

FINRA proposes significant changes to regulatory regime for limited corporate financing brokers

DLA Piper
Edward J. Johnsen

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The Financial Industry Regulatory Authority has issued [Regulatory Notice 14-09](#) soliciting comments on a [proposed new regulatory structure](#) for firms that limit their activities to advising companies and private equity funds on capital raising and corporate restructuring.



Author page »

The proposal, published on February 26, is **one of the most important advanced by FINRA in some time.**

Many firms limit their business to corporate advisory services, but this nevertheless can fall within the broad definition of broker-dealer activity. Such firms advise companies on mergers and acquisitions,^[i] assist them in raising capital in private placements to institutional investors and/or help them assess strategic and financial options.

The Securities and Exchange Commission and FINRA (and, from time to time, the courts) have taken the position that such firms must register as broker-dealers because they are involved in key points in the distribution of securities. This is especially true when such firms receive transaction-based compensation for their services.

Realizing that such firms do not engage in most of the activities typically associated with broker-dealers, such as maintaining customer accounts, handling customer funds and/or securities, purchasing and selling securities for the order of customers, exercising investment discretion for customers, or engaging in proprietary securities trading and/or market-making, FINRA is proposing a bespoke set of rules for what they now refer to as “limited corporate financing brokers” (LCFBs). While LCFBs would be subject to FINRA bylaws and those core rules that FINRA believes rightly apply to all firms, they otherwise would be subject only to rules tailored to the LCFB business.

General standards

An LCFB would be a broker that engages solely in one or more of the following:

- ▶ advising issuers, including private funds, with respect to securities offerings and other types of capital raising
- ▶ advising companies regarding the purchase or sale of businesses or assets, corporate restructuring, divestitures or mergers
- ▶ advising companies regarding selection of investment bankers
- ▶ assisting issuers in preparing offering materials
- ▶ providing fairness opinions and
- ▶ qualifying, identifying or soliciting potential institutional investors.^[ii]

A firm would not qualify as an LCFB if it:

- ▶ carries or maintains customer accounts
- ▶ holds or handles customer funds or securities
- ▶ accepts customer orders for the purchase or sale of securities
- ▶ exercises investment discretion on behalf of any customer or
- ▶ engages in proprietary trading or market-making.

Registration

Generally, firms wishing to register as LCFBs would follow the same procedures as all other FINRA applicants, but with **important modifications**:

1. The applicant would have to affirmatively state that it will operate as an LCFB.
2. FINRA's Member Regulation Department would consider whether the proposed activities are consistent with the limitations imposed in the new regime.
3. A FINRA member firm seeking to change its status to LCFB, if already approved to engage in LCFB activities and not changing ownership, control or operations, could file a request to amend its membership agreement rather than filing a New Member Application or Change in Membership Application.
4. An LCFB wishing to terminate such status and continue as a general FINRA firm would be required to file a Change in Membership Application and to amend its membership agreement to provide that it agrees to comply with all FINRA Rules.

Principals and representatives would be subject to the same registration and exam requirements as principals and representatives of other FINRA firms; however, they would be eligible for fewer registration categories. LCFB continuing education requirements would be more streamlined than those of other firms. For example, there would be no Regulatory Element continuing education requirements, although Firm Element requirements would apply to persons registered with an LCFB who have direct contact with customers (and their immediate supervisors). The rule would allow FINRA to require special training to LCFB personnel in areas that FINRA deems appropriate.

Duties and conflicts rules

The proposal would establish streamlined conduct rules for LCFBs, which would include current FINRA rules concerning standards of commercial honor and principles of trade; use of manipulative, deceptive or other fraudulent devices; transactions involving FINRA employees; and certain others. There also would be streamlined know-your-customer and suitability obligations, and abbreviated rules for communications with the public (basically a prohibition against false and misleading

statements).

Supervision of and responsibilities related to associated persons

The proposal would establish limited supervisory rules for LCFBs. FINRA rules regarding influencing or rewarding employees of others, borrowing from or lending to customers, and outside business activities of registered persons would apply, as would certain requirements of FINRA's general supervision rules. LCFBs would have flexibility in tailoring supervisory systems to their particular business models. Many existing requirements for supervising offices, personnel, customer complaints, correspondence and communications would apply, but the requirements for annual compliance meetings, review and investigation of transactions, and internal inspections would not. An LCFB would be required to designate and identify one or more chief compliance officers, and would need to implement a written anti-money laundering program.

Financial and operational rules

The proposed rules would establish simplified financial and operational requirements. An LCFB would be subject to FINRA rules regarding, among other things, audits, guarantees by or flow through benefits for FINRA members, verification of assets, fidelity bonds, books and records requirements, and records of customer complaints.

The proposed rules include some, but not all, of the capital requirements of FINRA Rule 4110. An LCFB would be required to suspend business operations whenever it is not in compliance with the applicable net capital requirements, and FINRA would be authorized to direct an LCFB to suspend operations under those circumstances. There are also LCFB-specific requirements for withdrawal of capital, subordinated loans, notes collateralized by securities and capital borrowings.

Because LCFBs would not carry or maintain customer accounts, they would be subject to more limited customer information requirements than other FINRA member firms. LCFBs would be required to maintain each customer's name and residence, whether the customer is of legal age (if applicable), and the names of persons authorized to transact business on behalf of the customer. There would be limited requirements for supervision and review of general ledger accounts.

Investigations, sanctions, codes of procedure, arbitration and mediation

LCFBs would be subject to most FINRA rules governing investigations, sanctions and disciplinary and other proceedings, and LCFBs would be subject to fines with respect to an enumerated list of FINRA By-Laws, LCFB rules and SEC Exchange Act rules. FINRA staff would be authorized to require LCFBs to file communications with FINRA's Advertising Regulation Department prior to use if the staff determines that the LCFB departed from applicable standards.

An LCFB would be subject to the FINRA Code of Arbitration Procedure, Code of Arbitration Procedure for Customer Disputes, Code of Arbitration Procedure for Industry Disputes and Code of Mediation Procedure.

FINRA is requesting comments

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

estimates of how many firms would be eligible for LCFB treatment.

FINRA also wants comments that specifically address the following issues:

- ▶ Whether the proposed rules provide sufficient protections to LCFB customers and, if not, what additional protections are needed.
- ▶ Whether the proposed rules appropriately accommodate the scope of LCFB businesses and, if not, what else is needed and how customers will be protected.
- ▶ Whether the definition of LCFB is appropriate, or there are other activities that should be included (or specifically excluded).
- ▶ Whether there are firms that would qualify for LCFB treatment but would choose not to be so treated, and why they would not.
- ▶ The likely economic impact of the proposed rules on LCFBs, other broker-dealers and their competitors.
- ▶ Other principal and representative registration categories that should be added, and whether there are any that are unnecessary for LCFB associated persons.
- ▶ Whether persons holding registrations not included in the LCFB rules should be permitted to retain them.
- ▶ Whether LCFBs normally make recommendations to customers to purchase or sell securities, and whether they should be subject to “know your customer” and “suitability” obligations.

Finally, FINRA asks whether the M&A No-Action Letter impacts the analysis of the proposal, including whether firms that limit their activities to those specified in the letter will or will not register as LCFBs.

FINRA is asking for comments by **April 28, 2014**.

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