



July 14, 2017

Via email only: [pubcom@finra.org](mailto:pubcom@finra.org)

**RE: Regulatory Notice 17-14:  
Capital Formation**

FINRA360 was announced in a Special Notice issued by FINRA on March 21, 2017 (the “Special Notice”), as “...a comprehensive self-evaluation and organizational improvement initiative” designed “...to ensure that FINRA is operating as the most effective self-regulatory organization (“SRO”) it can be....<sup>1</sup> To meet that goal, FINRA requested input from FINRA stakeholders, including regulated firms and the public, on the effectiveness of FINRA’s current engagement programs. As part of the FINRA360 initiative, FINRA has issued Regulatory Notice 17-14, Capital Formation (“RN 17-14”), seeking comments on FINRA rules impacting capital formation.

Integrated Management Solutions USA LLC (“IMS”) is pleased to comment on RN 17-14. We are one of the largest providers of compliance consulting and financial accounting services to the financial services industry, including to about 100 FINRA members, among others types of financial services firms.<sup>2</sup> We counsel clients daily on the scope of permissible broker-dealer activities under various FINRA, SEC and other rules.

Most of the firms we work with engage regularly in capital formation activities. IMS has routine, daily experience with FINRA’s membership categories and rules, including, without limitation, capital formation rules, SEC and other rules, and the financial reporting requirements applicable to broker-dealers that provide capital formation services, and how they are, in fact,

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<sup>1</sup> <http://www.finra.org/about/finra360> (April 5, 2017).

<sup>2</sup> The statements in this comment letter incorporate the views of IMS, not those of our clients. However, in the course of providing our services, many of our clients regularly convey to us their frustrations in dealing with FINRA and other regulators in terms of their operational needs and meeting regulatory compliance obligations. Although these clients may not themselves submit comment letters to FINRA, we believe our comments give voice to many of their ongoing concerns.

implemented by the various regulators. We have previously submitted comment letters on some of the more recent capital formation initiatives promulgated by FINRA, with SEC approval, that are cited in RN 17-14, as well as other rules that directly affect capital formation. We believe this experience enables us to assess FINRA's, and the SEC's, impact on capital formation from both a regulatory and business perspective.

### **FINRA, the SEC and Effective Regulation**

We laud the concept of FINRA360. We believe FINRA's intentions are honorable. A critical dynamic affecting FINRA's effectiveness as a regulator was well-described in the Special Notice:

FINRA is an SRO for the broker-dealer industry and is dedicated to investor protection and market integrity through effective and efficient regulation that facilitates vibrant capital markets. [Ftn. omitted.] There are many stakeholders with strong interests in how FINRA pursues this mission, including FINRA's member firms, investors and other regulators and policymakers.<sup>3</sup>

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Congress, the Securities and Exchange Commission ("SEC") and FINRA's members (when they voted to approve FINRA's By-Laws) have established a variety of checks and balances that are intended to enable FINRA to be a membership organization that is also an effective regulator. These checks and balances permit the extensive member engagement necessary to achieve the benefits of the SRO structure while preventing such engagement from compromising FINRA's regulatory mission.<sup>4</sup>

We appreciate FINRA's candor in acknowledging that its effectiveness depends on respecting those checks and balances. The Special Notice also discussed FINRA's well-known relationship with the SEC.

Furthermore, FINRA is subject to comprehensive SEC oversight to ensure that FINRA is acting in the public interest even as it has extensive engagement with the firms it regulates. As more fully described below, FINRA is required (with limited exceptions) to obtain SEC approval for all of its rules that apply to its operations and its member firms, must comply with applicable SEC regulations and is subject to numerous SEC oversight investigations

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<sup>3</sup> Special Notice, p.2.

<sup>4</sup> Id., p.3

and examinations each year. The SEC also has broad authority to add, delete or amend FINRA rules; suspend or revoke FINRA's registration; censure or impose limitations on FINRA's activities, functions and operations;....<sup>5</sup>

Although FINRA has clearly articulated its mandate, we believe those very constraints will prevent FINRA, and the SEC, from fully addressing the impact of their rules on capital formation, as set forth in RN 17-14, unless FINRA and the SEC act jointly to assess, and address, which regulations facilitate capital formation and why. If the SEC and FINRA were to approach Congress together, requesting changes to certain existing rules that harm or limit capital formation, we believe that viable and practical solutions are achievable and can be implemented.<sup>6</sup>

In prior responses to various comment letters submitted to FINRA concerning capital formation rules, including, without limitation, those submitted by IMS, FINRA has often refused to discuss specific recommendations, saying, all-too-facilely, that it defers to the SEC to deal with a particular issue.<sup>7</sup> It's time for that charade to stop. Capital formation is too vital for the economic health and future of this country as a global economic leader. It's time for FINRA and the SEC, which purport to liaise constantly and regularly, to determine jointly whether their respective rules impacting capital formation have continuing validity, operate effectively or truly provide investor protection.

For years now, we have heard all the financial regulators (not just FINRA and the SEC) state that they are engaged in risk management. Engaging in such a joint assessment would also constitute effective risk management. It's time to put some teeth into that precept.

### **The Current State of the Brokerage Business**

In our view, the brokerage industry consists of three broad categories of firms: traditional brokerage firms that solicit trades and trade securities on behalf of their customers, those that engage in clearing and carrying activities and everyone else, i.e., "the non-custodial broker-dealers." While the risks associated with each of these business lines are well-understood, we

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<sup>5</sup> Id., p.4.

<sup>6</sup> This would also accord with certain regulatory objectives articulated by the current Executive Branch. See, e.g., The White House, Office of the Press Secretary, "Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs" (Jan. 30, 2017), available at <https://www.whitehouse.gov/the-press-office/2017/01/30/presidential-executive-order-reducing-regulation-and-controlling>.

<sup>7</sup> See, e.g., Rel. No. 34-76675, CAB Proposal, p. 48, ftns. 76 and 77 and accompanying text.

question whether FINRA’s current rules realistically address those risks. Certainly, the activities of the “bulge bracket firms” include all possible brokerage business. There are still some smaller firms that engage in trading activities, either directly or through various alternative trading system platforms (“ATSs”). There are also a limited number of other firms, well-known in the industry, that, directly or indirectly,<sup>8</sup> provide clearing and carrying services. However, the vast majority of FINRA member firm restrict their activities to capital formation and never handle traditional brokerage accounts, customer funds or securities or provide clearing and carrying services. These non-custodial broker-dealer firms do not, and do not wish to, allocate resources to engage in the heavily-regulated and capital-intensive trading and/or clearing and carrying businesses. Occasionally, firms providing capital formation services have a limited need for clearing and carrying services,<sup>9</sup> but they are more than willing to pay for those services on an as-needed basis. Yet all FINRA-member firms bear the costs that, from a regulatory, risk and business perspective, more appropriately should only be charged to those firms that provide trading and/or clearing and carrying services. No one is challenging that the industry needs such firms, but the current regulatory scheme largely uses a “one-size fits-all approach” that is detrimental to effective risk management or regulation of the vast majority of member firms. FINRA’s monolithic regulatory scheme impacts most adversely on firms that focus on capital formation transactions.

If FINRA and the SEC are truly committed to eliminating unnecessary regulatory burdens, particularly with respect to capital formation, a good place to start is to evaluate which of their respective rules should apply to capital formation activities and which are more appropriately applicable solely to the businesses of trading and/or clearing and carrying securities. Many of the existing rules, as we have stated in other comment letters, result in unintended – and wastefully expensive – consequences.

### **Financial, Record-Keeping and Reporting Rules**

In our view, the biggest deterrents for broker-dealers engaged in capital formation activities are the net capital rules and their associated record-keeping and reporting requirements.<sup>10</sup> This

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<sup>8</sup> Firms that have contractual arrangements with clearing firms to provide piggyback arrangements for other firms needing clearing and carrying services.

<sup>9</sup> For example, when they earn options or warrants as part of their underwriting compensation.

<sup>10</sup> We will address the nine questions posed by FINRA in RN 17-14 later in this Comment Letter, but believe that those nine questions are premised on the status quo and do not challenge, as they should, the underlying principles

burden is exacerbated by the requirement that almost all FINRA-member firms must have annual audits performed by PCAOB-member public accountants, which has become a very expensive cost of doing business. On that last point, in our experience, the end product of the audited financial statements of non-custodial broker-dealers is hardly looked at by anyone other than the regulators and SIPC.

We believe FINRA and the SEC need to address whether the net capital rules benefit capital formation, and, if so, how?<sup>11</sup> The SEC describes the purpose of the net capital rules as follows:

The Securities and Exchange Commission's (SEC) [ftn. omitted] uniform net capital rule (15c3-1) and customer protection rule (15c3-3) form the foundation of the securities industry's financial responsibility framework. The net capital rule focuses on liquidity and is designed to protect securities customers, counterparties, and creditors by requiring that broker-dealers have sufficient liquid resources on hand at all times to satisfy claims promptly. Rule 15c3-3, or the customer protection rule, which complements rule 15c3-1, is designed to ensure that customer property (securities and funds) in the custody of broker-dealers is adequately safeguarded. By law, both of these rules apply to the activities of registered broker-dealers, but not to unregistered affiliates.<sup>12</sup>

In 1975, the SEC amended the net capital rules, explaining the purpose of net capital as follows:

[The] SEC amended the net capital rule (Rule 15c3-1) in 1975 to establish uniform net capital standards for brokers and dealers [ftn. omitted] registered with SEC under Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act). With few exceptions, all broker-dealers registered with SEC must comply with this liquidity standard. [Ftn. omitted.] The primary purpose of this rule is to ensure that registered broker-dealers maintain at all times sufficient liquid assets [ftn. omitted] to (1) promptly satisfy their liabilities - the claims of customers, creditors, and other broker-dealers; and (2) to provide a cushion of liquid assets in excess of liabilities to cover potential market, credit, and other risks if they should be required to liquidate....The net capital rule thus enhances investor/customer [symbol deleted] confidence in the financial integrity of broker-dealers and the securities market.<sup>13</sup>

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“justifying” those rules. If the FINRA360 initiative is truly to be effective and address business realities and risk management, all so-called fundamental rules, such as the net capital rule, and the logic behind those rules, should be subject to examination and rigorous analysis. What should be implemented is principles-based regulation.

<sup>11</sup> Historically, FINRA states it defers to the SEC on net capital issues. In our view, this is FINRA’s flimsy and disingenuous way of saying that not only is it unwilling to take responsibility for the operational and risk management hardships these rules have on capital formation, but also that it will not re-assess whether those rules serve any business or risk management purposes. Instead of advocating for its members based on principles-based business and operational realities, it blindly perpetuates the regulatory status quo.

<sup>12</sup> GAO/GGD-98-153 Risk-Based Capital, p. 130, available at [https://www.sec.gov/about/offices/oia/oia\\_market/key\\_rules.pdf](https://www.sec.gov/about/offices/oia/oia_market/key_rules.pdf).

<sup>13</sup> *Id.*, at pp. 130-31.

We think it appropriate to ask whether these rules, in fact, meet the SEC's stated purposes.<sup>14</sup> Even if, for argument's sake, these rules accomplish their stated objectives, are there alternative ways of achieving the same stated goals? To do so requires a risk-based assessment of the business activities of the broker-dealer industry. We do not have available either the statistical data or the resources the SEC and FINRA have, and call on them to release data relevant to determine when net capital remains a useful tool to maintain "...the financial integrity of broker-dealers and the securities market."<sup>15</sup> IMS' extensive experience (since 1985) in providing services, including, but not limited to, financial and operational services to firms engaged in a broad range of broker-dealer businesses, enables us to assess, at least anecdotally, whether the net capital rules accomplish the SEC's stated objectives.<sup>16</sup>

For firms that routinely engage in trading activities and/or provide clearing and carrying services, the net capital rules are one tool that "...provide[s] a cushion of liquid assets in excess of liabilities to cover potential market, credit, and other risks if they should be required to liquidate."<sup>17</sup> It is likely not the only tool as most such firms not only maintain FINRA-mandated fidelity bonds,<sup>18</sup> but also errors & omissions and other insurance policies, even though the exclusions in such policies mitigate their effectiveness in protecting customers and creditors. In addition, customers have some protections provided through SIPC. To us, it makes more sense, as an optional alternative to some "one-size-fits-all" rules such as the net capital rule, to allow broker-dealer firms to maintain market-based insurance risk coverage, particularly for those firms

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<sup>14</sup> These concerns are not new and were raised by a Committee of the American Bar Association more than a decade ago. "Report and Recommendations of the Task Force on Private Placement Broker-Dealers," 60 *Business Lawyer* 959 (May 2005). See, also, <https://www.sec.gov/rules/other/265-23/gvniesar091205.pdf>.

<sup>15</sup> *Id.* If FINRA or the SEC expect detailed analysis of the economic costs of their respective proposals, data need to be made freely available. In response to one Comment Letter IMS submitted, the SEC stated that we described the cost of broker-dealer compliance with Form Custody as "staggering," but "...did not provide any suggestion for reducing the costs associated with Form Custody." SEC Release No. 34-70073; File No. S7-23-11, Final Rule, Broker-Dealer Reports, p. 135, fn. 536. Our conclusion was based on the SEC's own estimate of nearly \$70 million in compliance costs to the industry, amounting, according to the SEC, to \$13,680 per broker-dealer, a number we find troubling because we don't know what costs actually went into its determination and have no way to determine if the economic benefit to a hypothetical broker-dealer actually justifies that outlay; *Id.*, at p.202, fn. 718. If we had the statistical data and expertise available to the SEC, we could probably calculate a more realistic cost structure and suggest alternatives.

<sup>16</sup> Though IMS began in 1985, a number of its staff people have been associated with the securities industry in one form or another since the late 1960s, and a few of them have been employed by the New York Stock Exchange in its Regulation and Surveillance Group.

<sup>17</sup> *Id.*

<sup>18</sup> FINRA Rule 4360. Fidelity bonds are very limited in scope and hardly cover many risks.

handling customer assets. We are confident that the insurance industry can develop such policies, if they are not already available at a reasonable cost, particularly if backed by SEC and FINRA initiatives.

But do firms that provide capital formation services (whether as their sole business or as part of a more full-service brokerage business) create the same customer, creditor and market risks as firms that actually handle customer securities and funds? When providing capital formation services, most firms, especially small ones, never hold customer funds or securities. They never commit their own capital to facilitate the transaction (unless for investment purposes, which is not a net capital question at all). So, where's the risk? Capital formation on behalf of others does not result in the creation of liabilities (beyond ordinary operating costs) or create liquidation risks (if a particular firm is bordering on insolvency, it has not assumed additional transaction-based risk by providing capital formation services to a third party). We even question the value of a fidelity bond for firms that do not handle customer assets.

When raising capital from the public, there is a "moment-in-time" when the firm's capital is at risk because an underwriter participant nominally "takes" those securities in inventory. But since these transactions are generally pre-sold through indications of interest,<sup>19</sup> we believe that risk is minimal. It could also be more realistically covered by insurance at a lower cost than complying with the net capital rules. In that regard, FINRA should start a dialog with insurers that could create policies that would offer good coverage to customers and creditors of broker-dealers or to the broker-dealers themselves. Perhaps the coverage should be even better than the excess-SIPC coverage that used to be offered years ago. For non-custodial broker-dealers, the annual premium cost might be much lower than the cost of maintaining net capital accounts, maintaining books and records and having annual audits by PCAOB firms. We believe that the SEC and FINRA should study whether insurance should be an alternative option to these burdensome rules that provide no realistic protection to anyone involved in capital formation.<sup>20</sup>

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<sup>19</sup> Actually, pre-sales of securities that are not required to be registered, e.g., municipal bonds and securities issued by government-sponsored issuers, are treated as offsets to the exposure that would otherwise nominally accrue to the underwriter of the securities.

<sup>20</sup> Based on our work in providing FinOp and consulting services to firms that solely engage in capital formation activities, these hard, direct costs range from about \$60,000-\$100,000 per year. What such firms get from these expenditures is headaches from FINRA examiners who impose fines for technical record-keeping violations and a PCAOB-audit that no one except for regulators reads or uses. We recognize that this is the cost of doing business under current rules and regulations. What we question is who benefits from these expenditures? Certainly not the firm's customers, creditors or the markets because none of this information guides their investment decisions. Certainly, they hardly help these firms to operate more efficiently or affect the substance of their advice in capital

## **Audits**

If the net capital rules are amended to apply solely to firms that potentially create customer, market and creditor risks, are those the firms that should remain subject to an annual audit requirement? We believe they should.

Concomitantly, we question whether firms engaged only in capital formation activities need an audit at all; and if they do, what benefit is achieved by mandating that it be conducted by PCAOB-registered auditors? Generally, no customers or the markets rely on such audits. PCAOB audits are expensive and we believe customers would benefit more from diverting audit costs to more robust insurance coverage.

This issue arose when FINRA proposed creating a new category of broker-dealer, CABs (“Capital Acquisition Brokers”). In the various iterations of the CAB proposals, FINRA ducked the issues of whether the net capital rules should be applicable to CABs and should such firms be required to undergo an annual audit, saying it lacked the authority to reduce or limit these requirements. As we noted at the time, FINRA glossed over two intriguing alternatives to requiring audited financial statements suggested by commenters as part of the CAB proposal. One such suggestion was that an AICPA-member “review” would suffice. The other sought to impose threshold barriers, specifically suggesting excluding CAB firms from the annual audit requirement if they had fewer than 20 employees or less than \$10 million in net revenues.<sup>21</sup> Many if not most firms engaged solely in capital formation activities would likely meet those criteria. We believe these alternatives merit further consideration through a joint working task force of the SEC and FINRA. An even better approach would be to eliminate the net capital and audit requirements altogether for broker-dealers that never hold securities or cash belonging to others.

## **A bit of historical perspective**

Before we delve into the specific questions asked by FINRA about the Capital Formation Rules, it is useful to describe certain recent historical events.

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formation transactions. On a principles-based analysis, these rules should not apply to non-custodial broker-dealers and FINRA’s and the SEC’s rules should be re-focused to implement the reality of where the risk is for the investing public and the securities markets.

<sup>21</sup> CAB Proposal, p. 51.



- **Mary Was Right**

Former SEC chair and FINRA chair Mary Schapiro was right when she travelled all over the country to promote the idea that it would be useful to have a single rulebook by merging together NYSE Regulation and the NASD. While she was right in celebrating the efficiencies that would be gained by such a merger, what has happened since is that only a couple of regulatory bodies have been eliminated. Broker-dealers are still regulated by multiple-regulators whose rules often conflict with each other. Consider that many broker-dealers are regulated by the following regulators and each of them have their own rulebooks and protocols:

- SEC
- FINRA
- Securities exchanges
- MSRB
- Each of:
  - 50 states
  - Puerto Rico
  - Virgin Islands
  - Washington, D.C.
- CFTC
- NFA

We believe that most of the rulebooks should be eliminated and that capital formation would be promoted significantly by declaring once and for all that, at most, 2 or 3 regulators should regulate all broker-dealers, especially the smaller ones. This is not rocket science; it's been done before quite successfully. Have we already forgotten the National Securities Markets Improvement Act of 1996? The fact that it became effective at the end of the previous century does not diminish its current importance. What it did to eliminate duplicative and unnecessary regulation of investment advisors provides a lesson to the securities industry. It offered some relief for the securities industry, but not quite enough, particularly for those non-custodial broker-dealers that engage solely in capital formation activities.

- **The 2016 election has promoted the notion of regulation elimination**

As we noted above,<sup>22</sup> the current federal government seems very committed to eliminating wasteful regulation. This may be an administration that would be receptive to re-assessing which regulations are appropriate for which segments of the securities industry, based on a principles-based analysis that incorporated risk management criteria. We would recommend that the first rule that should be evaluated is the net capital rule to determine what benefit, if any, does it serve with respect to capital formation? Are there viable alternatives to protect the investing public and capital markets, such as alternative insurance coverage? We've discussed above the record-keeping and audit burdens the net capital rule imposes on non-custodial broker-dealers.

- **Dodd-Frank might be changed**

We believe that many of the safeguards mandated by Dodd-Frank were valuable in restoring public confidence in the securities markets. Do these safeguards continue to serve their intended purpose? We recognize that many broker-dealer have invested significant sums to implement the Dodd-Frank mandates, including, without limitation, those that impact on capital formation activities. We believe that the SEC and FINRA should use their considerable expertise to advise Congress and other policy makers as to which Dodd-Frank rules continue to benefit the markets and the industry, particularly with respect to capital formation activities. Conversely, they should determine which rules should be eliminated, especially if they inhibit capital formation in the United States or encourage capital formation to be done overseas because some of our rules are unnecessarily punitive or discouraging.

- **FINRA's membership ranks are diminishing**

Sadly, we believe that many FINRA members are leaving the broker-dealer industry because they are being strangled by current FINRA rules and regulations. The numbers speak for themselves. It doesn't mean that talented people are abandoning their capital formation activities; instead, they are channeling them by providing advice and strategies through various funds that

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<sup>22</sup> In ftm. 6, above.

avoid FINRA regulation, leaving the business of finding qualified investors to broker-dealers. The SEC regulates the investment adviser industry with a lighter hand.

FINRA examinations of members have turned into orgies of finding violations, no matter how insignificant or technical. For example, enforcement of the Outside Business Activity Rule.<sup>23</sup> Are the investing public safer and the securities markets more efficient and transparent by knowing that a particular broker-dealer associated person is a landlord who rents out half of his or her two-family home? Or raises goats as a sideline business? What happens is that FINRA examiners impose significant fines for a broker's failure to disclose those activities on his or her Form U4. If there are multiple associated persons at a particular member who have omitted to make such disclosures, the firm itself may be fined and its CCO further fined for his or her failure to supervise. In another instance, we assisted a broker-dealer client when the FINRA examiner found a discrepancy in the firm's books and records of \$37 and insisted that the discrepancy be explained and rectified; ultimately, cooler, more senior heads at FINRA prevailed.

One more anecdote. We know of a very well-known global conglomerate which, among multiple other business operations, maintained a substantial commodities operation in both London and New York. Fortunately, the New York firm was regulated by the NFA because an NFA examiner determined that the New York firm had incorrectly believed it could rely on the London firm's Anti-Money Laundering ("AML") manual and policies and procedures, even though they were legally distinct entities. The NFA examiner found that the New York firm had conducted appropriate AML reviews of all customers and potential customers; what it lacked was an AML manual. The NFA examiner suggested that he and the New York firm's CCO sit down right then and draft an AML manual, a process that took approximately 45 minutes. We laud that NFA examiner for coming up with a very practical solution. No fines, warnings or sanctions were issued by NFA.

Had the regulator of record been FINRA in the above situation, we strongly believe, based on the multiple firms we have assisted during FINRA examinations over many years, that fines and sanctions would likely have been imposed, particularly since this was a marquee company with global name recognition. Had this happened at a capital raising, non-custodial broker-dealer firm, FINRA examiners would have imposed significant fines and sanctions requiring disclosure on the firm's Form BD and its CCO's U4. The substance of the AML requirements had been met

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<sup>23</sup> FINRA Rule 3270. FINRA has undertaken to evaluate the effectiveness of that particular rule. See, RN 17-20.

by that commodities firm, that is, what could have adversely affected the markets and capital raising because a “bad actor” was assisted in its activities through a firm’s failure to conduct an appropriate AML examination never happened. FINRA examiners do not distinguish substance over form. We have come to believe that FINRA examiners get promoted and rewarded for the fines they impose on firms and its associated persons, or at least so it seems. Is it any wonder that broker-dealer firms assume that a FINRA examiner will not stop until violations are found, no matter how insubstantial? Is it surprising that many firms complain about the costs of regulation, particularly when the focus is on technical matters that have no substantive impact on any of the constituencies FINRA ostensibly protects?

Firms are MEMBERS of a self-regulatory association. What used to be a more cooperative arrangement where the member firms and FINRA assisted each other in promoting investor protection and market integrity has been perverted into “gotcha” enforcement mentality. Form has devoured substance in many instances of enforcement by FINRA. There will always be worms in the apple barrel, associated persons who foolishly think they have found a loophole to exploit that no one else has understood. Most people in the industry loathe these bad actors as much as anyone. Their conduct, and the publicity it generates, reflects poorly on the industry as a whole. But these bad actors are in a small minority. FINRA should devote more resources to working cooperatively with its members and begin ameliorating this adversarial situation that currently exists between the members and FINRA examiners and coordinators. Substance, principles-based enforcement and risk management should be the controlling factors, not belt notches for discovering technical violations that have no impact on customers, the investing public or market integrity. Hasn’t anyone at FINRA figured out that declining membership means fewer jobs for regulators?

That the number of FINRA members continues to decline should not come as a surprise to anyone given the regulatory enforcement climate FINRA has created. This is particularly true at non-custodial broker-dealers that focus on capital formation.

- **NSMIA is old and dated**

We desperately need a NSMIA of 2017. We do not need state registration of broker-dealers or their associated persons, particularly for the non-custodial broker-dealers that facilitate capital formation activities. It serves little purpose. What we’re seeing in our capacity as compliance

consultants is state regulators enforcing state registration rules. It's a revenue source to those state regulators, but where is the concomitant benefit to the investing public and the securities markets?

### **FINRA's Nine Questions Concerning its Capital Formation Rules**

RN 17-14 cites several regulated business activities that have an impact on capital formation, including, without limitation, market making and the research rules. Although described, the impact of those rules is not included in the nine questions FINRA has asked the industry for comments. Accordingly, we will limit our additional comments to answering those nine questions to the extent possible.

#### **1. Have FINRA's rules covering the capital-raising process effectively responded to the problem(s) they were intended to address?**

The FINRA rules governing capital formation are essentially record-keeping rules. The 5000 series, in particular Rule 5123 for private placements, contains so many exemptions that it applies only in a very limited number of situations. More seriously, its filing requirements essentially duplicate state regulatory filing rules for the same transaction. How could duplicative filings and record-keeping requirements promote efficient capital-raising?

#### **2. What have been the economic impacts, including costs and benefits, arising from FINRA's rules on the capital-raising process? To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models?**

We've discussed in great detail above the negative impact the net capital rule and its mandated compliance processes impose on capital formation by broker-dealers. "One-size-fits-all" rules have repeatedly failed to incorporate principles-based regulation or risk assessment on how FINRA regulates non-custodial broker-dealers that engage in capital formation activities. FINRA360 has created a unique opportunity to re-assess the compliance costs – and benefits - of the net capital rule on capital formation and which FINRA rules promote such activities. We

believe that this review should consider the alternative of using insurance policies to substitute for net capital compliance by smaller firms that are non-custodial.

We suggest that FINRA and the SEC harmonize and reduce the various categories of institutional investors. Do the varying definitions of institutional investors help capital formation? Any reassessment of what regulations may impede the capital-raising process should evaluate whether all the sub-categories of institutional investors provide any benefit to customers or market integrity. Do these categories incorporate risk assessment? Are the markets better off by distinguishing among institutional investors, QIBs (“qualified institutional buyers”), qualified purchasers, Major U.S. Institutional Investors, U.S. Institutional Investors, etc.?

On the retail side, existing rules, such as the key definition of the financial status of potential investors, e.g., “accredited investors” or “qualified client” provide a significant and effective barrier to protect the investing public. The Crowdfunding limitations are intended to protect less sophisticated investors, but it is too soon to determine if they are really effective.

**3. Where have FINRA rules around the capital-raising process been designed particularly effectively? Are there other rules or applications where this approach might enhance capital formation while maintaining investor protections?**

Please see our comments to Question #2, above.

**4. What, if any, unintended consequences have arisen from FINRA’s rules related to the capital-raising process? How have firms limited or amended their business models and practices in ways unintended by FINRA with a consequence to capital formation or investor protection in order to comply with FINRA’s rules in these areas?**

Our comments to the net capital rule, above, discuss its unintended consequences and how it needlessly, i.e., without benefit to customers, the investing public or market integrity, is a drag on capital formation. Too many firm resources are devoted to complying with the net capital rule and its ancillary, but mandatory, rules such as the need for an annual PCAOB audit. We also question the benefits, if any, of expensive FINRA enforcement of technical failures. We believe that for a first technical FINRA rules violation unaccompanied by any other violations a caution

is warranted, not a fine and disclosure on the firm's Form BD and/or a Registered Representative's U4.

**5. Are there other FINRA rules not identified above that impact the capital-raising process? If so, what has been your experience with these rules?**

Discussed above. This includes our concern about compliance with state regulatory requirements in addition to FINRA and SEC rules.

**6. Are there any ambiguities in the rules that FINRA should address to aid firms' compliance and enhance the capital-raising process while ensuring investor protection concerns are addressed?**

Discussed above. The securities industry regulators should work cooperatively among themselves, and seek member input, to implement principle-based regulation. Once those guiding principles are in place, existing rules should be reviewed. The current practice of promulgating patchwork rules does not necessarily result in smart, efficient and risk-based policy. Not every problem is resolved by separate regulators, each drafting their own versions of rules that attempt to focus on the same issue.

**7. Can FINRA make any of its administrative processes or interpretations related to the capital-raising process more efficient and effective? If so, which ones and how?**

Discussed above.

**8. As currently designed, are the eligibility requirements for the CAB rules over- or under-inclusive in any respect? What changes, if any, to these requirements should be considered? Are the requirements applicable to CABs appropriately tailored to their business activities? Should any changes to these requirements be considered?**

Our opposition to, and concerns about the uselessness of, CABs (in its various iterations) is on record, in several comment letters.<sup>24</sup> We remain intrigued by FINRA’s preliminary estimate that between 650 and 750 member firms would meet the definition of a “CAB” and would likely choose to be regulated as such.<sup>25</sup> So, about a year after the CAB Rules took effect, we asked a senior member at FINRA’s MAP Group about how many firms had registered as CABs? We were told approximately 25 firms, with a small number of pending applications for membership as CABs. We think that this underwhelming response (less than 5% of supposedly eligible firms) is due to at least several factors: the many restrictions on CAB activities, who its customers can be, the very minimal relief from existing FINRA compliance rules, no relief from net capital or audit requirements and the need to work with, and learn, a separate CAB Rulebook.<sup>26</sup>

Among other goals, the CAB Rules seem to have been intended to bring firms under the FINRA regulatory umbrella whose activities otherwise qualified under the Six Lawyers No-Action Letter concerning merger and acquisition brokers (the “Six Lawyers Letter”).<sup>27</sup> We believe, based on people who have approached us for advice on how to conduct what they believe is limited to merger and acquisition activities and for which they want transaction-based compensation, the burdens of FINRA regulation far outweigh the perceived “seal of approval” that FINRA membership ostensibly conveys. They’ve all heard the horror stories of FINRA’s examination focus as one of imposing fines and sanctions. Most prefer to tailor their operations to conform, if at all possible, to the parameters stated in the Six Lawyers Letter.

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<sup>24</sup> We submitted comment letters in response to RN 14-09 (“Limited Corporate Finance Brokers”), and 2 letters in response to SR-FINRA-2015-054 (“Proposed Rule Change to Adopt the Capital Acquisition Broker Rules”).

<sup>25</sup> SR-FINRA-2015-054 at p. 23.

<sup>26</sup> Indeed, this is most telling. When rule-making is done without recognizing the probable consequences of the rule-making, the resources of the rule-makers are wasted and the public is ill-served. That is so even if the rule-makers had the best of intentions.

<sup>27</sup> SEC No-Action Letter, dated Jan. 31, 2014, revised February 4, 2014; available at: <http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf>.



**9. As currently designed, do FINRA’s funding portal rules appropriately address the requirements and objectives of the JOBS Act and the SEC’s Regulation Crowdfunding? What changes, if any, should be made to FINRA’s rules, and why?**

We think it’s too soon to provide an assessment of the regulatory regime applicable to funding portals.

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FINRA360 provides the regulators and the industry with what could turn out to be an unprecedented opportunity to consider the risk, financial, operational, regulatory and financial reporting costs affecting broker-dealers. RN 17-14 specifically does so in the context of capital formation, an activity that has global ramifications. We hope that these two initiatives will inspire a new beginning of cooperation among the various regulators to assess business risks and adopt a framework of regulatory simplification that will benefit broker-dealers and the investing public<sup>28</sup>.

We appreciate this opportunity to comment on RN 17-14. Should you have any further questions, please feel free to call Howard Spindel at 212-897-1688 or Cassondra Joseph at 212-897-1687, or contact us by e-mail at [hspindel@integrated.solutions](mailto:hspindel@integrated.solutions) or [cjoseph@integrated.solutions](mailto:cjoseph@integrated.solutions), respectively.

Very truly yours,



Howard Spindel  
Senior Managing Director



Cassondra E. Joseph  
Managing Director

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<sup>28</sup> Lest anyone believe after reading our remarks that we might receive short term benefit through some of the initiatives that we have suggested above, we can unequivocally state that, for our particular company, the exact opposite is true. Our short-term success is inextricably linked to the mass confusion caused by the current rules. In the long run, however, we believe that voicing our concerns will benefit the capital formation process and thus, ultimately, we, too, will succeed.