

FINRA representative –

As requested in FINRA Regulatory Notice 14-09, below are the comments of Achatas Capital Advisors LLC on the subject rule set.

### Summary

The Limited Corporate Financing Broker (“LCFB”) rules proposed by Regulatory Notice 14-09 are, in their present form, of no interest to our firm; no benefits of consequence are offered by the rule set, and its restrictions are unacceptable. It is difficult to imagine that most LCFB-eligible firms would not feel the same way.

### Preclusion of the Offering of Private Placements to Accredited Investors

Although our small firm meets the criteria for conversion to an LCFB – i.e., it conducts only the types of businesses allowed by proposed LCFB Rule 016(h)(1) – the inability to offer private placements to “accredited investors,” rather than only to much narrower “institutional investors,” precludes conversion. The other abatements of the broader FINRA rules, which themselves are disappointingly minimal, do not offset this unreasonable stricture.

FINRA states that it has “uncovered serious concerns with the manner in which firms market and sell private placements to accredited investors.” Reg. Notice 14-09 n.3. Accordingly, FINRA states that if it were to permit LCFBs to “market and sell private placements to accredited investors,” it would have “to expand the applicable conduct rules and other provisions” in the LCFB rules. *Id.* FINRA, however, gives no examples of the “serious concerns” or describes the putative necessary expansion.

Whatever “serious concerns” FINRA has uncovered, they presumably were violations of the applicable suitability, know-your-customer, communications, etc., rules committed by firms of all sizes. Yet FINRA does not contend that these violations were committed disproportionately by LCFB candidates, so as to justify barring them from a segment of the private placement market that larger firms can reach. This puts LCFBs at a serious, and unacceptable, commercial disadvantage.

In any case, there is no indication that such violations would more likely be committed under the proposed LCFB rules. Would these “serious concerns” not also be violations under them as well?

The clear implication of the restriction is that would-be LCFBs cannot be expected to offer private placements to accredited investors without indulging in some sort of wrongdoing that the new rules do not address. The answer is not to bar LCFBs from the accredited-investor marketplace altogether, but to incorporate in the new rules provisions that address the “serious concerns,” and to enforce compliance with them through FINRA’s existing range of disciplinary measures. (It seems unlikely that such provisions would “eviscerate the benefits” of the rules, since they scarcely have any benefits of consequence now.)

A final comment on the limitation: SEC Rule 506(c) under Regulation D, recently adopted pursuant to the JOBS Act, now permits the broad marketing of private placements, provided they are sold exclusively to accredited investors. Under the proposed rules, LCFBs would not be able to use Rule 506(c), in an illogical narrowing of access to the very marketplace that Congress sought to expand.

### Annual Audit

In addition to permitting the offering of private placements to accredited investors, the proposed LCFB rules should eliminate the requirement for an annual audit.

An LCFB cannot carry customer accounts or handle customers' funds or securities; it cannot accept customer orders to purchase or sell securities nor engage in proprietary trading or market-making. Proposed LCFB Rule 016(h)(2). Thus no one who deals with an LCFB can have any financial risk related to its securities positions, purchases or sales, or money handling, because they are not permitted. There is therefore no justification for an expensive annual audit to ensure an LCFB's financial responsibility to and protection of customers (in the sense of investors), since no customer assets are at risk. (But see below for confusion on the definition of "customer.") In view of this, an appropriate outside annual examination of an LCFB's financial statements would be the professional, but more limited and less expensive, "review" under the standards of the AICPA. (See AR Sec. 90, <http://www.aicpa.org/Research/Standards/CompilationReview/DownloadableDocuments/AR-00090.pdf>.)

#### Definition of Customer

The proposed rules define a "customer" as "any natural person and any entity receiving corporate financing services from a limited corporate financing broker." Proposed LCFB Rule 016(d). They also prohibit, *inter alia*, an LCFB from "accept[ing] orders from customers to purchase or sell securities, either as principal or as agent for the customer." Proposed LCFB Rule 016(h)(2). Thus, on their face, the rules prohibit an LCFB from accepting and executing private placement engagements.

This is obviously not the intent of the rules, inasmuch as LCFBs may "solicit[] potential institutional investors," *id.* (h)(1)(F). However obliquely stated, this must include effecting private placements as agent, or else the LCFB rules can have no utility whatsoever. Moreover, the term "customer" is used elsewhere in the proposed rules in the sense of "investor." See, e.g., Proposed LCFB Rule 211.

A solution to this confusion is not to use the term "customer" to apply to those receiving corporate financing services, but instead to define them as "clients." The distinction between "customers" – investors who buy and sell securities from, to, and through a broker-dealer firm – and "clients" – those who use the firm's corporate financing services – has been employed in Wall Street for decades. The term "customer" (in the sense of an investor) should be defined separately, and the rules entirely rewritten using both definitions.

#### Return to Non-LCFB Status

Conversion to LCFB status by a currently LCFB-eligible firm may be made simply by requesting an amendment to the firm's FINRA membership agreement. Proposed LCFB Rule 116(b). On the other hand, if such a firm later wishes to return to non-LCFB status for whatever reason, even with no change in its business lines, it must file a continuing membership application and seek an amendment of its membership agreement. Proposed LCFB Rule 116(c). Apart from the administrative time and effort entailed in such a procedure, the firm will effectively have to "buy back" its original status for \$5,000, the minimum "material change" continuing membership application fee (absent a waiver). See Schedule A to FINRA Bylaws, Section 4(i)(1). This, too, is a substantial disincentive to converting to LCFB status.

#### Answers to Specific FINRA Questions Raised in Regulatory Notice 14-09

The following responses to the specific questions raised by FINRA should be viewed in the context of the comments above. The questions are repeated in abbreviated form.

1. Do the Rules provide sufficient protection for LCFB customers? Yes, an LCFB customer (in the sense of “investor”) would enjoy all the protections for a customer of a non-LFCB; the rules do not compromise any aspect of the existing suitability or “know-your-customer” requirements.
2. Do the Rules appropriately accommodate the scope of the LCFB business model? No.
  - (a) An LCFB should be permitted to market and sell private placements as agent to “accredited investors,” not just to “institutional investors.”
  - (b) Proposed Rule 016(h)(1)(F) should explicitly state that an LCFB may act as agent in the sale of private placements, not simply that it may “solicit” investors.
  - (c) An LCFB should be permitted to engage in the private placement of Direct Participation Programs.
  - (d) An LCFB should be required to undergo only an annual outside review of its financial statements, rather than an audit.
3. Is the definition of LCFB appropriate? No, as noted in the “Definition of Customer” comment above.
4. Are there firms that would qualify for LCFB status but choose not to elect it? Yes, virtually all broker-dealers that engage exclusively in merger and acquisition advisory and private placement work would qualify, but virtually none, we believe, will choose it under the proposed rules. There are serious limitations on an LCFB’s ability to offer private placements, with no meaningful benefits to LCFB status. Indeed, the very word “limited” carries a connotation of an LCFB’s inadequacy to would-be clients – quite rightly, given its restricted market access.
5. What is the likely economic impact of the adoption of the LCFB Rules? Because we do not foresee any meaningful number of broker-dealers opting for LCFB status under the proposed rules, we do not believe that their adoption will have any meaningful impact.
6. Estimate the number of firms eligible for the new rule set. Our firm has no estimate, but in a December 20, 2012, e-mail to small FINRA members, FINRA small-firm governors Norensberg, Carreno, and Keenan stated that the forthcoming LCFB proposal was “expected to affect nearly 700 broker-dealers.”
7. Are there any registration categories that should be added or eliminated from the Rule? Yes. The allowable activities should include DPP (direct participation program) securities (Series 22 examination), the sales of which are almost always effected as private placements.
8. Should principals and representatives be allowed to retain registrations not required by the Rules? Yes; there is no reason to remove such registrations. FINRA’s doing so would be yet another reason not to convert to an LCFB.
9. Does an LCFB make recommendations to customers? And should an LCFB be subject to K-Y-C and suitability rules? An LFCB would not make recommendations to buy or sell securities, other than the buy “recommendation” implicit in offering a private placement to an investor, or the “buy” or “sell” recommendations implicit in a merger and acquisition advisory engagement. And, of course, an LCFB should observe the suitability and K-Y-C rules in selling a private placement as agent.
10. Does the SEC staff no-action letter to Faith Colish impact the analysis of whether a firm would become an LCFB? In view of the no-action letter, it is possible that firms that (a) offer only merger and acquisition advisory services and (b) otherwise meet the conditions of the no-action letter might decide to abandon their status as broker-dealers and FINRA

members and operate exclusively as “M&A brokers,” as defined in the no-action letter. (We have no estimate of how many such firms there are.) Any non-FINRA-member firms – say, attorneys – that meet the conditions in the no-action action letter and wish to act collaterally as “M&A Brokers” will surely not see a reason to become FINRA members.

Please contact me with any questions you may have about these comments.

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