NATIONAL INVESTMENT BANKING ASSOCIATION

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filed via e-mail to rule-comments@sec.gov

Ms. Elizabeth M. Murphy, Secretary

Securities and Exchange Commission

100 F Street, N.E.

Washington, D.C. 20549

Re: File No. S7-08-07

Dear Ms. Murphy

The National Investment Banking Association ("NIBA") thanks you for the opportunity to provide comments related to the Securities and Exchange Commission's ("SEC" or "Commission") request for comments in advance of its rulemaking in connection with the Broker Dealer Financial Responsibility Proposed Amendments.

NIBA (www.nibanet.org) is an eleemosynary organization comprised of several hundred FINRA member firms ("member firms"), approximately 95% of which are defined by FINRA as Small firms[1]. These firms employ approximately 8,800 registered persons; have been responsible for the underwriting or placement of over $10 Billion in equity and debt for predominantly Small Issuers, as that term is defined by the Commission, and Small Businesses, as that term is defined by the Small Business Administration; have been responsible for approximately 90% of the underwritten IPO's or primary and secondary registered offerings of under $20 million per offering; represent approximately 60 different industry sectors and services; and manage approximately $78 Billion in client assets, at the retail and smaller institutional levels.

Our comments concern the effects these proposals would have on Small Broker Dealers, while some are applicable to all levels of firms.

E. Amendments to the Net Capital Rule
1. Requirement to Subtract From Net Worth Certain Liabilities or Expenses Assumed By Third Parties and Non-Permanent Capital Contributions

►**The SEC writes:** *"Based on our experience, we also are concerned that broker-dealers may be receiving capital contributions from individual investors that are subsequently withdrawn after a short period of time (often less than a year). In some* *cases, the capital may be contributed under an agreement giving the investor the option to withdraw the capital at the investor's discretion."* **It later writes: "**<u>We also believe that most broker-dealers do not accept capital contributions under agreements permitting the investor to withdraw the capital at any time."</u> *"In the past, the Commission has emphasized that capital contributions to broker-dealers <u>should not be temporary</u> and the Commission staff has explained that a capital contribution should be treated as a liability if it is made with the understanding that the contribution can be <u>withdrawn at the option of the investor</u>."*

NIBA agrees that there should not be any circumstances pursuant to which a broker-dealer would accept a capital contribution for net capital purposes that can be withdrawn at the option of the investor, irrespective of any other factors affecting that broker-dealer.

However, there exists a substantive difference between what the Commission proposes and the reality of conducting a compliant broker-dealer business in the current economic environment, especially among small broker-dealers.

Likewise, the TIMING AND MATURITY/REDEMPTION FEATURES of capital for small broker-dealers, which make up the predominant majority of all broker-dealers licensed by the Commission, has become the key issue facing broker-dealers broker-dealer as they require additional net capital. According to FINRA, there are less than 400 large and medium size firms, and over 4,000 small firms.

Broker-dealers, especially small broker-dealers, as defined by the Commission as firms with under $500,000 in net capital, and as further differentially defined by FINRA as firms with under 150 registered persons (disregarding net capital or revenue thresholds), do not have the access to private or public capital enjoyed by large firms or even medium sized firms, i.e., from new non-involved shareholders or partners, or subordinated lenders. Thus, capital not contributed by owners, shareholders or partners who actually work in small firms,, is virtually unavailable at reasonable costs to broker-dealer and when available, is costly. When such capital is available to smaller firms, total yields of 30% to 50% are not uncommon.

The Commission writes, in its analysis of costs in their assumptions that <u>such capital is available at 5% to 7.5%</u>. We can assure you that no member of NIBA, and we believe very few if any small broker-dealers, can attract new capital anywhere near a 5% to 7.5% cost. A quick survey of other organizations whose members are small broker-dealers resulted in similar findings. <u>The aforesaid "available" 5% to 7.5% cost is a bank rate, not a private business rate.</u> Even B rated corporations with hundreds of millions in revenues pay more than 5% for their capital, and few small broker-dealers carry a national rating by any rating agency. Our members regularly assist large corporations in obtaining secured and mezzanine loans, as well as equity, and none of these companies can obtain funding anywhere near the 5% rate or cost of funds. This unrealistic assumption by the SEC is dangerously misleading in its overall premises for proposing some of these rules.

🏛 **<u>Small broker-dealers need to occasionally insert capital into their firms for a many legitimate business purposes other than for regulatory purposes.</u> These include, but are not limited to:**

1) **losses incurred from expenditures on investment banking, corporate finance, M&A transactions or offerings that were initiated to some degree but never completed, or were terminated; or, where Due Diligence investigations provided reasons to abandon a transaction;**
2) **periods of reduced revenue activity as a result of economic factors unrelated to the broker-dealer or a series of transactions which were not successfully completed;**
3) **losses incurred due to uncollectible fees or expense reimbursements;**
4) **cost overruns in the Due Diligence process of transactions, or in investment banking, corporate finance, M&A, or offerings; and,**
5) **regulatory mandates, not the least of which will be increases in net capital requirements if these proposals are implemented by the SEC.**

All of these afore stated circumstances could give rise to a small firm's need to seek additional capital.

In the current environment, and looking forward to the increased administrative costs that confront small firms as a result of their compliance with rules recently enacted or proposed, more and more small firms will require more net capital than they currently carry. <u>The Commission, in its rulemaking analysis and implementation, needs to appropriately consider the needs of over 3,000 small firms (approximately 70% of all firms) that are more likely than not likely to require additional net capital during the next decade.</u>

🏛 **For small firms to have access to private or public capital, <u>investors must be comfortable that regulatory obstacles will not prevent them from receiving a return of their investment within a reasonable period of time,</u> whether their investment was in the form of preferred equity, with redemption rights over a time frame, and dependent on firm net capital requirements, consistent with Commission timing rules; or, whether subordinated debt, where the maturity term is in excess of the minimum statutory requirement, and again in keeping with the net capital rules; or common stock, that may be repurchased by the issuing firm after the expiration of the applicable time period as defined by the Commission, and again, in keeping with the net capital rules.**

<u>Virtually all small firms are private companies, which</u> means that by practical application, there is no market for their securities, equity or debt that they issue or for any private subordinated loans. Therefore, <u>there must be provisions for investors to reasonably withdraw their capital, or where the firm, at its earliest convenience, can redeem any securities issued privately, or repay any private subordinated debt.</u>

Without such clarity in the rules, capital for small firms will continue to be virtually unavailable at any cost. Without reasonable standards of timing redemption or repayment and other considerations, capital for small firms will continue to be virtually unavailable at any cost.

As such, several considerations stand in the forefront of issues to be determined prior to the rulemaking establishing didactic thresholds:

- Timing of insertions and withdrawals.
- Length of time insertions can be made and withdrawn.
- Dollar limitations of insertions.

TIMING: Currently, if an owner, partner or shareholder, who has contributed capital over a period of time, and in many instances on multiple occasions, in return for shares, subordinated debt, or paid-in capital without an issued security or specific loan agreement, desires to withdraw some of its capital and the firm is financially and regulatorily capable of returning some capital, the application of the timing rule is problematic. For instance, a shareholder has inserted capital or purchased shares over a 10 year period of time in the cumulative amount of $2,000,000, with the last insertion of $50,000 made 8 months ago. The shareholder desires to withdraw $200,000. Under current procedures, the rule would prohibit the shareholder from removing any capital, despite the fact that over $1,950,000 in capital was contributed commencing 10 years ago to more than one year ago.

NIBA believes this is a misuse of the timing aspect of the rule.

The shareholder should be able to designate that it is withdrawing capital VERSUS a specific capital insertion date in the past that is over the current 1 year requirement. In open market trade transactions, a shareholder may designate a sale vs. a purchase date, for purposes of establishing which shares are being sold versus a prior acquisition price or capital contribution date. For purposes of third part investors, not otherwise affiliated with firms, this is a critical distinction. If an equity or debt investor makes multiple capital contributions to a firm, they need to be able to withdraw their earliest contributions as long as the minimum time period has passed since that earliest insertion, and the firm can otherwise afford to redeem or repay the investment, whether all at once, or over a prescribed period of time, without being in net capital violation.
For purposes of registered principals of the firm, who have made multiple insertions of capital over time, this is equally critical. With profit margins being squeezed at small firms, sometimes the most readily available distributable funds to owner-operators is the considerable amount of equity, subordinated debt, or paid in capital these owners have contributed. Rather than salaries or other fees, or the absence of any material amounts of such, there are legitimate reasons why an owner-operator may desire a return of, a tax-free event, as opposed to a taxable event.

<u>By simply designating a redemption or repayment event versus a specific insertion of capital date in the past, which date would be in compliance with the current 1 year rule, or any other applicable time period if that time frame is modified, in compliance with net capital and business operating requirements</u>, the ability of small firms to raise new capital, to strengthen their balance sheets for the public good, is enhanced and materially improved. More capital would be available at more reasonable costs and owners and third party investors are better served, without creating a temporary capital environment.

LENGTH OF TIME BEFORE INSERTIONS OF CAPITAL CAN BE WITHDRAWN:

The current 1 year rule is a substantive disincentive for third party investors and owner-operators to contribute capital in small broker-dealers, even when the firm would be strengthened by such contribution with increased public protection. While the temporary capital considerations must be weighed vs. the convenience of the investors or owner-operators, there is a reasonableness test that can be examined in relation to this quandary. Would a 9 month, or 6 month, standard for withdrawal, redemption or repayment of capital to an investor or owner operator significantly reduce the protection for the public versus a one year rule, as long as the firm had adequate capital, after the withdrawal, redemption, or repayment, despite the 3 month or 6 month reduction from the current one year limit?

We believe that the standard for withdrawal should be shortened to 9 months or 6 months with <u>other applicable safeguards included to ameliorate any weakening of a firm's financial status</u>

For example, as long as the firm had a 30% net capital excess after the withdrawal, and based upon its near term expected revenue stream, it had adequate operating capital in addition to the 30% overage to meet its operating obligations, <u>the 1 year rule does not materially protect the public any more than a 9 or 6 month rule.</u>

In conjunction with the previous comments related to the designation of past insertion date vs. withdrawal, this also provides owner-operators of small firms and investors in small firms the confidence that their capital, once inserted, can be redeemed, repaid, or withdrawn at appropriate times, without any uncertainty.

NIBA believes that this will increase availability of funds from investors and owner-operators at costs less than currently required, and will allow more broker-dealers to raise capital, strengthen their financial stability, and better protect the public.

DOLLAR LIMITATIONS OF WITHDRAWALS:

At small firms, distributions of a return of paid in-capital, whether to investors or owner-operators, shareholders or partners; or the redemption of securities; or the repayment of subordinated debt, <u>are often subsequent to a material revenue event, or series of events, which resulted in a material increase in the firm's excess net capital.</u> As such, a firm's continuance of its regular operations do not require it to maintain levels of net capital excess at increased levels. In addition, the expectation

of shareholders, owner-operators, and lenders is that when such levels of excess net capital excess are attained, they would trigger a distribution of paid-in capital, redemption or repayment events for such owner-operators, shareholders or lenders. As long as a small firm maintains its required net capital, and any excess required in anticipation of its continuing revenue recognition or accruals, and can adequately meet its operating requirements, such firm, should not be limited by any artificial threshold amount that it may distribute. It is the viability of such firm's continuance of its business lines and overall financial stability that should be the basis for its determination of the redemption, repayment or distribution of capital, and not any artificially and arbitrarily contrived dollar limitation on such distributions.

Therefore NIBA recommends that in conjunction with the preceding two comments, the Commission establish an overall firm criteria related to its excess net capital under its licensing and membership agreement, its obligations for continued operations, and compliance with other net capital rule requirements, so that as long as the firm has adequate coverage in all these respects, that the firm would be able to redeem, repay or distribute paid-in capital in the amounts consistent with the above. Conversely, if they cannot establish that distributions can be made using these conditions, that they not be permitted to redeem, repay or distribute capital at that time.

Small firms must be able to raise capital in the private marketplace, whether from existing owner-operators, shareholders or partners, or third parties; and must be able to provide investors with an adequate level of assurance that when funds are available for distribution, redemption, or repayment, that extraneous regulatory constraints beyond the reasonable standards provided would not detrimentally affect their ability to recapture their investment.
Any rules which would further restrict small broker-dealersbroker-dealer from raising capital as a result of uncertainty of investors or owner-operators related to the return of their capital in a reasonable time frame will create a disproportionate and impossible hurdle for small broker-dealers to overcome.

When taken in conjunction with other net capital rule proposals in these Commission amendments requiring significant net capital increases, especially within the small broker-dealer sector, over 1,000 (see SEC analysis computations based on 2006 and 2007 statistics, which would have increased significantly by this time) small broker-dealers could be forced to merge, sell or otherwise withdraw their registrations.

NIBA believes that this is not in the public interest, restricts competition to the benefit of the less than 170 large firms, and the less than 220 medium sized firms, and unfairly discriminates against the vast preponderance of the small firms.
In 2007, the Commission stated that 905 firms had net capital of less than $500,000, yet it has not disclosed, based on 2012 FOCUS reports, how many firms have net capital of less than $500,000. Based upon our cumulative observations, we believe that the number of firms with less than $500,000 in capital is much larger figure

today and also represents the predominant number of small firms as defined by FINRA's calculation of small firms.

According to FINRA published statistics, as of May 10, 2012, there were approximately 4,059 small firms. Some of these small firms have in excess of $500,000 in capital, because that while they have under 150 registered persons, their business as market makers, clearing companies, proprietary trading platforms, or other underwriting business lines require higher net capital to conduct their lines of business, despite the presence of less than 150 registered persons.

All firms conducting any securities business with the public are entitled to a return on equity, much like utility companies performing a public service. While the previous comments relate only to returns of capital, equally important for a healthy and prosperous public marketplace for investors' securities, and capital formation, especially for small issuers, is the ability of small broker dealers to earn a fair return on equity. Limitations on broker dealers that restrict the return of capital inordinately, also constricts their ability to earn a return on equity versus the lower levels of excess capital actually required to conduct their business in full compliance with all net capital rules. The more excess net capital that is held by a broker dealer that is not required for compliance regulatorily, or by their business conduct, decrease the yield of the return of equity as a percentage of the excess net capital not otherwise required, but that is erroneously held "captive" as a result of current and proposed regulation.

►**The Commission's proposal:** *"We are proposing to codify these views by amending Rule 15c3-1 to add a paragraph (c) (2) (i) (G), which would require a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it [within one year].*"

NIBA requests that the Commission modify its proposal, as follows:

1) **Retain the provision whereby a broker-dealer may obtain written approval from its designated examining authority to withdraw capital in less than the time period to be designated in the new rule amendment;**
2) **Shorten the period from one year to 9 months or 6 months;**
3) **Allow the designation dates of capital withdrawals versus specific dates of capital insertions in the past (similar to capital asset treatment) that were in excess of the minimum time period to be designated in the new rule, or the retention of the current 1 year rule, if not changed, so that distributions could be made by firms, especially small firms, irrespective of subsequent insertions within the minimum time frame (as in the example provided above); and,**
4) **Establish an overall firm financial condition rule, inclusive of net capital excess, operating capital sufficiency versus operating obligations, revenue recognition expectation, and total paid-in capital of all forms, so that this basis, and not a particular dollar limit, would determine a firm's ability to**

redeem, repay or distribute capital at any specific time, and in what amounts.

These modifications will result in the increase of the ability of <u>small firms</u> to raise capital, strengthen their balance sheets, increase their ability to implement the new compliance measures being promulgated at a record pace, avoid massive dishevelment in the small broker-dealer sector, earn a fair return on equity, and better protect the public without creating discriminatory and non-competitive conditions.

►The Commission has also requested, related to this topic, *"comment on all aspects of these proposed amendments."*

- **<u>NIBA requests that the Commission publish an update to all the statistics and costs referenced in the 2007 version of the proposals, inclusive of separate statistics as relates to small firm impact (such as the cost of funds for small private firms being significantly in excess of 5% to 7.5%) and re-open another comment period for these amendments as they may be modified through this round of comments, so that smaller firms and the public may comment based on current conditions and statistics, versus our current comments without the benefit of the Commission's access to the new statistics.</u>**

- **<u>NIBA further requests that the Commission standardize and conform the definition of small firms.</u> Neither the Commission definition of under $500,000 in net capital, nor the FINRA definition of under 150 registered persons, which are both restricted to a single factor for determination, are sufficient in this modern complex era of differing firm business lines and services offered to the public. FINRA has stated in the past that a major factor in their definition is solely for FINRA member voting purposes, but other factors are also important for its role as a regulatory authority.**

We believe that the Commission should adopt a new definition, and apply that definition to FINRA, which should include:

a) **total net capital;**
b) **total revenues; and**
c) **total registered persons**

We believe that ALL <u>three factors, i.e., net capital, revenue and number of registered persons should be the criteria</u> for how a firm is categorized.

We believe that both the SEC and FINRA should have conformed definitions, so that a small firm is a small firm whether using a Commission or a FINRA definition, and the same would apply to medium and large firms. We recognize that the term "Medium" is largely a FINRA designation, and not a Commission designation, but we would encourage the Commission to create a "Medium" firm size designation as we believe that there are justifiable differences between Small

and Medium firms, and between Medium and Large firms, that can be effectively utilized by the Commission and FINRA in its rulemaking and enforcement activities.

NIBA has been an advocate, for many years, of conforming the definitions for regulatory purposes, of what constitutes Small, Medium and Large firms. The proposed amendments create a unique opportunity for the Commission to conform and modernize its standard definitions.
We do not believe that net capital alone, nor the number of registered persons alone (as is currently utilized by FINRA) are singularly effective methods for determining the size of a broker-dealer.

<u>What are the types of facts and circumstances that mandate such conformation at this time, using all three material factors of firms' categorization?</u>

There are, according to FINRA, over 400 and less than 500 clearing firms, all of which have substantive capital and revenues, in the tens of millions to the billions of dollars, but many of them have fewer that 150 registered persons because clearing operations don't require a large number of registered persons. They are not small firms, yet their number of registered persons places them in a FINRA small firm category while their capital places them in the Commission's larger firm category.

Likewise, there are firms comprised of predominantly independent brokers, or specialty firms, which have under $500,000 in capital, but have large revenues and thousands of registered persons, which under the Commission definitions are "small firms," but are in fact "large firms." Also, there are firms with thousands of registered persons, but who have small capital requirements and whose revenues are moderate, yet they are considered "large firms," even though they are actually "small firms" in their scope, business lines and management.

Market making operations and many proprietary trading platform firms also have higher revenues and net capital, but fewer registered persons.
Conversely, independent retail broker-dealers, and broker-dealers that have many OSJ's or small branches nationally, often have over 500 registered persons, and higher revenues, but don't require large net capital positions based on the nature of the independent retail representatives' business lines, in non-risk-related transactions as agents or immediately closing principal transactions or exchanges.

Boutique and specialty M&A or corporate finance firms have higher revenues, but few registered persons and small net capital requirements.
Again, according to FINRA, there are over 500 special purpose firms, or firms dedicated to a single issuer, like real estate, energy, insurance, leasing or banking companies, where their net capital and number of registered persons is very low, but their revenues are disproportionately high.

Then, there are firms that have small revenues, few registered persons, and small net capital requirements, but no risk-related transactions, who need not be bulked into higher net capital requirement categories as their businesses do not pose material risks to clients based upon their capital.

There is significant variety and complexity in the financial make-up of firms operating successfully from both a public basis and a private corporate/partnership basis. This begs the need for a modification of firm classifications and conformity to establish a single definition for all examining authorities, including the Commission, to employ.

- **NIBA recommends that the Commission establish a task force of several broker-dealer organizations, like NIBA, TNDDA, NAIBD, REISA, FSX, SIPA, NB-DA, etc., (all of which are predominantly membership populated by small broker-dealer's), inclusive of SIFMA (as essentially most large and medium firms are members of SIFMA), as well as some small firm associations which are predominantly membership populated and dually licensed (securities licensed and investment advisor licensed), which could assist the commission in establishing guidelines of revenue, net capital and number of registered persons in creating a new definition. While we would be happy to suggest such parameters for the Commission's consideration, we believe that all sizes and types of member firms should be included in such determinations.**

The types of amendments proposed in these re-opened considerations clearly impact small, medium and large broker-dealer differently, and if implemented, the proposed amendments will differentiate small, medium and large firms. Further, some of the issues we comment upon in this letter are predominantly only of concern to small firms.

A firm with high revenues and high expenses and many registered persons, but low net capital requirements currently, but whom will need to raise $300,000 or more in net capital as a result of the proposed amendments, is obviously sensitive to characterizations that apply to their net capital requirements.

Firms that don't have very many registered persons, but have high net capital requirements are obviously affected differently, and many of them may be required, (according to some of the proposed amendments upon which we are not commenting in this letter) nonetheless to raise their net capital by millions or tens of millions.

<u>**We believe the Commission should first determine the classifications of firms utilizing all 3 major factors before it modifies the rules, and then modify the rules in respect to the impact to the new various classifications, using current statistics and calculations relative to the actual classes of different broker-dealers, rather than**</u>

<u>attempt to put the horse before the cart, by attempting to modify the old rules using old parameters and statistics.</u>

When reviewing revenues as a criteria item, the Small Business Administration (the "SBA") has a host of criteria involving types of business and also involving number of employees, and assets owned by a company, so there is a governmental agency precedent for employing multiple criteria to establish whether a particular entity is considered small or large.

We believe that utilizing general average SBA definitions and applying these to the broker-dealer realm would improve regulatory enforcement and rulemaking efforts. As the gap of the combination of capital, revenues and number of registered persons grows wider and wider between small and large broker-dealers, it is becoming easier to segment small firms from medium firms, and medium firms from large firms. The Commission has all the data necessary at its command to readily assign new categories for broker-dealers.

Under any threshold levels that are chosen, the vast majority of the largest firms will remain large firms. Some small firms will become large firms, such as clearing companies and larger wholesale market makers who have few registered persons under FINRA definitional rules. Some medium firms will become large firms while others may become small firms due to capital and revenue definitions.

The changes will be beneficial in several ways. For Commission and FINRA rulemaking and procedural guidelines, the firms being classified more accurately will improve the ability to tailor rules and procedures as they may affect small or medium firms, but have little effect on larger firms, or in converse, have effect on larger firms conducting certain types of activities, but not affecting smaller or medium firms. Firms seeking to merge or acquire other firms could transpire more effectively during the regulatory approval process and the implementation of the combination process. Even FINRA voting processes would be more accurate as firms would be voting based upon size designations that included revenues and capital, and not merely number of registered persons.

This would create a more accurate basis by which the Commission and FINRA would regulate its licensed or member firms, respectively, as the net capital of a firm has more impact on the ability of a firm, among many factors, to: generate revenues; withstand increases in expenses; employ more non-producing support personnel (including compliance and financial reporting oriented personnel); underwrite or act as placement agents in larger capital offerings; undertake larger or more complex M&A or corporate finance advisory assignments; engage in more different lines of business; engage in lines of business that are more complex or have more inherent risk; engage in proprietary trading or market making; hold more long or short positions as a principal; inventory more securities; invest for its own account in more securities; act in a self clearing capacity; act as, or be affiliated

with, a clearing operation for introducing member firms; and acquire other broker-dealers, or the client bases of other broker-dealers, or a large number of brokers (associated registered persons) from other broker-dealers in numbers that exceed Safe Harbor provisions.

We have studied, over many years of membership by our various member firms, the differences in operations between firms that have small capital requirements, relatively few registered persons, and modest to moderate revenues. We have witnessed the differences in management staff, boards of directors' involvement, staff levels related to marketing, underwriting, investment banking, market making, and compliance with regulations. Less than 0.1% of our member firms have been involved in material regulatory sanctions and 99.9% of our member firms work with us and other organizations of broker-dealers to communicate important regulatory changes to other member firms through our notices, conferences, special forums, emails and panels. <u>If any organization is positioned to adequately address the issues proposed in the proposed amendments, NIBA, and a number of other small Broker dealer organizations, has the experience and cumulative membership knowledge and experience to do so.</u>

►**The Commission requests: "***With respect to the proposal on capital contributions and withdrawals, we request comment on whether the time period within which withdrawn and intended to be withdrawn contributions must be treated as liabilities should be longer than one year."*

- **NIBA supports the Commission's goal of clarifying third party disclosure related to expense sharing or obligation and the treating as liabilities contributions of capital that are for periods of shorter than 6 or 9 months. However, we are adamantly opposed to liability treatment for periods of longer than one year, as this will restrict privately owned broker-dealers from seeking private capital in all its forms allowable under current statutes and rules under terms that are competitively reasonable, at profit margin spreads currently available to broker-dealers in the current increasingly costly rulemaking and compliance environment. NIBA believes that the treatment of capital contributions as liabilities for over a one year period will cause the immediate demise, merger, sale or withdrawal of a high percentage of small and some medium sized firms that is unprecedented in the history of the regulated securities industry. It will also significantly reduce or eliminate the prospect of attaining a reasonable return on equity.**

►**The Commission writes**: *"We believe the vast majority of broker-dealers either do not seek to transfer responsibility for their liabilities to a third-party or, if they do so, rely on a third-party that has the financial resources – independent of the assets and revenue of the broker-dealer – to pay the obligations as they become due. <u>We also believe that most broker-dealers do not accept capital contributions under agreements permitting the investor to withdraw the capital at any time.</u>*

Since the Commission states this belief, then let's not throw the small firms "under the bus." We believe our requests and comments sufficiently address how to modify the amendments to achieve appropriate and reasonable regulation and protect the public, without creating havoc for approximately 3,000 small firms that are likely to be affected.

►**The Commission writes**: "*FOCUS Report filings [[from 2007]] indicate that approximately 702 [[2007 figure]] broker-dealers report having no liabilities. For the purposes of this analysis, we conservatively estimate that the proposed amendment would impact all of these firms. Requiring these broker-dealers to book liabilities would decrease the amount of equity capital held by the firms and in some cases may require them to obtain additional capital. The majority of broker-dealers reporting no liabilities are introducing broker-dealers that have a $5,000 minimum net capital requirement. The reported average for total aggregate liabilities of introducing broker-dealers is $280,354 per firm. Therefore, conservatively estimating that the 702 broker-dealers would have to each raise $280,354 in additional capital as result of the proposed requirement, the total aggregate amount of additional capital that would need to be raised would be $196,808,508. Therefore, we estimate that the total annual cost to the industry would be approximately $10 million .... (and) that the cost of capital is approximately 5%.*"

When—how much time will they have?
If $5,000 or $25,000 or $50,000 or $100,000 requirement firms that have less than $500,000 in capital, are required to add (in 2012 figures) over $300,000k each, there will be the largest dissolution of small broker-dealers in the history of the regulated securities industry. The public, small issuers, fund managers, small institutions and corporations will be severely negatively impacted by the demise of 1,000 to 2,000 broker-dealers and their 200,000 to 250,000 registered persons and RIA's. For what purpose? The Commission is basically saying, 'let's do away with most of the Small Firms. Who needs them?' This is a preposterous proposal utilizing the most misinformed and inaccurate assumptions that we have ever had the need to consider.

The Commission, in its proposal, also makes no statement as to the length of time it will allow broker-dealers to raise capital to meet its proposed new standards. SIFMA also commented on this aspect of the proposed amendments. Since broker-dealers that will be required to increase their net capital by such substantial proposed amounts will be in net capital violation if they do not raise the appropriate capital, this proposal will effectively force hundreds, and perhaps over 1,000, small broker-dealers to withdraw, merge, or sell, in the event that they cannot raise the capital in a short period of time.

- **We believe that the Commission should state a reasonable time period for broker-dealers who would be required to raise additional capital to raise that capital, and allow such proposed time period to be subject to an additional comment period before enactment.**
- **<u>The Commission, in determining this time period, needs to take into account that</u>: (1) FINRA will require each such member firm to submit its offering documents to FINRA for comment and a no objection letter, a process that could require many months of review prior to the firms' offering; and,**

(2) the offering period of any private placement or REG D offering (since virtually all small firms are private entities) may require many months to conduct and complete; and,
(3) the costs to each member firm so offering securities or subordinated debt: (i) will be extraneous to its normal business operations; (ii) will be a drain to its net capital otherwise required for its continued operations; (iii) may be capital that is additionally required to be inserted to meet the costs of such offering; and, (iv) may constitute a significant obstacle to small firms to compliantly offer securities or subordinated debt;
(4) firms that do not engage in "retail" business with individuals do not currently possess customers in the accredited investor space, meaning that such firms would need to seek investors outside of their current "exempt" clientele, a vaunting task for such firms, since "exempt" QIB's and QP's do not usually make investments of $300,000 or under $3,000,000to $5,000,000in general; and
(5) M&A firms, specialty firms (like those owned by real estate, energy, insurance or banking institutions, or regulated investment companies), market making firms, proprietary trading firms, institutional only firms, and larger independent rep oriented firms will be particularly disadvantaged in their quest to raise capital from investors that are truly unfamiliar with the smaller broker-dealer industry, and could be totally unsuccessful in attracting what is for them, such large of amounts of capital in comparison to its current levels of net capital requirements and its revenue base; and,
(6) such firms would be required to carry amounts of net capital, as compared to its revenue base, that would make the cost of providing a return on equity or subordinated debt to its new investors providing the increase in net capital a significant fundamental hurdle to attracting such capital without a significant increase in its revenue base, a feat that also may be unattainable by such firms within any reasonable period of time envisioned by the Commission.

►***The Commission writes:*** *We estimate that amendments requiring broker-dealers to treat certain capital contributions as liabilities should not result in significant additional costs. Generally, broker-dealers do not enter into agreements permitting an owner to withdraw capital at any time. To the extent some firms may have engaged in this practice, they could have to pay more for capital. Conservatively, we estimate that no more than $100 million in capital at broker-dealers is subject to such agreements. Assuming an incremental cost of capital of 2.5%, we estimate that the proposed amendment would result in an annual cost of approximately $2.5 million. As noted above, we request comment on these proposed cost estimates. In particular, we request comment on additional costs to broker-dealers that would arise from these proposals.*

The Commission's estimates of a gross cost of 7.5% (5% plus the 2.5%) is a totally unrealistic cost of capital for small broker-dealers, and any broker-dealer that is both private and doesn't possess a national credit rating of B+ or better, which is probably 99% of all small broker-dealers, and certainly the small broker-dealers that are members of NIBA, RIESA, TNDDA, NAIBD, FSX, SIPA, NB-DA, the many regional small broker-dealer associations too numerous to recite herein, or even the small firm members of SIFMA. These broker-dealers, categorically will have costs significantly higher than 7.5%.

As such, until the Commission can convene a small broker-dealer representative panel to assist it with establishing such costs on a "real time" and true availability basis, NIBA believes that the Commission is "speculating" on such costs, and is therefore, without adequate information to even consider the effects of such costs and changes to small firms, let alone propose regulatory changes that endanger the future viability of the industry which has historically served small issuers, smaller customers and smaller money or asset management firms.

Our comments previously set forth in this letter related to additional costs to Small Firm broker- dealers related to the capital raising process. In addition to those costs, the additional bookkeeping, accounting, compliance, and management time costs would adversely affect small broker-dealers who would be overly burdened due to those additional costs.
Further, any new third party investors may require, as a condition to their investment, additional personnel or procedures to ensure that the broker-dealer is not taking any actions which would endanger the investors' ability to redeem or be repaid their investment within the time frames compliantly detailed in their investment agreements; these requirements will cause the Small Firm broker-dealer to undoubtedly incur costs which are not part of its current cost structure.

►*We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers.*
Broker-dealers are dealing with a relatively static commission and fees matrix versus what they may charge customers. Offerings fees are relatively fixed and have not been raised for decades; commissions (not adjusted materially since 1975) are competitively assessed and few transactions are completed at the maximum amounts allowed regulatorily due to competitive factors; flat fees or hourly rates for investment banking or corporate finance transactions are also more subject to competitive pressures; and M&A transactions, or market making services are further limited by competitive pressures.

As such, broker-dealers will be unable to pass any of these costs increases directly to customers, irrespective of the type of customer or type of business that they are conducting with small broker-dealers, which further threatens the financial profit potential and return on equity of small broker-dealers. These levels of cost increase over a relatively short period of time threatens the viability of all small broker-dealers, irrespective of their business line types or classes.

►*<u>2. Requirement to Deduct the Amount a Fidelity Bond Deductible Exceeds SRO Limits</u>*

Under SRO rules, certain broker-dealers that do business with the public or are required to become members of the Securities Investor Protection Corporation ("SIPC") must comply with mandatory fidelity bonding requirements. While the form and amounts of the bonding requirements vary based on the nature of a broker-dealer's business, the SRO rules typically permit a broker-dealer to have a deductible provision included in the bond. However, the rules provide that the deductible may not exceed certain amounts. With regard to firms that maintain deductible amounts over the maximum amount

permitted, a number of SRO rules provide that the broker-dealer must deduct this excess amount from net worth when calculating net capital under Rule 15c3-1.
Rule 15c3-1, however, does not specifically reference the SRO deductible requirements as a charge to capital. Accordingly, while the SROs require that the excess fidelity bond be deducted from net capital, the Commission's rule does not specify such a deduction. This means that a broker-dealer would not be required for the purposes of Commission rules to show the impact of the deduction in the net capital computation on the FOCUS report it is required to periodically file.

To address this gap, we are proposing to amend Rule 15c3-1 by adding a paragraph (c)(2)(xiv) that would require a broker-dealer to deduct, with regard to fidelity bonding requirements prescribed by a broker-dealer's examining authority, the excess of any deductible amount over the maximum deductible amount permitted.

🏛**NIBA believes that the original FINRA rule change that became effective in January of this year, and the Commission's current desire to conform its rules with the FINRA rule, creates a *de facto* net capital rule increase for some broker-dealers that are arbitrarily included in the deductible dilemma as a result of insurance underwriting industry mandates and procedures, rather than securities law or rule mandates. As such, the Commission and FINRA are effectively allowing insurance underwriters, which are not regulated by either the Commission or FINRA, or any other SRO, to determine certain broker-dealer net capital minimum requirements, resulting in a *de facto* net capital rule increases without the guidance or mandate of Congress.**

Net capital rules requiring levels of net capital for broker-dealers at the $5,000, $25,000, $50,000, $100,000, and $250,000 levels for various types of business lines conducted by broker-dealers, has its basis in legislation which the Commission responded to by implementing these levels of net capital requirements; as such they are long standing and tested by time and procedure. Now, as a result of the recent FINRA rule change, certain broker-dealers who are unable, at any cost, or competitively reasonable increase in costs, to obtain deductibles which would NOT cause them to increase their minimum net capital requirements to new higher limits, are thrown into a pool of insured risks that have the effect of permanently raising their minimum net capital requirements to levels above the stated $5,000, $25,000, $50,000, $100,000, and $250,000 levels. It should NOT be the intent of the Commission, nor FINRA, nor any SRO, to create a "back door" increase to minimum net capital requirements, yet that is exactly what the FINRA rule, and the Commission's proposal, would create. This is nothing more than a method of increasing minimum net capital requirements for certain broker-dealers, especially small broker-dealers, without the mandate of Congress. It is allowing the insurance industry to select certain broker-dealers and prescribe, without the involvement of the Commission nor any SRO, new requirements for certain broker-dealers that are higher than the generally accepted practices governed by long standing minimum net capital requirements applicable to all broker-dealers.

Let us examine, for illustrative purposes, an example of insurance industry practices as actually experienced by certain broker-dealers.

1) **There are a <u>limited number</u> of insurance underwriters in the Fidelity Bond coverage industry; only some of these cover most levels of broker-dealers, while some only cover larger, better capitalized broker-dealers. As such, small and some medium sized broker-dealers have difficulty in placing coverage at all, while others pay more to obtain coverage irrespective of the current level of risk to the underwriter, based on aged or previous one-time claims. The limited numbers of carriers for such required coverage is an existing problem for broker-dealers, and a greater problem for broker-dealers that ever had any claim on a Fidelity bond, irrespective of how long ago it occurred, whether the circumstances in which it occurred no longer exist, or whether firms have taken actions over time to alleviate such risks to the carrier.**
2) **A firm which ever had a claim in its operating history is typically denied the availability of a $5,000 or $10,000 deductible, and some firms report being required to carry $25,000 deductibles. As such, a firm with a $5,000 minimum capital requirement in its membership agreement with FINRA whom is subject to a $25,000 deductible, would now have an additional $20,000 minimum requirement, which, if underwriting criteria doesn't change from year to year, has effectively increased the minimum net capital requirement of that firm permanently from $5,000 to $25,000. Likewise, a firm with $5,000 minimum capital requirement in its membership agreement with FINRA whom is subject to a $10,000 deductible, would now have a $10,000 minimum requirement; or, a firm with a $25,000 minimum requirement and a $10,000 deductible, would now have a $30,000 minimum requirement; or, a firm with a $100,000 minimum requirement and a $25,000 deductible, would now have a $120,000 minimum requirement.**
3) **Congress has not passed on the subject of increasing minimum net capital rules above the $5,000, $25,000, $50,000, $100,000, and $250,000 levels.**
4) **We are not speaking hereof of simply paying more to obtain a $5,000 deductible, as that is a separate issue; as is the practice of insurance underwriters, past claims or other insurance underwriter mandated criteria, out of the scope of the Commission or any SRO to regulate, make lower deductible levels simply unavailable to certain broker-dealers whose compliance and regulatory standards are currently the same as firms that can obtain $5,000 levels of deductibles, yet these firms now would have to carry more net capital, at increased cost to the firm, without the benefit of Commission or SRO approval, since the levels are set by insurance underwriter standards, and not the Commission nor any SRO.**

NIBA believes that the *de facto* increase of minimum net capital levels without the guidance of Congress is beyond the scope of any SRO, and that the Commission's stated objective of conforming its rules to any SRO which has exceeded the boundaries or scope of their entitlements, without Congressional mandate, is a

flawed rulemaking objective. NIBA is certainly not informed as to the number of broker-dealers that this impacts; however, we can readily understand that this proposal, as well as FINRA's new rule, impacts small broker-dealers disproportionately to medium and large firms that carry substantially more net capital excess than small broker-dealers, and as such, is predominantly a small broker-dealer issue.

It is FINRA's role to examine broker-dealers regularly, but also to monitor broker-dealer compliance with their net capital maintenance supervisory controls, as well as each firm's month to month, or quarter to quarter, financial reporting. FINRA personnel are assigned to monitor each firm's net capital compliance. If a firm is approaching certain guideline "warning levels" relative to net capital requirements, <u>FINRA has been extremely effective at conducting month to month, or quarter to quarter, *ex-officio* "instant enforcement</u>" of such firms' net capital posture, right down to the examination of current ledgers and accruals of expenses, expectation of revenues or capital insertions, and recommendations for capital insertions. Their effectiveness at such procedures has aided broker-dealers and protected customers, even when such broker-dealers were negatively impacted.

FINRA's current procedures to safeguard net capital compliance of broker-dealers, and especially small broker-dealers at the $100,000 or less net minimum capital requirement levels, have been exemplary, and do not need to be artificially modified or increased.

To impose universal new rules which affect only those broker-dealers which cannot obtain $5,000 deductibles if they are a $5,000 or $25,000 minimum capital requirement firm, or $10,000 deductible if they are a $50,000 or $100,000 firm, effectively creates new minimum capital requirements for broker-dealers for which there has been no offset in time or cost to raise new capital, and discriminates against firms which currently maintain the same rules and compliance levels of firms that can obtain $5,000 or $10,000 deductibles, but because of an aged event, are unable to obtain like coverage.

NIBA believes that the Commission should:

1) **Place a stop order on the enforcement of FINRA rules relating to the deductible level until the Commission has conducted a thorough study of all firms to ascertain:**
    (a) **How many firms are affected by the unavailability of $5,000 deductibles at firms subject to the $5,000 and $25,000 net capital requirement, and the unavailability of $5,000 or $10,000 deductibles for firms subject to the $50,000 or $100,000 net capital requirements?**
    (b) **What are all of the costs that will be incurred by the firms affected by compliance with the *de facto* minimum net capital increase?**
    (c) **How many of these firms had to raise, or are still attempting to raise, capital to meet the new requirements?**
    (d) **How many firms were forced to withdraw their membership or merged, sold, or otherwise discontinued operations as a result of their inability to**

both obtain $5,000 or $10,000 deductibles, and to raise net capital to accommodate the liability increase?

2) **Conduct a hearing with the appropriate Congressional committee(s) to ascertain the Congressional viewpoint of whether such "back-door" increases of minimum net capital were the intention of Congress in its role to mandate minimum net capital requirements for broker-dealers.**
3) **Interview the few remaining underwriters of Fidelity Bond coverage for small broker-dealers and obtain their statistics of how, what, who, and when their criteria are imposed on small broker-dealers, as well as obtain statistics on how many broker-dealers that are carrying $10,000 or higher deductibles have been denied the opportunity of $5,000 deductibles.**
4) **Table any proposals related to conforming Commission rules related to Fidelity Bond deductibles until after the studies are completed, and then re-issue its new proposals for comment at that time based upon such studies.**

►►*4. Amendment to Rule Governing Orders Restricting Withdrawal of Capital From a Broker-Dealer* ***This proposed amendment to Rule 15c3-1(e) would eliminate the qualification on Commission orders restricting withdrawals, advances and unsecured loans made by broker-dealers that limits the order to instances when recent withdrawals, advances or loans, in the aggregate, exceed thirty percent of the broker-dealer's excess net capital.***

Paragraph (e) of Rule 15c3-1 places certain conditions on a broker-dealer when withdrawing capital. For example, a broker-dealer must give the Commission two days notice before a withdrawal that would exceed 30% of the firm's excess net capital and two days notice after a withdrawal that exceeded 20% of that measure. Paragraph (e) also restricts capital withdrawals that would have certain financial impacts on a broker-dealer such as lowering net capital below certain levels. Finally, under the rule, the Commission may issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances. The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a thirty calendar day period, exceed thirty percent of the firm's excess net capital.

►***i. Benefits***

The proposed amendment to Rule 15c3-1 would benefit the securities markets by protecting customers and counterparties of a financially stressed broker-dealer. For example, the broker-dealer would not be able to make an unsecured loan to a stockholder or withdraw equity capital while the order was outstanding, thereby preserving the assets and liquidity of the broker-dealer and enabling the Commission and its staff to examine the broker-dealer's financial condition, net capital position and the risk exposure to the customers and creditors of the broker-dealer to ensure the financial integrity of the firm.

🏛 **ONE SIZE DOES NOT FIT ALL. While NIBA supports the deletion of the 30% threshold rule, NIBA believes that this rule most clearly distinguishes differences in**

rulemaking between the Commission's desire to regulate large firms with complex financial capitalizations and many varieties of business lines conducted with both institutional and "retail" clients, and small broker-dealers that have limited and simple capitalizations, limited business lines and fewer and less complex product lines for predominantly "retail" or smaller institutional clients. In creating rules that are clearly intended to protect the capitalizations and clients of large firms doing business with many clients of all types over many varying risk parameters of more complex nature, the Commission is ignoring the predominant number of member firms that exist as small broker-dealers. Further, large broker-dealers include in their capital securities that may often be difficult to price on a mark to the market basis, or may include securities issued by affiliates or related parties, increasing the regulatory risk in the event that the firms' risk parameters require a current valuation or liquidity level of such securities in a time frame inconsistent with market conditions.

These risks and regulatory enforcement procedures are virtually non-existent in the small broker-dealer community of firms. Small firms may have less liquid, OTCQB or Pink Sheet securities as part of their capital that were acquired in their conduct of business, often in lieu of cash fees, which are appropriately accounted with prescribed "haircuts" and concentration procedures, but in most cases, that is about as "complex" as it gets. Most small firms maintain larger cash, CD, money market, liquid notes or bonds convertible into cash in the open markets in 3 to 5 days, or large cap securities traded on national exchanges, as all, or virtually all, of their net capital and excess net capital.

Most small broker-dealers in the $5,000, $25,000, $50,000, or $100,000 minimum net capital requirement license categories maintain only enough net excess capital so as to comfortably support their business expenses vs. expected and realized revenues. It is simply too costly for small firms, whether capitalized from predominantly owner-operator, registered shareholder or partner sources, or from third party non-registered and uninvolved shareholders, partners or lenders, to carry and pay its investors a fair return on excess net capital not required for the conduct of its business lines.

Often, small firms will experience recurring windfalls in their revenues and excess net capital, emanating from single or multiple larger transactions completed, or a particularly active market period, where the $5,000, $25,000, $50,000, or $100,000 minimum net capital requirement firms bring in hundreds of thousands of dollars of commissions or fees in excess of its near term, or even annual, operations requirements. In such cases, firms that experience such windfalls, often chose to redeem securities issued in the past that are costing them a return of that capital, or allow such redemptions to reduce the capital outlays of its owner-operators or registered shareholders or partners, or to repay subordinated debt. Likewise, due to the lower capital limits of the $5,000, $25,000, $50,000, or $100,000 minimum net capital requirement firms, even smaller amounts of $50,000 to $200,000 in increased revenues would trigger a redemption or repayment event for the majority of such revenue recognition in dollar amounts that could represent 70%, 80% or 90% of the amount so realized, without disrupting the firms' regular capital requirements to continue to conduct its ordinary business lines.

For example, a $5,000 net minimum capital requirement firm which ordinarily maintains $10,000 to $15,000 in excess net capital, after allowance for all accruals and liabilities, closes an M&A transaction or private placement or registered 'best efforts' offering, that after payment of all deal related and personnel costs, retains a $300,000 profit. The firm has $2,000,000 in paid in capital on its balance sheet from its owner operators, and $100,000 in redeemable preferred shares from outside investors. As long as the firm determines that its other ongoing regular business continues as before such transaction closed, and its current and next few quarter's expected expenses and revenues are consistent in maintaining its excess net capital at $10,000 to $15,000 levels in the next 2 quarters, and that it has no need for any of the $300,000 to be retained as an increase in its net capital excess, it should be allowed to redeem the $100,000 in securities, and repay whatever portion of the remaining $200,000 (less any interest or returns on the preferred redeemed above the repayment of principal) that it deems prudent.

In the absence of some deterrent not readily evident, it would seem that <u>the Commission should state all the conditions that need to exist for the firm to withdraw, repay or redeem any amount that that does not endanger the firm or its customers.</u>

<u>As such, we believe that such conditions include, but may not be limited to:</u>
Regulatory minimum capital requirement related to all lines of business; plus,
Excess mandated by that firms' accruals for that period; plus,
Excess mandated by the firms' upcoming one-time non-recurring costs within that quarter; plus,
Excess mandated by operating costs expected not related to accruals for that period; plus,
Costs related to increased personnel coverage or recruitment within that quarter; plus,
Revenue expectations or receivables collectible during that period; plus,
Determination of the Board of the firm that there is no reasonable expectation at the time of its approval of the capital withdrawal, repayment or redemption, that the firm would be required to, or advisable to, increase its net capital excess.

NIBA believes that if a small firm follows such guidelines in its determinations of capital withdrawals, repayments or redemptions, it will be compliant with the new proposal deleting the 30% rule, since the vast majority of small firms already maintain essentially cash and cash convertibles as their predominant net capital and net capital excess; but also believes that the Commission should include an analysis or recite a list of criteria for firms to utilize so that if questioned by the Commission or FINRA after the fact, they can rely on the standards upon which they based their decision, and as long as that decision was implemented as presented at the time, the firm would not be subject to after the fact "second-guessing" by the Commission or FINRA.

As it relates to firms identified by the Commission or FINRA or a national exchange such as the New York Stock Exchange, as firms that are "financially distressed," such firms would already be aware of regulatory initiatives implemented by its SRO or the Commission, as a result of communications by the Commission or its SRO and that firm, so that firm's Board would be on alert that capital withdrawals, repayments or redemptions would not be advisable under such regulatory scrutiny, and could subject

the firms' principals and directors to regulatory punitive actions. The current procedures of the SRO's and the Commission are adequate to maintain compliance and protection related to "financially distressed" firms. Adding another layer of compliance to the vast majority of firms that are NOT "financially distressed" is penalizing responsible firms unnecessarily.

As for large, complex firms, NIBA defers to SIFMA comments on this proposal, as SIFMA is in a better position to comment on the more complex aspects of application of this proposal related to large complex firms.

So while the deletion of the 30% rule and its ancillary reporting requirements is positive for small broker-dealers, the lack of any definitive guidelines could place a small firm in a compromised position, after the fact, if FINRA or the Commission should decide later that a withdrawal, redemption or repayment of capital was excessive, even where the firm was maintaining adequate capital for the continuance of its ordinary business lines, but where the capital withdrawn was a majority of the excess net capital that predominantly materialized from windfall transactions or market activity, and did not represent a necessarily repetitive or repeatable set of revenue or expense circumstances.

The rule as proposed does not just affect financially troubled firms, but all firms, and especially small firms.

►*ii. Costs*
The current rule permitting the Commission to restrict withdrawals of capital from a financially distressed broker-dealer was adopted in 1991. Based on this experience with the rule, we estimate that the proposed amendment would result in no or de minimis costs to broker-dealers.
As noted above, we request comment on this cost estimate. In particular, we request comment on whether there would be costs to broker-dealers as a consequence of this proposal. We also request comment on whether this proposal would impose costs on other market participants. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

🏛**NIBA believes that any rules which impede or delay the small broker-dealer from repaying, redeeming or withdrawing excess net capital without affecting the firms' abilities to continue its ordinary lines of business will make capital less available to them, as investors will be unsure of their capital repayment, redemption or withdrawal timing. It will therefore also make such capital, when and if available to small broker-dealers, excessively expensive, and deprive continuing owners of profits and a reasonable return on equity earned in the course of the successful operation of their business. This will also reduce the value of small broker-dealers, for business succession and estate planning purposes, and immediately reduce their value from a selling price basis. <u>NIBA opposes regulation that arbitrarily reduces the value of small broker-dealers and reduces their competitive position relative to larger broker-dealers.</u>**

►*ii. Money Market Funds*

We are proposing an amendment that would reduce the "haircut" broker-dealers apply under Rule 15c3-1 for money market funds from 2% to 1% when computing net capital. ....In particular, the rule requires that the securities purchased by a money market fund be short-term instruments of issuers that are deemed a low credit risk. The rule also requires the fund to diversify its portfolio of securities.
We request comment on all aspects of this amendment, including on whether it is appropriate to reduce the haircut to 1% and, alternatively, whether the haircut for certain types of money market funds should be reduced to 0% as suggested by Federated in its petition to the Commission.

NIBA believes that the differential between a 1% haircut and a 0% haircut is *de minimis*, and the added protection to the public or the firm in the amount of money involved between a 1% and a 0% haircut is also *de minimis*. If a firm is so close in early warning related to its capital that the dollar difference of a 1% haircut is material, then there are already other circumstances present that require greater attention than whether the haircut is 1% or 0%. Therefore, Money Market Funds ("MMF") should be at a 0% haircut, but subject to the following conditions:
1) that the MMF be a fund where none of the investments reported by the fund are invested in an affiliate of the MMF or its manager or holding company; and,
2) that the MMF is in a bank or managed fund not affiliated with the bank in which the broker-dealer holds its cash reserves and operating funds.

►*3. Accounting for Third-Party Liens on Customer Securities Held at a Broker-Dealer*

For these reasons, we request comment on how third-party liens against customer fully paid securities carried by a broker-dealer should be treated under the financial responsibility rules, including Rule 15c3-3, Rule 17a-3 and Rule 17a-4. For example, should the broker-dealer be required to: (1) include the amount of the customer's obligation to the third-party as a credit item in the reserve formula; (2) move the securities subject to the lien into a separate pledge account in the name of the pledgee or pledges; or (3) record on its books and records and disclose to the customer the existence of the lien, identity of the pledgee(s), obligation of the customer, and amount of securities subject to the liens.

NIBA believes that third party liens imposed by an appropriate authority (governmental or otherwise), court of appropriate jurisdiction, or regulatory entity, should be immediately verified by the broker-dealer and confirmed as a valid and current lien; and, upon verification and confirmation of the validity of the lien, using reasonable standards of verification to be written by the Commission as part of this proposal prior to enactment, would enable the broker-dealer to place such securities into a separate pledge account in the name of the pledgee or pledges, record on its books and records and disclose in writing to the customer, within some reasonable time frame as to be further defined by the Commission, the existence of the lien, identity of the pledgee(s), obligation of the customer, and amount of securities subject to the liens, mail to the customer a confirmation of the transfer of

the securities to the pledge account, and upon its next regularly scheduled statement date, or the statement date of its clearing company, ensure that the customer receives a statement of this separate pledge account.

The problem that will be incurred by such broker-dealers will be in circumstances where a customer attempts to prevent such transfer through legal action, or where the customer has sought legal redress in injunctive relief from a court of appropriate jurisdiction to prevent the enforcement of the lien, wherein the broker-dealer gets "caught in the middle" between a pledgee and its customer. As such, the Commission should be definitive in its procedural description as well as in the rulemaking itself, to protect broker-dealers from unnecessary expense and delay in implementing such procedures.

<u>The Commission should also stipulate that the customer shall be liable for, and the broker-dealer may offset, through the sale of securities as required, all reasonable costs of the broker-dealer</u>, inclusive of legal advice of its counsel, notifications, verification and confirmation of the validity of the lien, any transfer costs, any travel costs of its personnel or counsel related to the verification and confirmation of the lien and its subsequent disclosure and transfer of securities, any extraordinary personnel costs related to the imposition of the lien, or related costs of the additional confirmations or statements.

<u>Without a stipulation by the Commission that the broker-dealer may offset such costs against the customers' liabilities, and that such costs be deemed administratively offset by the broker-dealer prior to the collection of the lien by the pledgee</u> (similar to an administrative claim in a bankruptcy proceeding which supersedes the claim priority of all other claimants), to ensure that the broker-dealer can recover its costs, the pledgees may claim the value of the securities and leave the broker-dealer with no practical way to recover its costs, thus producing a loss for the broker-dealer without the broker-dealer having a realistic and cost effective legal remedy. The Commission must make sure in its rulemaking that the broker-dealers are not serving as the unpaid "pawns" of pledgees that are not regulated by the Commission, or that the Commission is not acting to aid and abet the pledgees rights at the expense of the broker-dealers.
Since we believe the conditions set forth above will adequately allow effective rulemaking and procedural guidance, as further written by the Commission as stated, this eliminates the need to include the amount of the customer's obligation to the third-party as a credit item in the reserve formula. Further, as it relates to small broker-dealers, the burden of accounting and reporting such credit item on an ongoing basis would be overly severe for small broker dealers.

►D. Total Annual Reporting and Recordkeeping Burden
As discussed in further detail below, we estimate the total recordkeeping burden resulting from these amendments would be approximately 373,938 annual hours, 105,900 one-time hours, and a one-time cost of $1,000,000 arising from the retention of outside counsel.

NIBA believes that the estimates provided by the Commission utilized only that number of broker-dealers in its estimates that the Commission justifiably considers to be affected by the proposals, whereas it is our belief that most, if not all broker-dealers will spend over 90 hours each in analyzing the effects of these proposals, or rules as implemented, will spend many more than 90 hours each in implementing procedures to comply with the new rules, to modify their written supervisory procedures and supervisory controls, will spend in excess of 240 hours each in the monitoring of such rules on an ongoing basis, and will spend in excess of $15,000 each for outside counsel and auditor opinions or work product. That's in excess of 1,080,000 annual hours, 960,000 one time hours, and over $60,000,000 for outside counsel and auditors, spread over approximately 4,000 broker-dealers, not just those the Commission has targeted.

The rule changes are multifarious, sweeping, and affect small, medium and large broker-dealers in the largest shift of requirements related to net capital and the continuing existence of small broker-dealers to date. To assume that small broker-dealers will not be affected, or will not seek to analyze the impact of rules that may only affect them in some circumstances, is a gross underestimation.

The Commission admits within this proposal that a large number of broker-dealers will be required to raise capital of approximately $300,000 or more, yet it makes no analysis of the time to prepare such offerings, the cost of such offerings, the effect on broker-dealers, the public and the small issuers these broker-dealers serve (who are often the only source of capital raises for small issuers, as larger firms don't participate in smaller offerings by small issuers) that fail to raise the required capital. The net capital increases proposed could easily have the effect of closing down 1,000 to 1,500 small broker-dealers that currently maintain $5,000, $25,000, $50,000 or $100,000 in net capital requirements pursuant to their FINRA membership agreements.

Some of the rules proposed, as commented on above, could cause the largest disruption in the small capital markets and small issuer sectors of any rules proposed by the Commission in its history, as the potential dissolution of 1,000 to 1,500 small broker-dealers would have irreconcilable effects on our economy as a whole.

Congress has been clear in its recent initiatives that the capital raising initiatives of small issuers and start-ups or developing companies should have better access to capital markets, yet the net capital requirements, and their costs to small broker-dealers, as proposed by the Commission, is 180 degrees in conflict with Congress' intentions at this time.

If it is the Commission's intent to remove up to 1,500 small broker-dealers from the Broker Dealer community, then the proposals upon which we have commented will surely create that result over a relatively short period of time.

►VI. CONSIDERATION OF BURDEN ON COMPETITION, AND PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider if the action will promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact that any such rule would have on competition. Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed amendments are intended to promote efficiency, competition, and capital formation. They should not have any anti-competitive effects.

🏛 NIBA believes that the proposed changes to the net capital rule will negatively impact capital formation for small issuers and small businesses, which is the sector predominantly served by our members and small firms in general. Small businesses and small issuers employ approximately between 60% to 68% of all Americans at any point in time, and the majority of placements and offerings conducted by broker-dealers for such businesses and issuers are conducted by small broker-dealers, who raise most of the capital for businesses and issuers of smaller size.

Therefore, NIBA does not concur with the Commission's position that these rules will promote efficiency, competition or capital formation. To the contrary, they will (i) have severe anti-competitive effects, substantially reducing the number of small broker-dealers; (ii) adversely affect broker-dealers availability to raise capital or service smaller retail, institutional or corporate clients' (iii) benefit the larger broker-dealers, and deny smaller issuers any outlet to raise capital in amounts of $15,000,000 or less. This in turn will produce more mergers and sales of corporations or their assets, increasing M&A activity for large broker-dealer firms, as smaller issuers will experience fewer outlets in raising $2,000,000 to $15,000,000 in equity or debt. That size range is selected by example since it constitutes the typical size range of over 98% of offerings, placements or M&A activity by NIBA members, who have raised over 90% of broker-dealer placements and offerings for small issuers and businesses for over 3 decades.

Further, capital withdrawal rules as proposed will increase the costs of capital to small broker-dealers by such unknown amounts, or make capital generally unavailable to small broker-dealers, the effects of which are simply unimaginable.

We believe that is a significant and material consideration for the Commission. We are not the legal, accounting, banking, investment advisors, money managers or general public making these comments, none of whom fully understand or particularly care about the distinctions between small and large broker-dealers.

We represent the folks who own the broker-dealers that have been out there making it happen for small issuers and businesses for over 3 decades. We believe we are in the best position to comment effectively on issues that affect small broker-dealers.

►*Commission's request for alternative suggestions and comments related to the intent of the Broker Dealer Financial Responsibility Rule Change Proposals*

The Commission estimates that there are approximately 915 [2007 number] broker-dealers that are "small" for the purposes Rule 0-10.236 These proposed amendments would apply to all "small" broker-dealers in that they would be subject to the requirements in the proposed amendments.

<u>FINRA lists over 4,000 broker-dealers as Small by number of Brokers. The SEC has therefore not accurately ascertained the true effect on how many broker-dealers will be affected.</u>

►**<u>FINRA RULE 6490</u>**. In September of 2010, FINRA enacted Rule 6490, related to filings required of the majority of Issuers whose shares trade in the open markets (over 19,000 issuers), but are not listed on a national exchange, a service that traditionally would have been related to the auspices of the Commission. Since FINRA had not previously undertaken responsibility for Issuers, but limited its scope as an SRO to its regulation activities of broker-dealers, Registered Investment Advisors that were dually licensed, Registered Persons and Investment Advisors that were dually licensed, FINRA was for the first time materially involved in key decisions related to corporate actions related to Issuers rather than its broker-dealers, <u>*et. al.*</u>
None of the activities related to FINRA's role in 6490 are related to its role as an SRO for its member firms and registered persons or Investment Advisors.
The fees that FINRA requires such filers to pay are inadequate to properly investigate and assess, by experienced and appropriately educated and trained personnel, the type of information involved in the nature of the material corporate actions being sought by the respective Issuers. Not only are deficits resulting from the shortfall of collected fees from Issuers versus the costs that FINRA is incurring, which costs must be offset from FINRA's general revenues, but we believe that approvals are being allowed that indicate that the level of investigation on many companies is apparently inadequate as well. In essence, funds paid by broker-dealers are subsidizing corporate issuers which have no relationship with FINRA's activities related to broker-dealers, and the financial shortfalls, and potential lack of adequate staffing levels, is also causing inadequate or incomplete investigations or assessments.

Recently, the Commission has increased its enforcement of issues related to "corporate shells" that are Pink, Grey or other OTC trading vehicles, as well as the promoters, predominantly unlicensed individuals and entities, who deal in such affairs.
We applaud the efforts of the Commission in this regard, and believe that it can be further assisted by better investigation and assessment at the FINRA level as many of these "shells," as well as corporations with nominal operations, are seemingly filing requests pursuant to 6490 that give us pause to ascertain what criteria is being utilized to approve many of these requests.

We believe that the Commission, in transferring this obligation to FINRA that wound up covered in 6490, should include an amended provision that FINRA <u>must</u>

collect fees from issuers that anticipate all **of their costs for providing this service to issuers, and further, that FINRA be prohibited from utilizing funds obtained from fees and expenses it receives from its member firms to pay any such issuer costs. Further, we believe that FINRA should be required to validate the criteria it is utilizing to assess and investigate the requested corporate actions. Clearly, as member firms have reviewed the condition of some of the corporations who have received approvals, it is difficult to ascertain how a regulatory authority could have provided approval for some of these requested actions in light of the information publically available about such corporations.**

There are a number of complex conditions that often accompany such assessments, and given FINRA's current lack of appropriate staff and budget to adequately handle many thousands of such requests annually, in addition to monitoring all the requests that should be made, but are not currently being made, by corporations who are not in compliance with filing requirements of 6490; and approvals of requests that may have been rejected, or would have required alternative actions by such corporations, had more appropriate investigations and assessments been conducted; is having an effect which is OPPOSITE the intentions of the Commission in fighting illicit or manipulative business combinations, retention of trading status, illicit promoters, and penny stock promotion and manipulation.

NIBA would offer the Commission a panel of experienced broker-dealers who could work with the Commission and FINRA to resolve this problem and result in a program that would establish adequate financial expense control and better investigative and assessment procedures to ensure that approvals of such requested actions fall within a scope that would better protect the public and make it more difficult for many of the reconstituted "shells" and nominal operations trading corporations to perpetrate illicit schemes on both the public and member firms.

►VII. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA," we must advise the OMB as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in (1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease), (2) a major increase in costs or prices for consumers or individual industries, or (3) significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of each of the proposed amendments on the economy on an annual basis.

NIBA believes that based upon our comments herein, especially related to the increased net capital provisions of these proposed amendments, the additional net capital required for broker-dealers that cannot obtain lower deductibles for their fidelity bond coverage, the number of broker-dealers that may be forced out of business, and the number of offerings for smaller issuers that could be adversely effected, that the effect to the economy could readily be in excess of $100,000,000,

and would significantly adversely effect competition, and investment in smaller issuers, whether operating companies or funds.
<u>As such, we believe that any such proposals would require their presentation for Congressional review.</u>

In addition, to adequately assess the impact, we would need to know certain facts that are currently not readily available, but of which the Commission is in possession.

We need to know approximately how many offerings and M&A deals at different sizes are conducted currently by member firms, in size ranges as indicated below.

How many:
Over $100mm?
Over $50mm and less than $100mm?
Over $20mm and less than $50mm?
Under $20mm?

Armed with such information in just this one category of investment banking activity, we believe that we would be able to offer the Commission additional perspective on the true costs and effects of many of the proposed amendments contained in the Commission's Broker Dealer Financial Responsibility initiatives.

► <u>"SHELLS AND NOMINAL BUSINESS PROMOTERS AND PROMOTIONS":</u>
The Commission needs to set new standard for non-broker-dealer offerings and M&A, corporate finance, reverse mergers and business combinations with public shells and nominal business corporations. The propensity of actions taken by promoters and non-licensed entities and individuals out of the radar scope of the Commission has become a drain on legitimate corporate finance activities of licensed practitioners and member firms for smaller issuers, and has continued to flagrantly disguise illicit schemes in the promotion of inadequately disclosed and fraudulent plans of questionable business viability, to the adversity and loss of the investing public. Most of these promotions and transactions <u>lack</u> broker-dealer participation, adequate Due Diligence and disclosure, and are rift with negative consequences for unsuspecting investors. As the Commission also ponders the implementation of rulemaking for the upcoming Crowd-funding initiatives and advertising for Regulation D private placements, the coincidence of these Congressionally mandated rules bear even greater importance for "cleaning up" the nano-cap and penny stock arena.
Again, NIBA stands ready to provide the Commission with experienced broker-dealer representatives to work with the Commission related to any such initiative.

►<u>NON-LICENSED ENTITIES AND PERSONS.</u> Issuers must be accountable and liable for activities in raising funds, conducting merger or acquisition activities, and other corporate finance activities, in which they pay a non-licensed entity or person a fee for services that require a licensed member firm, whether such services or transaction fees are paid in cash, goods, stock, revenue/profit sharing, or services.

The Commission has related in the past that it lacks the budget and personnel to investigate and assess the vast majority of potentially illicit transactions or activities. We believe that relatively minor amendments to current rules could enhance the ability of Federal and state enforcement officials and courts to better control illicit activities that are harming investors throughout the United States.
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We would welcome the opportunity to have a small group of representatives from our member firms meet, and work with, your staff to assist in the equitable creation of the amendments sought by the Commission, as we understand that the Commission does not desire to create draconian conditions that will cause the sale, merger, or withdrawal of a large percentage of small broker-dealers comprising approximately 90% of all Broker Dealers.

Please contact Gerald Adler, Esq., or Michael Scillia, (contact info provided separately) to further conversations in the discussion of any of the issues or comments raised herein, and to arrange for representative panels or representatives from NIBA, or the coordination with other predominantly small broker-dealer populated associations.

OUR COMMENTS RELATED TO THE COMMENTS OF OTHER COMMENTERS:

1. **We agree with the Institute of International Bankers in regards to their comments relative to deposits by broker-dealers in US branches of International banks.**
2. **We agree with JP Morgan Chase related to deposits by Small broker-dealers (which is another reason to further adequately define size categories of broker-dealers addressed in our comments).**
3. **We agree with SIFMA as to the phase in period should any of the net capital related amendments be implemented. The phase in period should be very long, well over a year, to provide sufficient time to both create compliance procedures and to raise the required capital. We also agree that small firms should be allowed to deposit all their reserves in money center banks, or banks covered by FDIC insurance on their deposits. We agree that the Commission has significantly underestimated the cost of their proposal to smaller firms.**
4. **We definitively disagree with the comments of the PIABA as unrealistic and representative of conflict of interest. Broker-dealers cannot raise any of their customer rates to pay for an unnecessary insurance. The problems don't lie in all broker-dealers that are small—only the bad ones- drum out the bad ones and you solve that problem—making it more costly or impossible for the good ones to continue is like establishing an impaired pool for insurance purposes—the only benefit is to insurance**

companies—and they will have the largest law firms defending their claims—so customers won't be helped at all. These PIABA comments are unusually naïve from an otherwise outstanding organization.

5. **We definitively disagree with the comments of the Cornell group —their research is either flawed or inadequate. Law firms benefit from additional rulemaking and compliance measures that must be undertaken in deference to such new rules, irrespective of the rules' efficiency or resultant good or evil. We would rather have read positive suggestions for correcting any perceived problems, rather than indictments which fall short of reality for the vast preponderance of legitimate firms.**

Thank you for the opportunity of providing our views related to the Commission's re-visitation of the Broker Dealer Financial Responsibility initiatives.

The Board of Directors of the National Investment Banking Association.

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