Professor Andrew F. Tuch

Comments on Proposed Rule Set for Limited Corporate Financing Brokers (February 2014)

April 28, 2014

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506
Via Electronic Mail (pubcom@finra.org)

Dear Ms. Asquith

I am submitting this letter in response to the invitation by the Financial Industry Regulatory Authority in Regulatory Notice 14-09 to comment on its proposed rule set for limited corporate financing brokers ("LCFBs").[1] In light of the time frame in which FINRA has invited comments, I focus on the implications of the proposed rule set for those LCFBs that engage in traditional investment banking activities.

By way of background, I am a law professor who has researched and written in the areas of securities and financial regulation. In recent years, my writing has focused on the liability of broker-dealers, including investment bankers.[2] The views expressed in this letter are solely my own, and the institutional affiliation provided below is given for identification purposes only.

I. The Definition of LCFB

The proposed rule set will apply to LCFBs and persons associated with LCFBs. An LCFB is defined in terms of the activities in which it engages (Proposed Rule 016(h)), and thus the proposed rule set applies to firms, and to persons associated with firms, whose activities do not extend beyond certain enumerated activities (Proposed Rule 014). Generally speaking, the enumerated activities encompass the traditional investment banking activities of advising firms on securities offerings, mergers and acquisitions, and restructurings.[3] The

[1] See FINRA, Regulatory Notice 14-09, Limited Corporate Financing Brokers, February 2014.

[2] Most of my publications are publicly available at www.ssrn.com.

[3] As to the activities traditional performed by investment bankers, see Alan D. Morrison & William J. Wilhelm, Investment Banking: Institutions, Politics, and Law 22 (2007); James D. Cox et al., Securities Regulation: Cases and Materials 115 (7th ed, 2013); and Bruce Wasserstein, Big Deal: 2000 and Beyond 556 (2000).

The term mergers and acquisitions is used broadly to include numerous types of often overlapping transaction categories, including purchases and sales of businesses or assets, going-private transactions and divestitures.

enumerated activities also include assisting in the preparation of offering materials on behalf of an issuer and providing fairness opinions, which are also activities traditionally performed by investment bankers.[4] However, the proposed rule set would not apply to firms that underwrite securities offerings (another traditional investment banking activity). It is nevertheless clear that the proposed rule set would apply to firms that engage in the traditional investment banking activities other than securities underwriting.

II. FINRA REGULATION OF INVESTMENT BANKING

To begin, I applaud FINRA for specifically addressing the regulation of investment banking activities. Although these activities are not typically performed by traditional broker-dealers, as FINRA's Regulatory Notice acknowledges, they generally fall within the definition of broker in the Securities Exchange Act.[5] In general terms, I understand that firms and individuals engaging in investment banking activities, including advising on securities offerings and M&A, have registered with FINRA.[6] In legal scholarship, little attention has focused on the requirement for those engaged in investment banking activities to register as broker-dealers. Your proposed rule set is likely to lead to broader discussion of the regulation of investment banking activities and FINRA's role in it – a desirable development.

III. CONTENT OF RULES

The proposed rule set includes relatively minor reforms to the content of the rules that apply to firms and individuals engaging in investment banking activities. With the exceptions noted below, the proposed rule set largely includes those rules in FINRA's existing Manual relevant to broker-dealers satisfying the definition of LCFB, although some accommodations have been made for LCFBs. The proposed rules set will provide certainty to LCFBs as to the rules with which they must comply. At the same time, the proposed rule set is unlikely to change the regulatory burden facing LCFBs. It is also a piecemeal set of rules, rather than a broad-based rule set comparable to the conduct rules that apply to other market gatekeepers, such as lawyers and accountants.

The proposed rule set would seem to omit rules concerning two important matters. The first concerns fairness opinions. Rule 5150 has been omitted, an apparent unintended oversight considering the explicit reference to fairness opinions in the definition of LCFB.

---

[4] The proposed rule set enumerates two other activities: qualifying, identifying, and soliciting potential institutional investors; and advising on the selection of an investment banker. The former activity may well be performed by investment bankers, although it differs from other enumerated activities since its focus is on investors, rather than corporate clients engaging in transactions. The latter activity is clearly not one performed by an investment banker and its inclusion therefore suggests that LCFBs perform activities beyond investment banking.

[5] Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c.

[6] This approach was supported most recently by the SEC in a no-action letter. *See* Letter re: Merger and Acquisition Activities of Foreign Firms in Reliance on Rule 15a-6, SEC No-Action Letter, July 12, 2012, *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2012/ernstyoung071212-15a6.pdf. However, no-action relief was provided for certain advisers to private-company M&A transactions. *See* Letter re: M&A Brokers, SEC No-Action Letter, January 31, 2014 (revised February 4, 2014), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

The second concerns rules relating to information barriers. The proposal rule set would benefit from an explicit reference to FINRA guidance on these measures to cabin information flows.[7]

IV. ENFORCEMENT OF RULES

The proposed reforms overlooks the more pressing issue of the extent to which FINRA enforces its rules against firms and individuals engaging in investment banking activities. As a regulator concerned with deterring its members and their associated persons from harming investors and others, FINRA must be concerned not only with the content of its rules, but also with their enforcement. The proposed reforms suggest no change in FINRA's enforcement intensity against firms and individuals performing investment banking activities.

The issue of enforcement by FINRA of its rules against those engaged in investment banking deserves close scrutiny. In "The Untouchables of Self-Regulation," a paper forthcoming in the *George Washington Law Review*,[8] I examine the extent to which FINRA enforces its rules against both investment bankers and firms for the conduct of their investment bankers. (I define investment banking to include the investment banking activities referred to above; those activities are therefore largely consistent with the activities enumerated for LCFBs in the proposed rule set, but exclude private placement activities). The study covers the period January 2008 to June 2013.

As the paper explains, I find remarkably weak enforcement intensity against investment bankers and their firms. During the 66-month period under investigation, FINRA sanctioned 4,116 individuals and 1,645 firms. Of these 4,116 individuals, only 18 were investment bankers, and only 10 of these were sanctioned for misconduct toward their clients (rather than toward other actors, such as their firms). Of the 1,645 firms FINRA sanctioned, only seven involved the misconduct of their investment bankers.

Applying optimal deterrence theory, the paper argues that the self-regulation of investment bankers offers no credible deterrence against professional misconduct. It further argues that the costs of self-regulation likely exceed its benefits (measured in terms of deterrent force), and therefore that the self-regulation of investment bankers by FINRA should be considered a failure. Of course, these conclusions depend on the view that some wrongdoing by investment bankers and their firms escapes detection and sanction. That view is based on an extensive consideration of empirical evidence (regarding certain forms of misconduct by investment bankers) as well as anecdotal evidence. However, because the underlying level of wrongdoing by investment bankers is unknown, it is not possible to demonstrate conclusively whether FINRA fails to effectively enforce its rules against investment bankers and their firms. Some doubt will inevitably remain.

Nevertheless, the problem may be considered in more concrete terms. As is well-known, Delaware courts often opine on investment banking conduct in the course of adjudicating

[7] FINRA guidance is provided by NASD, Joint Memorandum on Chinese Wall Policies and Procedures, Notice to Members No. 91-45 (1991) (explaining the "minimum elements" for "adequate" Chinese walls).

[8] The paper will be available on www.ssrn.com in coming days.

disputes in M&A transactions. In 2011, for instance, the Delaware Court of Chancery criticized investment bankers for "secretly and selfishly manipulat[ing] the sale process to engineer a transaction that would permit [their firm] to obtain lucrative … fees."[9] The following year, it criticized a prominent investment banker for failing to disclose a material conflict of interest with his client, a failure the Court described as "very troubling" and "tend[ing] to undercut the credibility of … the strategic advice he gave."[10] The disputes involved alleged conduct that would seem at least to have infringed FINRA Rule 2010, which requires broker-dealers and their associated persons to "observe high standards of commercial honor and just and equitable principles of trade." In both of these cases, the investment bankers involved were registered with FINRA. According to FINRA BrokerCheck, however, none has faced disciplinary action. While not conclusive, this evidence raises questions about FINRA's enforcement activities against investment bankers.

Moreover, the actions that FINRA did bring against investment bankers or firms for the conduct of investment bankers (during the period under analysis) are a rather odd assortment, one suggesting no particular enforcement priorities. I do not mean to belittle some of the actions; although small in number, some involve either individuals from prominent firms or apparently serious misconduct. At the same time, most of the disciplinary matters FINRA did bring against investment bankers or against firms for the conduct of investment bankers would have registered little interest among investment bankers. For example, one investment banker was sanctioned for violating his employer's internal policies while "attempting to procure investment banking and consulting business … from a publicly-traded company."[11] He had used his personal e.mail account (rather than one provided by his firm) to communicate with the potential client and had posted messages about the client on the Yahoo! message board, including "[t]his one looks like a gem" and "[s]till digging into this one but looks like the real deal."[12] FINRA sanctioned another investment banker for embellishing his experience by falsely telling a prospective client that he had advised on a reverse takeover and for misleading another potential client about the work he was doing for it.[13] Not persuaded, the clients went elsewhere – but the banker faced FINRA discipline.[14] Given the nature of these matters, it is surprising that FINRA's enforcement intensity is not significantly stronger than the data in my study suggest.

V. APPLICATION OF THE PROPOSED RULE SET

One further concern with the proposed rule set relates to its application. It will clearly apply to so-called boutique investment banking firms – firms that do not engage in traditional

[9] In re Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 818 (Del. Ch. 2011).

[10] In re El Paso Corp. S'holder Litig., 41 A.3d 432, 442 (Del. Ch. 2011).

[11] FINRA Letter, No. 2011030840501, Re: Christopher A. Carra, June 29, 2012.

[12] *Id*.

[13] FINRA Letter, No. 2010021116001, Re: Richard S. From, Oct. 5, 2011.

[14] He was fined $5,000 and suspended for associating with a FINRA member for 30 days. *Id.*

broker-dealer activities (such as managing client funds or executing client trades) or in other financial activities, such as commercial banking or asset management. But will the rule set also apply to the broker-dealer affiliates of financial conglomerates – enterprises that engage in a broad and diverse range of financial activities, but whose broker-dealer affiliates may engage in a narrow range of activities?

There is a clear danger is seeking to streamline the rules for financial conglomerates, even for their broker-dealer affiliates that may satisfy the definition of LCFB. Financial conglomerates are significantly more likely to face conflicts of interest than boutique investment banking firms. Otherwise put, financial conglomerates have greater incentives and opportunities than boutiques to engage in misconduct, such as skewing their advice to clients and misusing non-public client information.[15] Empirical evidence confirms these dangers.[16]

I would therefore recommend clarifying the propose rule set to provide that it applies only to broker-dealers who enterprise-wide activities satisfy the definition of LCFB. There is no apparent basis for providing any accommodations to broker-dealers affiliated with financial conglomerates, even if those broker-dealers satisfy the definition of LCFB.

Nevertheless, FINRA must ensure that it does not create unjustified distinctions between investment bankers working for financial conglomerates and those working for investment banking boutiques. After all, these individuals may well perform largely identical functions. Yet, if the proposed rule set applies only to the latter type of firm, those investment bankers would seem to benefit from some regulatory relief. One area in which the proposed rule set provides relief is continuing education requirements. Why so? It is difficult to understand the benefits of imposing education requirements on investment bankers that differ depending on the type of firms employing them. However, there would seem to be merit in tailoring education requirements to the distinctive work that investment bankers perform, whatever business model their employer adopts.

* * *

Thank you for the opportunity to comment on the Regulatory Notice. I would be pleased to discuss these comments further.

Andrew F. Tuch
Associate Professor of Law
Washington University School of Law
atuch@wustl.edu

[15] For further discussion, see Andrew Tuch, Financial Conglomerates and Information Barriers, J. CORP. L (2014) (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2363312.

[16] *Id*.