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FINRA Seeks SEC's Approval for "Capital Acquisition Broker" Rules

On December 4, the Financial Industry Regulatory Authority (FINRA) filed with the Securities and Exchange Commission (SEC) a proposed rule change to create a separate rule set (Capital Acquisition Broker Rules) for brokers that are solely corporate financing firms that advise companies on mergers and acquisitions, advise issuers on raising debt and equity capital in private placements with institutional investors, or provide strategic and financial advisory services. These firms often are registered as broker-dealers because they may receive transaction-based compensation for their services. Firms that meet the definition of "capital acquisition broker" and elect to be governed by the new rules will benefit from reduced regulatory burdens while retaining the ability to receive transaction-based compensation. FINRA estimates between 16 and 19 percent of all FINRA member firms may be eligible to operate under this proposed rule set, but the number could be far higher. If the SEC approves the Capital Acquisition Broker Rules, FINRA will announce the implementation date of the proposed rule change in a future filing. The proposed rules define a "capital acquisition broker" (CAB) as any broker that solely engages in any 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 its corporate restructuring, including a going-private transaction, divestiture or merger;
- advising a company regarding its selection of an investment banker;
- assisting in the preparation of offering materials on behalf of an issuer;
- 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 with respect to institutional investors in connection with purchases or sales of unregistered securities; and
- effecting M&A transactions solely in connection with the transfer of ownership and control of a privately held company to a buyer that will actively operate the company, in accordance with the terms of the SEC's M&A Brokers no-action letter, or similar SEC rule, release or interpretation that permits a person to engage in such activities without having to register as a broker-dealer.[1]

CABs may not handle customer funds or securities, accept orders to buy or sell securities either as principal or agent for the customer, exercise investment discretion on behalf of any customer, carry or act as an introducing broker with respect to customer accounts, produce research for the investing public, engage in proprietary trading of securities or market-making activities, or participate in an online platform to offer securities pursuant to the SEC's Regulation Crowdfunding or Regulation A under the Securities Act of 1933, as amended. The principals and representatives of a CAB would be subject to the same

registration, qualification examination and continuing education requirements as principals and representatives of other FINRA member firms. Significantly, a CAB would be limited to facilitating private placements to "institutional investors." Institutional investors would include any:

- bank, savings and loan association, insurance company or registered investment company;
- governmental entity or subdivision thereof;
- employee benefit plan or qualified plan that meets certain requirements;
- person acting solely on behalf of any such institutional investor;
- person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million); or
- person meeting the definition of "qualified purchaser" as that term is defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended.

The inclusion of "qualified purchasers" – natural persons or family-owned companies that own not less than $5 million in investments, and institutions that own not less than $25 million in investments – within the definition of "institutional investor" would allow CABs to raise capital for private funds as well as offer unregistered securities to high-net-worth individuals who are qualified purchasers. Notably, firms that solicit accredited investors will not be eligible to be CABs. The rule proposal states that "FINRA's regulatory programs have uncovered significant concerns associated with the ways in which firms sell private placements to accredited investors." In FINRA's view, qualified purchasers are more likely to have the resources necessary to protect themselves from potential sales practice problems. The Capital Acquisition Broker Rules contain a streamlined set of conduct rules and supervisory rules. For example, CABs would not be subject to the provisions of FINRA's supervision rule that require annual compliance meetings, review and investigation of transactions, and specific documentation and supervisory procedures for supervisory personnel. Nor would the chief executive officer of a CAB be required to certify annually to the firm's compliance program. Among other things, the proposed rules eliminate the requirement to maintain a business continuity plan and a fidelity bond. CABs would be subject to more limited customer information requirements than those imposed under FINRA Rule 4512. However, CABs would be required to comply with some of the FINRA rules that are considered the most onerous – meeting net capital requirements, filing supplemental FOCUS reports, obtaining audited financial statements and employing an operations principal. The proposed rules state that FINRA does not believe it has the authority to reduce or eliminate the audit requirement, and that a change to the net capital rules would require action from the SEC. In addition, Know Your Customer and suitability rules similar to those rules applicable to FINRA member firms would apply to CABs, and CABs would be required to implement a written anti-money laundering program. Associated persons of CABs would not be permitted to engage in private securities transactions away from the firm, since such activities would be beyond the scope of permissible activities for a CAB. Nor would a CAB-associated person be permitted to register with an affiliated or unaffiliated full-service broker-dealer. Firms applying to FINRA for membership as a CAB would be required to follow the same procedures as any other FINRA applicant. Although CAB applicants may have an easier time drafting their policies and procedures, the proposed rules do not establish a "fast-track" process for CAB registration, and the initial costs of establishing a new firm may not be significantly reduced. For those firms that are already FINRA members, the procedure to convert to a CAB appears to be relatively simple. Assuming the existing FINRA member does not intend to change its existing ownership, control or business operations, the firm would be required only to file a request to amend its membership agreement to provide that (i) its activities will be limited to those permitted for CABs, and (ii) it will comply with the Capital Acquisition Broker Rules. For firms that experience misgivings about their CAB conversion, FINRA proposes to permit a CAB to revert to its former status as a full-service broker-dealer without having to file an application for approval of a material change in business operations pursuant to NASD Rule 1017, if such reversion is

initiated during the first year following the FINRA member's conversion to a CAB. _____ [1] See M&A Brokers no-action letter.

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