.

Proposed LCFB Rule 331 would require each LCFB to implement a written anti-money laundering (AML) program. This is consistent with the SEC's requirements and Chapter X of Title 31 of the Code of Federal Regulations. Accordingly, the proposed rule is similar to FINRA Rule 3310 (Anti-Money Laundering Compliance Programs); however, the proposed rule contemplates that an LCFB would be eligible to conduct the required independent testing for compliance every two years.

Financial and Operational Rules (LCFB Rule 400 Series)

The proposed LCFB Rule 400 series would establish a streamlined set of rules concerning firms' financial and operational obligations. An LCFB would be subject to FINRA Rules 4140 (Audit), 4150 (Guarantees by, or Flow through Benefits for, Members), 4160 (Verification of Assets), 4360 (Fidelity Bonds), 4511 (Books and Records – General Requirements), 4513 (Records of Written Customer Complaints), 4530 (Reporting Requirements), and 4570 (Custodian of Books and Records), and NASD Rules 1150 (Executive Representative), 1160 (Contact Information Requirements) and 3170 (Mandatory Electronic Filing Requirements).

Proposed LCFB Rule 411 includes some, but not all, of the capital compliance requirements of FINRA Rule 4110. An LCFB would be required to suspend business operations during any period a firm is not in compliance with the applicable net capital requirements set forth in SEA Rule 15c3-1, and the rule also would authorize FINRA to direct an LCFB to suspend its operation under those circumstances. Proposed LCFB Rule 411 also sets forth requirements concerning withdrawal of capital, subordinated loans, notes collateralized by securities and capital borrowings.

Because an LCFB would not carry or maintain customer accounts, it would have more limited customer information requirements than is imposed under FINRA Rule 4512.⁸ Each LCFB would have to maintain each customer's name and residence, whether the customer is of legal age (if applicable), and the names of any persons authorized to transact business of the customer. An LCFB would still have to maintain all records required under SEA Rules 17a-3 and 17a-4.

Proposed LCFB Rule 452 establishes a limited set of requirements for the supervision and review of a firm's general ledger accounts.

Investigations and Sanctions, Code of Procedure, and Arbitration and Mediation (LCFB Rules 800, 900 and 1000)

Each LCFB would be subject to the FINRA Rule 8000 series governing investigations and sanctions of firms, other than FINRA Rules 8110 (Availability of Manual to Customers), 8211 (Automated Submission of Trading Data Requested by FINRA), and 8213 (Automated Submission of Trading Data for Non-Exchange-Listed Securities Requested by FINRA).

An LCFB would be subject to the FINRA Rule 9000 series governing disciplinary and other proceedings involving firms, other than the FINRA Rule 9700 series (Procedures on Grievances Concerning the Automated Systems). Proposed LCFB Rule 900(c) would provide that any LCFB may be subject to a fine under FINRA Rule 9216(b) with respect to an enumerated list of FINRA By-Laws, LCFB Rules and SEC Rules under the Exchange Act. Proposed LCFB Rule 900(d) would authorize FINRA staff to require an LCFB to file communications with the FINRA Advertising Regulation Department at least ten days prior to use if the staff determined that the LCFB had departed from LCFB Rule 221's standards.

An LCFB would be subject to the FINRA Rule 10000 series (Code of Arbitration Procedure), 12000 series (Code of Arbitration Procedure for Customer Disputes), 13000 (Code of Arbitration Procedure for Industry Disputes) and 14000 series (Code of Mediation Procedure).

Request for Comment

FINRA requests comment on all aspects of the proposed rules, including any impact on institutional customers and issuers, potential costs and burdens that the proposal could impose on an LCFB, and any cost savings and reduced burdens that the proposal would create for an LCFB. FINRA also requests comment on whether an LCFB should be subject to any FINRA Rules that are not included in the proposed rule set.

FINRA particularly requests comment concerning the following issues:

- ▶ Does the proposed rule set provide sufficient protections to customers of an LCFB? If not, what additional protections are warranted and why?
- ▶ Does the proposed rule set appropriately accommodate the scope of LCFB business models? If not, what other accommodations are necessary and how would customers be protected?
- ▶ Is the definition of “limited corporate financing broker” appropriate? Are there any activities in which broker-dealers with limited corporate financing functions typically engage that are not included in the definition? Are there activities that should be added to the list of activities in which an LCFB may not engage?
- ▶ Are there firms that would qualify for the proposed rule set but that would choose not to be treated as an LCFB? If so, what are the reasons for this choice?
- ▶ What is the likely economic impact to an LCFB, other broker-dealers and their competitors of adoption of the LCFB rules?
- ▶ FINRA welcomes estimates of the number of firms that would be eligible for the proposed rule set.
- ▶ Proposed LCFB Rule 123 would limit the principal and representative registration categories that would be available for persons associated with an LCFB. Are there any registration categories that should be added to the rule? Are there any registration categories that are currently included in the proposed rule but that are unnecessary for persons associated with an LCFB?
- ▶ Should principals and representatives that hold registration categories not included within LCFB Rule 123 be permitted to retain these registrations?
- ▶ Does an LCFB normally make recommendations to customers to purchase or sell securities? Should an LCFB be subject to rules requiring firms to know their customers (LCFB Rule 209) and imposing suitability obligations (LCFB Rule 211) to an LCFB?
- ▶ Does the SEC staff no-action letter issued to Faith Colish, et al., dated January 31, 2014,⁹ impact the analysis of whether a firm would become an LCFB? Is it likely that some limited corporate financing firms will not register as a broker consistent with the fact pattern set forth in the no-action letter, or will they register as an LCFB?

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. [See Notice to Members 03-73](#) (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the Federal Register. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. See proposed LCFB Rule 016(g)(1). 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 sales 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;
- 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;

- qualified plan, as defined in Section 3(a)(12) (C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that 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.

See proposed LCFB Rule 016(f).

FINRA purposely does not propose to define “institutional investor” based on a more inclusive standard, such as the definition of “accredited investor” in Regulation D under the Securities Act of 1933. See 17 C.F.R. § 230.501(a). The LCFB Rules are intended to govern the activities of firms that engage in a limited range of activities, such as advising companies and private equity funds on capital raising and corporate restructuring. As part of these activities, an LCFB would be permitted to qualify, identify and solicit potential institutional investors, as defined by the LCFB Rules.

FINRA’s regulatory programs have uncovered serious concerns with the manner in which firms market and sell private placements to accredited investors. Application of the LCFB Rules to firms that market and sell private placements to accredited investors would require FINRA to expand the applicable conduct rules and other provisions. Therefore, lowering the threshold of “institutional investor” would eviscerate the benefits of a streamlined rule set.

4. See proposed LCFB Rule 016(g)(2).
5. There would not be an application fee associated with this request.
6. Absent a waiver, such a firm would have to pay an application fee associated with the CMA. See FINRA By-Laws, Schedule A, Section 4(i).
7. See proposed LCFB Rule 123.
8. See proposed LCFB Rule 451(b).
9. See *Faith Colish, Esq., Carter Ledyard & Milburn LLP, et al.*, SEC no-action letter (Jan. 31, 2014).