



## Capital Acquisition Brokers: New Category of Broker-Dealers Provides Limited Relief for Some Investment Banking Boutiques

The SEC recently approved a set of FINRA rules which creates a new category of broker-dealers known as Capital Acquisition Brokers or CABs. The rules were originally proposed in 2014<sup>1</sup> and will go into effect on the date set forth in FINRA's regulatory notice regarding approval of the rules. The CAB rules are intended to provide regulatory relief for broker-dealers that limit their activities to investment banking. However, the relief provided is limited and the constraints on what business may be conducted by a CAB may diminish the interest of many broker-dealers in using this new category.

### The Historical Problem

FINRA has historically applied a single set of requirements for all broker-dealers. Many of these rules make little sense when applied to broker-dealers that limit their business to M&A advisory work or corporate financing transactions. For example, many FINRA rules are designed to protect retail customers who buy and sell securities through their broker-dealer. While the SEC Private M&A No-Action letter provided some relief,<sup>2</sup> it does not apply to firms providing corporate financing services or M&A services for public companies.

### Who Qualifies as a Capital Acquisition Broker?

The recently approved FINRA rules create a new category of broker-dealers who will be entitled to somewhat relaxed regulatory requirements. CABs are broker-dealers who limit their business to the following:

- Advising an issuer on capital raising activities
- Advising a company on M&A transactions
- Assisting in the preparation of offering materials for the sale of securities
- Acting as placement agent in the sale of newly issued, unregistered securities to "institutional investors" (see discussion below regarding the definition of institutional investors)
- Providing fairness opinions, assistance in negotiation, structuring advice and other support for M&A and other corporate transactions

<sup>1</sup> See our blog post, "FINRA Releases Proposed Rule to Reduce the Regulatory Burdens on Boutique Investment Banks," available at <http://www.bdiaregulator.com/2016/01/finra-releases-proposed-rule-to-reduce-the-regulatory-burdens-on-boutique-investment-banks/>.

<sup>2</sup> See M&A Brokers No-Action Letter (January 31, 2014), available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf>.

CABs may not:

- Underwrite registered offerings
- Sell securities in private placements to investors who do not qualify as “institutional investors”
- Engage in proprietary trading
- Act as a broker or dealer filling customer buy/sell orders
- Exercise investment discretion over customer accounts
- Handle customer funds or securities
- Operate a crowdfunding platform

Importantly, CABs may only sell securities in private placements to “institutional investors”—a category which is defined to exclude many persons who would qualify as “accredited investors.” “Institutional investors” is limited to:

- Institutional accounts as defined in the FINRA rules (\$50 million of assets)
- Qualified purchasers as defined in the Investment Company Act of 1940 (\$5 million of investments or \$25 million of investments under management)
- Certain retirement and other benefit plans with at least 100 participants
- Banks, insurance companies and registered investment companies
- Governmental entities

The definition of “institutional investor” under the CAB rules is thus substantially narrower than the definition of “accredited investor” under Regulation D. Many brokers who act as placement agents for private placements may find the narrower definition unworkable and therefore determine not to register as a CAB.

### **What Relief Is Provided for CABs?**

The relief for CABs from the requirements of the FINRA rules is summarized below.

***Membership Registration and Qualification of Associated Persons.*** CABs are required to comply with all FINRA membership registration requirements and their associated persons are subject to the same licensing and examination requirements as are personnel associated with other broker-dealers.

***Conduct Rules.*** CABs will be subject to most of FINRA’s rules governing the conduct of broker-dealers, including the Know Your Customer and Suitability rules (new Rules 209 and 211 which are similar to current Rules 2090 and 2111). They will also be subject to all AML requirements, although they may test their AML compliance every two years, as opposed to testing every year. An important benefit of CAB status is a simplified rule on customer communications (new Rule 221) which essentially consists of a command to avoid false or misleading statements vs. the detailed review and clearance requirements for communications set forth in current Rule 2210. In addition, certain current rules relating to fair prices and mark-ups will not apply to CABs given that CABs will not engage in retail trading or market-making.

***Supervision Requirements.*** CABs will be subject to a somewhat relaxed set of rules regarding the establishment and implementation of supervisory controls. CABs will have a fair amount of discretion to design a supervisory system which is suitable for the nature of their business. Registered principals will not be required to review all transactions, routine internal inspections will not be required, nor will annual certifications be required regarding the adequacy of the supervisory systems.

**Financial and Operational Requirements.** CABs will generally be subject to FINRA's rules on financial responsibility. However, many of the requirements will not be applicable in light of the fact that CABs cannot handle customer funds or securities, engage in firm commitment underwritings or engage in proprietary trading. CABs will not be required to adopt business continuity plans.

**Securities Offerings.** CABs will be subject to FINRA's rules governing private placements (current Rule 5122) and fairness opinions (current Rule 5150).

**Investigations; Arbitration.** CABs will be subject to essentially the same rules as other FINRA members regarding FINRA investigations and disciplinary actions, as well as the requirements to submit certain disputes for arbitration in accordance with the FINRA Code of Arbitration.

### **How Do Firms Register as Capital Acquisition Brokers?**

Broker-dealers who are currently members of FINRA may file a Continuing Membership Application under NASD Rule 1017 when seeking to amend their membership status.

New applicants will be able to elect CAB status when submitting their applications for membership.

### **Conclusion**

The CAB rules offer limited but meaningful relief from a number of FINRA requirements that are ill-suited for investment banking boutiques. FINRA has estimated that as many as 750 current member firms could be eligible for CAB status. However, given the limited business which may be conducted by a CAB, we expect that the new broker-dealer category will be attractive to a relatively narrow group of firms, primarily M&A boutiques, firms that provide advisory services on corporate financing transactions but do not engage in the sale of securities and firms that limit their selling activities to exempt offerings to institutional accounts.

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