FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

REGULATORY OPERATIONS, Complainant, v. MERRIMAN CAPITAL, INC. (CRD No. 18296), Respondent.	Expedited Proceeding No. FR160001 STAR No. 20160505679 Hearing Officer–MC **HEARING PANEL DECISION** July 25, 2016

For conducting a securities business without maintaining the required minimum net capital, Respondent is suspended under FINRA Rule 9557.

Appearances

For the Complainant: Ann-Marie Mason, Esq., Deon McNeil-Lambkin, Esq., William Otto, Esq., FINRA Regulatory Operations.

For the Respondent: Micah A. Taylor, Esq., Michael Doran, Esq.

DECISION

I. Introduction

Statutory minimum net capital is the amount of capital a broker-dealer must maintain to conduct a securities business. Broker-dealers must be able to demonstrate that they have sufficient net capital "at all times," from "moment to moment," as prescribed by Rule 15c3-1 of the Securities Exchange Act of 1934 (the "Net Capital Rule").[1] If the broker-dealer fails to do so, it cannot engage in its securities business. The rule's purpose is "to ensure that broker-dealers

[1] *See* Securities Exchange Act Rule 15c3-1 Interpretations: Net Capital Requirements for Brokers or Dealers, http://www.finra.org/sites/default/files/sea-rule-15c3-1-interpretations.pdf, at 1; NASD Notice to Members 07-16 (April 2007), http://www.finra.org/industry/notices/07-16.

have sufficient liquid assets on hand at all times to cover their indebtedness."[2] The required minimum amount of capital a firm must maintain generally ranges from $5,000 to $250,000.[3]

FINRA first became concerned about Respondent Merriman Capital, Inc.'s compliance with the Net Capital Rule in August 2015 when FINRA staff, reviewing the Firm's net capital computation, noticed a net capital deficiency.[4] In October 2015, FINRA staff asked the Firm to provide weekly net capital computations.[5] After several months of communication about the matter, FINRA staff issued an advisory letter in December 2015, and another by email in January 2016, informing the Firm that its net capital was deficient, explaining why, and advising the Firm it must cease conducting business unless it maintained its required minimum net capital.[6] The Firm replied that it disagreed with FINRA's calculation of its net capital, and that it was relying on a Securities and Exchange Commission interpretation of the Net Capital Rule for its computation.[7]

Then the Firm informed FINRA that it was going to stop sending the weekly computations. Concerned over the financial condition of the Firm, FINRA issued a Rule 8210 letter requiring the Firm to continue submitting the computations weekly.[8] The Firm achieved compliance with the Net Capital Rule at the end of March 2016, but in April FINRA noticed it began "slipping back out of net capital compliance."[9]

In June 2016, FINRA sent the Firm another net capital deficiency advisory letter, again warning that the Firm must cease business until it corrected the deficiency.[10] As before, the Firm disagreed.[11] In its calculation as of June 24, 2016, the Firm represented that its net capital exceeded the minimum requirement of $250,000 by more than $82,000.[12]

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[2] *Dep't of Enforcement v. Geary*, 2016 FINRA Discip. LEXIS __, at *3 (NAC July 20, 2016), *quoting Inv. Mgmt. Corp.*, No. C3A010045, 2003 NASD Discip. LEXIS 47, at *17 (NAC Dec. 15, 2003).

[3] Transcript of July 14, 2016 Hearing ("Tr.") 30.

[4] Tr. 64.

[5] CX-14.

[6] Tr. 68-70.

[7] Tr. 69; Complainant's Exhibit ("CX")-7.

[8] Tr. 70; CX-14.

[9] Tr. 65.

[10] Tr. 71.

[11] Tr. 72.

[12] CX-91, at 3 (Respondent's weekly net capital computation for week ending June 24, 2016).

On July 5, 2016, FINRA issued a Notice of FINRA Action ("Notice") under FINRA Rule 9557. The Notice imposed an immediate suspension of all business operations "based on violations of applicable net capital requirements" of the Net Capital Rule. The Notice stated that the Firm's net capital calculations were flawed. The Firm included assets that should have been treated as non-allowable under the Net Capital Rule and overstated its net capital, claiming to have excess net capital, when a correct calculation showed a significant deficit. The Notice set forth the steps the Firm must take, by infusing capital or changing its business operations to qualify for a reduced net capital requirement, to attain sufficient capital to conduct a securities business.[13]

On July 7, 2016, the Firm filed a request for a hearing challenging the grounds for the suspension. The Firm reiterated that in calculating its net capital, it properly relied on an SEC interpretation of the Net Capital Rule. The Firm attached a copy of the interpretation. It also contested its current net capital requirement, arguing that under its FINRA membership agreement, its minimum net capital requirement should be $100,000, not $250,000. Under Rule 9557, the Firm's request temporarily stayed the suspension, and set into motion a hearing held before an Expedited Hearing Panel on July 14.

On July 18, 2016, based on the testimony and evidence presented at the hearing, a Rule 9557 Suspension Order was issued approving the requirements and restrictions imposed by the Notice. The Order summarized the Hearing Panel's findings and conclusions and, under Rule 9559(n)(2), required the Firm to suspend all business operations immediately.

The Panel now issues this Decision setting forth the findings and conclusions supporting the Rule 9557 Suspension Order, in accord with Rule 9559(o)(4)(B).

II. Facts

At the hearing, the Firm stipulated that it engages in soft-dollar business and holds customer funds in special reserve accounts.[14] Consequently, the Firm is subject to a minimum net capital requirement of $250,000, as it previously acknowledged in its net capital computation submitted to FINRA for the week ending June 24, 2016.[15]

A. The Firm's Overvaluation of Assets

1. The Stock Inventory

When a broker-dealer includes a stock as an asset for the purpose of net capital computation, the Net Capital Rule requires it to demonstrate that the stock has a "ready market";

[13] CX-1.

[14] Tr. 55.

[15] Tr. 112-14; CX-91.

that is, it can be converted to cash in a reasonable time. As a FINRA witness explained at the hearing, this requires that the stock trade on a recognized market, such as the New York Stock Exchange, the American Stock Exchange, or NASDAQ, or other dynamic marketplace capable of showing price and volume of trading in the stock.[16]

In the Firm's net capital computation for the week ending June 24, 2016, the Firm claimed its net capital exceeded the required minimum by more than $82,000.[17] This computation was incorrect primarily because the Firm improperly treated one of its large stock inventory positions, in Loton Corp. ("Loton"), as an allowable asset, and failed to take the proper blockage charge on another position, in Mount Tam Biotechnologies, Inc. ("Mount Tam"). The Firm also overvalued the Loton stock serving as collateral for secured demand notes.

a. Loton Stock Inventory

The Firm valued its inventory of 40,000 shares of Loton at $10 per share, resulting in a fair market value of $400,000.[18] In doing so, the Firm treated Loton as having a ready market.[19] But the market data establishes that for the 11 weeks before June 24, 2016, there was no trading volume in Loton, no ready market, and no ascertainable market value.[20] Therefore, the Firm's inventory in Loton was a non-allowable asset for the purpose of its net capital calculation.[21]

The Firm not only overvalued Loton, it also included Loton as collateral for two secured demand notes it used in its net capital computation.[22] Because Loton has no ascertainable value, the Firm erred by valuing the Loton stock as collateral. Instead, the Firm should have taken a secure demand note deficiency charge in its computation.[23]

b. Mount Tam Stock Inventory

The Firm likewise overvalued its substantial position in Mount Tam. The Firm valued its 302,000 shares at $0.75 per share, giving it a fair market value of $226,500, subject to a 30%

[16] Tr. 115-19; CX-118.

[17] Tr. 114.

[18] Tr. 121.

[19] Tr. 117-18; CX-91, at 4.

[20] Tr. 119-20, 145: CX-111, CX-112.

[21] Tr. 121.

[22] Tr. 115-16.

[23] Tr. 147.

"haircut."[24] Although Mount Tam has a ready market, the Firm's position exceeded the total prior four-week trading volume in the stock. The Net Capital Rule requires a broker-dealer to apply a blockage charge to the portion of its inventory in a stock that exceeds the most recent four-week trading volume in the stock.[25]

FINRA consulted Bloomberg, Yahoo Finance, and an internal trade reporting system, WIAT, to find the trading volume in Mount Tam for the relevant period. Because WIAT showed the highest volume, benefitting the Firm in this analysis, the staff used the WIAT reported volume of slightly more than 87,000 shares. The 87,000 shares were allowable, subject to a 15% haircut.[26] As the Net Capital Rule requires, the staff disallowed the additional 214,000 shares exceeding the reported four-week volume. The result was an assessed blockage charge of more than $161,000 against the Firm's net capital.[27]

2. The Out-of-the-Money Warrants

In its June 2016 calculation, the Firm included marketable warrants it holds for the purchase of stocks. Using a valuation model, the Firm claimed the portfolio was worth more than $78,000. After applying a 30% haircut, the Firm gave the warrants a value of almost $55,000.[28]

FINRA determined that the warrants had no ready market and therefore were non-allowable for the purpose of computing net capital under the Net Capital Rule. Furthermore, the warrants were all "out-of-the-money," meaning it would cost the Firm more to exercise the warrants than the underlying stock shares were worth. Consequently, the warrants had no economic value and should not have been included in the net capital calculation.[29]

B. The Firm's Net Capital Deficiency

Based on the testimony and evidence presented at the hearing, the Hearing Panel finds that the Net Capital Rule requires the Firm to disallow from its net capital calculation:

- $400,000, the value the Firm claimed based on its inventory of Loton stock, which has no ready market;

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[24] Tr. 125, CX-91, at 4. A haircut is a deduction from the market value of securities the broker-dealer holds in its own account that a broker-dealer must take when calculating net capital, *Yoshikawa v. SEC*, 192 F.3d 1209, 1211 n.3 (9th Cir. 1999).

[25] Tr. 125-27; CX-117, at 172.

[26] Tr. 132.

[27] Tr. 131; CX-92.

[28] Tr. 132-33; CX-91, at 5.

[29] Tr. 134-36, 139.

- more than $367,000, by applying the blockage for the Firm's excess inventory claim for its Mount Tam stock and the incorrect secured demand note valuation;
- and more than $78,000, the value the Firm claimed for its out-of-the-money warrants.

The Panel further finds that FINRA properly adjusted the Firm's net capital calculation by correcting the Firm's mistaken acceptance of 30% haircuts in instances in which it ought to have applied 15% haircuts.[30] The Firm also failed to include a relatively small undue concentration charge that FINRA staff determined to be slightly more than $20,000.[31]

As noted above, the Firm claimed that as of June 24, 2016, it exceeded its $250,000 minimum net capital requirement by more than $82,000. FINRA concluded that, properly applying the Net Capital Rule, the Firm overestimated its net capital by more than $630,000.[32] Correctly computed, FINRA's analysis shows that the Firm's net capital is more than $550,000 below its minimum requirement.[33]

In its hearing request, the Firm claimed that it should only be required to maintain a minimum of $100,000 in net capital. At the hearing, Jon Merriman, the Firm's chief executive officer, testified that the Firm is exiting the soft-dollar business, ceasing to hold client funds, and ending its involvement in market making and proprietary trading, to qualify for a $5,000 required minimum net capital.[34]

There is no evidence that the Firm has terminated its soft-dollar business to qualify for a net capital minimum below $250,000. The Panel notes that if the Firm were to qualify for a minimum net capital requirement of $100,000 by ending its soft-dollar business and returning client funds, it would still have a net capital deficiency of more than $400,000. And even if the Firm qualified for a $5,000 minimum net capital requirement, its net capital would still be about $350,000 below the required minimum.[35]

C. The Firm's Misplaced Reliance on an SEC Interpretation

As noted above, the Firm relies on an SEC interpretation letter to justify its net capital computation and to include the face value of its Loton and Mount Tam stock, subject to a 30% haircut. The relevant section of the interpretation letter states: "Securities which can be sold

[30] Tr. 150-51.

[31] Tr. 151; CX-92.

[32] Tr. 151.

[33] Tr. 152; CX-92.

[34] Tr. 200-01.

[35] Tr. 152-53.

pursuant to an exemption from registration would be subject to a contractual commitment deduction under Exchange Act Rule 15c3-1(c)(2)(vii) of 30%. Any positions remaining in a firm's inventory after the date of the contractual commitment would be subject to the haircuts outlined above."[36]

However, the interpretation letter does not justify the Firm's treatment of its stock inventory for net capital computation. An associate vice president and director of FINRA's Financial Operations, who consulted with the SEC to confirm FINRA's understanding of the matter, testified that the Firm's reliance on the letter is misplaced.[37] The Panel finds this testimony persuasive. The provision in the letter applies to a deduction a firm may apply when it underwrites a security, not to a haircut on inventory.[38]

III. Conclusions

The Panel concludes that the Firm is conducting a securities business without maintaining the minimum net capital required to comply with the Net Capital Rule. The Panel approves the requirements and restrictions imposed by the Notice FINRA issued on July 5, 2016. The Panel holds that the Firm has not complied with the requirements contained in the Notice that it take appropriate steps to obtain sufficient capital to conduct a securities business, such as obtaining a capital infusion; changing its business operations to qualify for a reduced minimum net capital requirement; and demonstrating a ready market for the common stock shares and warrants that otherwise are non-allowable assets.

IV. ORDER

For these reasons, under the authority of FINRA Rule 9559 (n)(2), the Hearing Panel suspends Respondent Merriman Capital, Inc., effective July 18, 2016, the date we issued the Rule 9557 Suspension Order. The suspension shall remain in effect unless FINRA issues a letter of withdrawal of all requirements and restrictions in conformity with FINRA Rule 9557(g)(2).

Matthew Campbell
Hearing Officer
For the Hearing Panel

[36] Tr. 123; CX-97, at 3.

[37] Tr. 140-42.

[38] Tr. 123-24.