Proposed FINRA Rule 4110(e)(2) imposes barriers to the contribution of capital by general partners and LLC participants, possibly to the detriment of the member firm, its employees and representatives, and the securities industry. It imposes unequal treatment of general partners and LLC participants based solely on the choice of entity through which they are conducting business. The requirements proposed to apply to general partners and LLC participants (but not to sole shareholders of C corporations or S corporations, for example), include the following, if the source of funds for the capital contribution is a personal loan to the general partner or LLC participant:

1. The loan agreement must have at least a 12-month duration.
2. The loan must provide non-recourse to the assets of the member firm.
3. The loan must provide in the loan agreement a provision which will estop the lender from having the right to reach into the assets of the broker-dealer.

In the case of a closely-held broker-dealer, the most common and expeditious way to raise and contribute capital is to personally draw on an existing home equity line of credit. The standard provisions of a home equity line of credit would not include provisions "2" or "3" above.

Example: Broker-dealer A has 15 full time employees plus 100 registered representatives. A large, unexpected arbitration judgment is imposed and must immediately be accrued, reducing net capital and plunging the broker-dealer into net capital violation. The owner of the broker-dealer is able to immediately draw on his personal home equity line of credit to contribute capital to his broker-dealer and restore capital compliance:

A. In the case of a corporate stockholder, the net capital crisis has a quick solution, and business continues as usual.

B. In the case of a general partner or LLC participant, the home equity loan lacks the proposed required provisions "2" and "3", and big bank A is not about to consult with its legal department and re-write its loan documents to accommodate the individual owner of Broker-dealer A. Within a few days, the fully disclosed clearing agent panics over the net capital violation and declines to clear any more securities transactions, and the 100 registered representatives panic and seek registration with another broker-dealer (because they are no longer able to conduct business and earn a living at Broker-dealer A). The 15 full time employees are soon without a job. The momentum of the business has completely deflated and Broker-dealer A is out of business. The local newspaper reports the failure of Broker-dealer A, and thereby damages the reputation of the securities industry.

Banks always resist when an outsider (FINRA, in this case) seeks to dictate the provisions of their loans or accounts. As proposed, the general partner or LLC participant is helpless between two large institutions, and subjected to unequal treatment under FINRA rules.

The time to disallow the treatment of the owners contribution as part of computed net capital is only when the bank has asserted a demand for immediate repayment of the loan and has initiated procedures to seek recourse from the assets of the broker-dealer. Until that (distant and improbable) event, capital contributions from the personal resources of a general partner or LLC participant should not be treated differently from capital contributions from the personal resources of a controlling corporate stockholder.

The proposed FINRA Rule 4110(e)(2) is intended to promote stability of capital contributions and therefore the stability of broker-dealer firms. But as indicated in the example above, the proposed rule may create a barrier to capital contributions and the unnecessary failure of broker-dealer firms.

Respectfully submitted,

Stephen R. Kinkade CPA
Financial & Operations Principal