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Client Alert Commentary

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SEC Approves FINRA's Capital Acquisition Broker Rules

While the new rules may provide a measure of relief to certain entities that engage in a limited subset of broker-dealer activities, significant compliance requirements continue to apply.

On August 18, 2016, the U.S. Securities and Exchange Commission (SEC) approved a Financial Industry Regulatory Authority, Inc. (FINRA) proposal to adopt a separate regime for firms that meet the definition of a "capital acquisition broker" (CAB) and elect to be governed by a streamlined rule set specifically applicable to those firms (CAB Rules).[1]

The CAB Rules are essentially designed for firms whose activities are limited to advising companies on mergers and acquisitions, advising issuers on raising debt and equity capital in private placements with institutional investors, or acting as placement agent in such private placement transactions.[2] These activities are similar to those in which broker-dealers who are allowed to maintain regulatory net capital at the lowest level (so-called $5,000 Brokers) are permitted to engage. Because CABs may not engage in the types of activities associated with full-service broker-dealers, such as those that carry or introduce customer accounts, handle customer funds, accept orders to purchase or sell securities, or engage in market-making activities, FINRA believes a more customized and narrow rule set is appropriate and may encourage certain entities to elect to register as brokers, or to maintain their existing registrations, than might otherwise be the case in light of the significant cost associated with the existing regime.

For firms whose activities fall within the narrow confines of the CAB definition, the CAB Rules may indeed lessen the costs and resources necessary to be a FINRA member, which has represented a bar to entry for many smaller firms, but whether the more tailored rulebook will actually have the desired effect remains to be seen. Interestingly, while the CAB Rules are certainly far more limited in number and scope compared to the existing FINRA Rulebook which does not explicitly distinguish between member firms based on the types of activities in which they engage, FINRA members whose activities fall within the CAB definition are generally not subjected to many of the omitted rules in any event. Nonetheless, the reduced scope of the CAB Rules may help in simplifying and shortening firm policies and procedures manuals, and this more clearly delineated rulebook for CABs could lead to greater efficiencies in the compliance and oversight functions generally.

In particular, the CAB Rules may be useful for certain market participants, such as private funds who wish to raise capital through an affiliated registered entity or those who wish to perform certain securities-related services for portfolio companies, as well as unregistered M&A advisors who currently rely on SEC staff no-action guidance, such as the "M&A Broker Letter,"[3] to avoid federal broker-dealer registration but who still may face state broker-dealer registration issues,[4] or who may wish to expand their business into broader private placement activities beyond the scope of such guidance. However, even among these

potential constituents, the utility of the CAB Rules will be limited to those who only wish to access certain kinds of institutional investors, as further discussed below.

FINRA will announce the implementation date for the new CAB regime in a regulatory notice to be published no more than 60 days from August 18, 2016.[5]

Key Definitions

Capital Acquisition Broker

The CAB Rules define a CAB as any broker that *solely* engages in one or more of the following activities:

- Advising an issuer, including a private fund, concerning its securities offerings or other capital raising activities
- Advising a company regarding its purchase or sale of a business or assets, or regarding a corporate restructuring, including a going-private transaction, divestiture or merger
- Advising a company regarding its selection of investment bankers
- Assisting an issuer in the preparation of offering materials
- Providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services
- Qualifying, identifying, soliciting or acting as a placement agent or finder (i) on behalf of an issuer in connection with a sale of newly issued, unregistered securities to institutional investors; or (ii) on behalf of an issuer or control person in connection with a change of control of a privately held company[6]
- Effecting securities transactions solely in connection with the transfer of ownership and control of a privately held company through the purchase, sale, exchange, issuance, repurchase or redemption of, or a business combination involving, the company's securities or assets, to a buyer that will actively operate the company or the business conducted with the company's assets, in accordance with the terms and conditions of an SEC rule, release, interpretation or no-action letter that permits a person to engage in such activities without having to register as a broker-dealer under Section 15(b) of the Exchange Act[7]

The CAB Rules specifically exclude from the CAB definition an entity that (i) carries or acts as an introducing broker with respect to customer accounts; (ii) holds or handles customers' funds or securities; (iii) accepts orders from customers to purchase or sell securities, either as principal or agent for a customer (except as the CAB Rules permit); (iv) has investment discretion on behalf of any customer; (v) engages in proprietary trading of securities or market-making activities; (vi) participates in or maintains an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding or Regulation A under the Securities Act of 1933 (Securities Act); or (viii) effects securities transactions that would require the broker-dealer to report the transaction under the FINRA trade reporting rules.[8] Significantly, CABs are also prohibited from acting as chaperones for non-U.S. broker-dealers pursuant to Rule 15a-6 under the Exchange Act, even if the activities of the non-U.S. broker-dealer would be those in which a $5,000 Broker could engage.[9]

In its initial proposal, FINRA's definition of a CAB would have included among a CAB's permissible activities, "qualifying, identifying, soliciting, or acting as a placement agent or finder with respect to institutional investors in connection with purchases or sales of unregistered securities." At least one commenter interpreted this to include both primary issuances and secondary transactions in unregistered securities, and requested that FINRA confirm the intent to include secondary market transactions among a CAB's permitted activities. Instead, FINRA narrowed the range of permitted secondary market activities such that a CAB may only engage in soliciting or acting as a placement agent or finder in connection with a sale of newly issued, unregistered securities.[10]

Institutional Investor

For purposes of the CAB Rules, the term "institutional investor" is largely based on the same term defined in FINRA Rule 2210 (Communications with the Public), with the important addition of "qualified purchasers" (as that term is defined in Section 2(a)(51) of the Investment Company Act of 1940 (Investment Company Act)). Specifically, institutional investor means any:

- Person meeting the definition of qualified purchaser, which, in general, includes natural persons who own not less than US$5 million in investments; entities that own not less than US$5 million in investments and are owned directly or indirectly by or for two or more related natural persons; certain trusts with not less than US$5 million in investments; and persons acting for their own account or the account of other qualified purchasers who, in the aggregate own and invest on a discretionary basis, not less than US$25 million in investments

- Natural person, corporation, partnership, trust, family office or otherwise with total assets of at least US$50 million

- Bank, savings and loan association, insurance company or registered investment company

- Governmental entity or subdivision thereof

- Employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but does not include any participant of such plans

- Qualified plan, as defined in Section 3(a)(12)(C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but does not include any participant of such plans

- Person acting solely on behalf of any such institutional investor[11]

In response to comments requesting that the definition of "institutional investor" also include "accredited investors," FINRA declined to extend the definition to include such persons who have less than US$5 million in investments (that is, below the qualified purchaser level), since "those investors may not have the requisite investment acumen or financial means to understand or assume the risks associated with investments sold by CABs".[12] FINRA also declined to include "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act)[13] in the definition, which could also limit the utility of the CAB Rules for some private fund sponsors.

FINRA Membership

CABs will generally be required to follow the same procedures for FINRA membership registration as other applicants, except a CAB applicant would state in its application that it intends to operate solely as a CAB.[14] Notably, omission of a specific streamlined registration process for CABs may not be that significant, as CAB applicants (like $5,000 Brokers) may qualify for "fast track" treatment by FINRA's Membership Department. A firm that is already a member of FINRA and wishes to change its status to that of a CAB will not be required to file either a New Member Application or a Continuing Membership Application, so long as the firm is already approved to engage in the activities of a CAB and does not intend to change its existing ownership, control or business operations. Instead, the firm will be required to file a request to amend its membership agreement.[15]

CAB firm principals and representatives are subject to the same registration, qualification examination and continuing education requirements as principals and representatives of other FINRA member firms.[16]

Conduct Rules

The CAB Rules establish a more limited set of conduct rules to which CABs must adhere, which include "know your customer" and suitability obligations, similar to FINRA Rules 2090 and 2111, and an abbreviated version of FINRA Rule 2210 (Communications with the Public). The CAB Rule version of FINRA Rule 2111 is essentially limited to the institutional investor portion of the FINRA rule, and the CAB Rule version (Rule 221) of FINRA Rule 2210 is essentially limited to prohibiting false and misleading statements.[17] Interestingly, CAB Rule 221 does not include the general prohibition on projections found in FINRA Rule 2210. Whether this omission was intentional or not, the use of projections in marketing materials that are determined not to have a reasonable basis may still violate FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), to which CABs remain subject.

FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed) and 2124 (Net Transactions with Customers) do not apply to CABs.[18]

Supervision of Associated Persons

Under the CAB Rules, entities that elect to be CABs are subject to some — but not all — of the requirements of FINRA Rule 3110 (Supervision). Specifically, CABs are subject to the FINRA Rule 3110 provisions concerning the supervision of offices, personnel, customer complaints, correspondence and internal communications.[19] However, CABs are not subject to the provisions of FINRA Rule 3110 that require annual compliance meetings, review and investigation of transactions, specific documentation and supervisory procedures for supervisory personnel, and internal inspections.

CABs would be required to designate and identify one or more principals to serve as the firm's chief compliance officer. However, the CAB Rules do not require that the CAB's chief executive officer certify that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures, all of which are required under FINRA Rule 3130.[20]

Like "full service" broker-dealers, CABs must implement a written anti-money laundering (AML) program;[21] but the CAB Rules allow CABs to conduct the required independent testing for AML compliance every two years rather than annually.[22]

The CAB Rules prohibit any person associated with a CAB from participating in any manner in a private securities transaction as defined in FINRA Rule 3280(e).[23] FINRA stated that this prohibition would not allow "activities to be engaged in by associated persons in their capacities as" employees of a registered investment adviser.[24] This prohibition could be problematic for private equity funds seeking to utilize a

CAB in connection with transaction services for portfolio companies, as the employees who perform such services would typically be dually employed by the fund's adviser. This restriction does not, however, prohibit associated persons of CABs from investing in securities on their own behalf, or engaging in securities transactions with immediate family members, provided the associated person receives no selling compensation.[25]

Financial and Operational Rules

CABs are subject to many of FINRA's rules on financial and operational requirements, including FINRA Rules 4140 (Audit), 4150 (Guarantees by, or Flow through Benefits for, Members), 4160 (Verification of Assets), 4511 (Books and Records – General Requirements), 4513 (Records of Written Customer Complaints), 4517 (Member Filing and Contact Information Requirements), 4524 (Supplemental FOCUS Information), 4530 (Reporting Requirements) and 4570 (Custodian of Books and Records), as well as Rule 4523(a) (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts).[26] However, because CABs cannot carry or act as an introducing broker with respect to customer accounts, they will have more limited customer information requirements than those imposed under FINRA Rule 4512. CABs will only have to maintain each customer's name and residence, whether the customer is of legal age (if applicable), and the names of any persons authorized to transact business on the customer's behalf.[27] CABs will, however, still be required to make and preserve all books and records required under Exchange Act Rules 17a-3 and 17a-4.

Investigations and Sanctions, Code of Procedure, and Arbitration and Mediation

The CAB Rules provide that CABs are subject to FINRA rules governing investigations and sanctions, except FINRA Rules 8110 (Availability of Manual to Customers), 8211 (Automated Submission of Trading Data Requested by FINRA), and 8213 (Automated Submission of Trading Data for Non-Exchange-Listed Securities Requested by FINRA). CABs are also subject to FINRA's rules on disciplinary and other proceedings, other than the FINRA Rule 9700 Series (Procedures on Grievances Concerning the Automated Systems). Finally, CABs are subject to FINRA Rules on arbitration and mediation for customer disputes.

Conclusion

As discussed above, while the CAB Rules may provide some relief to certain FINRA members operating under the current rulebook or to advisory firms and others considering whether to become subject to broker registration and regulation, whether the CAB Rules will offer enough enticement is not yet clear, particularly given the narrow scope of activities allowed and that many of the requirements applicable to traditional, full-service broker-dealers would continue to apply.

Regarding broker-dealers affiliated with private funds or placement agents that only act on behalf of private funds, the CAB Rules may have limited utility since they prohibit CABs from soliciting investors who qualify as "accredited investors" but do not meet the monetary thresholds required of "institutional investors." As a practical matter, this restriction will limit a CAB's activity to funds formed under Section 3(c)(7) of the Investment Company Act, whereas $5,000 Brokers that are not registered as CABs could also perform similar functions on behalf of funds formed under Section 3(c)(1) of the Investment Company Act. The CAB Rules prohibiting activities for selling shareholders and purchasers in the secondary market may also limit the universe of firms willing to embrace CAB status.

Finally, as noted above, firms that provide M&A advisory services under the M&A Broker Letter may consider registering under the CAB Rules to either expand the types of services they are permitted to

offer to primary private placements, or to address current registration concerns about the provision of M&A advisory services in certain states. However, it may be that, when assessing the potential advantages offered by the new regime against the significant additional regulatory burdens that will attach to such entities, the trade-off may not ultimately prove to be worthwhile.

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Endnotes

1 *See* SEC Release No. 34-78617; File No. SR-FINRA-2015-054, Order Approving Rule Change as modified by Amendment Nos. 1 and 2 to Adopt FINRA Capital Acquisition Broker Rules (SEC Order) (Aug. 18, 2016), *available at*: https://www.sec.gov/rules/sro/finra/2016/34-78617.pdf

2 *See* FINRA Notice of Proposed Rule Change to Create a Separate Rule Set that would Apply to Firms that Meet the Definition of Capital Acquisition Broker and Elect to be Governed by this Rule Set (FINRA Proposal) (December 4, 2015) at p. 4, *available at:* http://www.finra.org/sites/default/files/SR-FINRA-2015-054.pdf

3 *See* SEC No-Action Letter, dated January 31, 2014 [Revised February, 4, 2014], available at: http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[4] Although the M&A Broker Letter provides no-action relief from federal broker-dealer registration requirements, applicable state registration requirements may continue to apply even if the activities of the firm fall within the scope of the M&A Broker Letter.

[5] *See* SEC Order at p. 20.

[6] For purposes of this part, a "control person" is a person who has the power to direct the management or policies of a company through ownership of securities, by contract or otherwise. Control will be presumed to exist if, before the transaction, the person has the right to vote or the power to sell or direct the sale of 25% or more of a class of voting securities, or in the case of a partnership or limited liability company, has the right to receive upon dissolution or has contributed 25% or more of the capital. Also, for purposes of this part, a "privately held company" is a company that does not have any class of securities registered, or required to be registered, with the SEC under Section 12 of the Securities Exchange Act of 1934 (Exchange Act) or with respect to which the company files, or is required to file, periodic information, documents or reports under Section 15(d) of the Exchange Act.

[7] *See* CAB Rule 016(c).

[8] *See id.*

[9] *See* SEC Order at p. 33.

[10] *See* SEC Order at p. 30.

[11] *See* CAB Rule 016(i).

[12] SEC Order at p. 36. FINRA also noted that the SEC is also considering whether the definition of "accredited investor" should be revised.

[13] Rule 3c-5 under the Investment Company Act defines a "knowledgeable employee" to include, in general, employees of a private fund that are executive officers, directors, general partners, advisory board members, or persons performing a similar function or that in connection with his or her regular functions or duties, participates in the investment activities of the private fund or a related entity.

[14] *See* SEC Order at pp. 8-9.

[15] *See id.*

[16] *See* Sec Order at p. 10. FINRA also noted that associated persons of CABs are only permitted to retain registration and licenses that are appropriate to their functions as associated persons of CABs.

[17] *See* SEC Order at p. 11.

[18] *See id.* CABs are subject to FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), which requires a member, in the conduct of its business, to observe high standards of commercial honor and just and equitable principles of trade. In addition, CABs must comply with FINRA Rules 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices), 2040 (Payments to Unregistered Persons), 2070 (Transactions Involving FINRA Employees), 2080 (Obtaining an Order of Expungement of Customer Dispute Information from the CRD System), 2081 (Prohibited Conditions Relating to Expungement of Customer Dispute Information), 2263 (Arbitration Disclosure to Associated Persons Signing or Acknowledging Form U4), and 2268 (Requirements When Using Pre-dispute Arbitration Agreements for Customer Accounts).

[19] *See* CAB Rule 311.

[20] *See* SEC Order at p. 16.

[21] *See* CAB Rule 331.

[22] *See* SEC Order at p. 17.

[23] FINRA Rule 3280(e) defines "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities that are not registered with the SEC, provided, however, that transactions subject to the notification requirements of NASD Rule 3050, transactions among immediate family members (as defined in FINRA Rule 5130), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.

[24] *See* SEC Order at p. 32.

[25] *See* SEC Order at pp. 16-17.

[26] *See* CAB Rules 414-416; 451 - 457.

[27] *See* CAB Rule 451(b).