

BROKER-LITE: FINRA BUILT IT, BUT WILL THEY COME?

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On August 18, 2016, the US Securities and Exchange Commission (SEC) approved a new Financial Industry Regulatory Authority (FINRA) rule series intended as a “lite” framework for the registration and regulation of brokers that limit their activities to certain capital raising and private placements, mergers and acquisitions (M&A) advisory, and related corporate financing.¹ Under the new framework, contained in a new FINRA rule series, a broker that qualifies as a capital acquisition broker (CAB), as defined below, can elect to be regulated under the new rules (CAB Rules). Both current and prospective FINRA members may opt in to the CAB Rules. FINRA will announce the CAB Rules’ effective date in a forthcoming regulatory notice.

WHAT IS A CAB?

Under the CAB Rules, a CAB is defined in CAB Rule 016(c)(1) 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 (i) on behalf of an issuer in connection with a sale of newly issued, unregistered securities to institutional investors (as defined in the CAB Rules and discussed below) or (ii) on behalf of an issuer or control person in connection with a change of control of a privately-held company
- 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, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company, 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 or dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act).

Prohibited Activities

A firm that chooses to be regulated as a CAB cannot

- carry or act as an introducing broker with respect to customer accounts;
- hold or handle customer funds or securities;
- accept orders from customers to purchase or sell securities either as principal or as agent for the customer (except as permitted by items 6 and 7 of the CAB definition above);

1. Order Approving Rule Change as Modified by Amendment Nos. 1 and 2 to Adopt FINRA Capital Acquisition Broker Rules, Exchange Act Release No. 78617, 81 Fed. Reg. 57,948 (Aug. 24, 2016), <https://www.federalregister.gov/articles/2016/08/24/2016-20211/self-regulatory-organizations-financial-industry-regulatory-authority-inc-order-approving-rule>.

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- have investment discretion on behalf of any customer;
- engage in proprietary trading of securities or market-making activities;
- participate in or maintain 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
- effect securities transactions that would require the broker or dealer to report the transaction under the following series of FINRA rules:
 - FINRA Rule 6300 Series—Trade Reporting Facilities
 - FINRA Rule 6400 Series—Quoting and Trading in OTC Equity Securities
 - FINRA Rule 6500 Series—OTC Bulletin Board® Service
 - FINRA Rule 6600 Series—OTC Reporting Facility
 - FINRA Rule 6700 Series—Trade Reporting and Compliance Engine
 - FINRA Rule 7300 Series—OTC Reporting Facility
 - FINRA Rule 7400 Series—Order Audit Trail System

Institutional Investor Definition

For purposes of the solicitation activities in which a CAB may engage under item 6 of the CAB definition above, an “institutional investor” is defined to include

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

2. Section 2(a)(51) of the 1940 Act defines “qualified purchaser” to mean: (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person’s qualified purchaser spouse) who owns not less than \$5,000,000 in investments, as defined by the SEC; (ii) any company that owns not less than \$5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouses (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments.

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Because “qualified purchasers” constitute “institutional investors” under the CAB Rules, firms that elect to become CABs may, consistent with the CAB Rules, solicit investors for private funds that rely on Section 3(c)(7) of the 1940 Act (3(c)(7) Funds), because such funds must restrict their investors to qualified purchasers.

In setting the definitional floor at the qualified purchaser level—and not at the accredited investor level, as that term is defined in Regulation D of the Securities Act—FINRA pointed to widespread fraud and abuse in recent years in the more “retail” private placement marketplace and emphasized that accredited investors with less than \$5 million in investments (the qualified purchaser threshold) may not have the requisite sophistication or financial means to understand or assume the risks associated with investments sold by CABs.

FIRM MEMBERSHIP AND ASSOCIATED PERSON REGISTRATION

A firm applying to FINRA as a CAB will generally have to follow the same procedures for FINRA membership as any other FINRA applicant, with the following four modifications:

- An applicant must explicitly state in its FINRA new member application (NMA) that it intends to operate solely as a CAB.
- FINRA’s Membership Regulation Department will consider whether the applicant’s proposed activities are consistent with the definitional limitations imposed on CABs.
- Existing FINRA members that seek to convert to CABs will not be required to file Continuing Membership Applications (CMAs). Rather, a firm must file a request to amend its membership agreement (or obtain a membership agreement if none currently exists) to provide that its activities will be limited to those permitted for CABs, and the firm must agree to comply with the CAB Rules. If during the first 12 months following conversion, the firm desires to cease its status as a CAB yet continue as a FINRA member, the CAB may notify FINRA’s Membership Application Program group of this change without having to file a CMA. The firm will instead file a request to amend its membership agreement. Barring unusual circumstances, the CAB may continue to operate as a CAB during the pendency of its efforts to revert to a non-CAB.
- If an existing CAB seeks to convert to a non-CAB FINRA member, it will be required to file a CMA and ultimately amend its membership agreement.

CAB principals and representatives will be subject to the same registration, qualification examination, and continuing education requirements as principals and representatives of other FINRA firms, including FINRA Rule 1230(b)(6)’s requirements regarding Operations Professionals. However, FINRA intends to assess the potential need for new qualification examinations specific to CAB activities over time.

HOW “LITE” ARE THE CAB RULES?

As mentioned above, the CAB Rules are intended to be a streamlined version of the rules applicable to full-fledged FINRA members. Listed below are notable differences between the CAB regulatory framework and that traditionally imposed by FINRA on full-service broker-dealers.

Conduct Rules

- **Know Your Customer and Suitability:** CABs will be subject to know-your-customer and suitability obligations substantially similar to those imposed under FINRA Rules 2090 and 2111, including the institutional exception to customer-specific suitability obligations.
- **Communications with the Public:** CABs will be subject to abbreviated communications with the public rules, effectively prohibiting (1) false and misleading statements, (2)

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communications that imply that past performance will recur, and (3) communications that make exaggerated or unwarranted claims, opinions, or forecasts. Notably, the CAB rule removes the prohibition on predictions or projections of performance.

- **FINRA Exams:** FINRA will retain the right to examine for and enforce all FINRA rules against a CAB or associated person of a CAB if the CAB or associated person has engaged in activities inconsistent with the limitations imposed on CABs, including any rule that applies to non-CAB FINRA members and associated persons.
- **Carve-Outs:** CABs will **not** be subject to FINRA Rules that govern commissions, mark-ups, and charges for services performed,³ because a CAB is not permitted to act as principal in a securities transaction. FINRA's rationale is that the transactions CABs will be permitted to effect on an agency basis will be limited to transactions involving (1) institutional parties that are generally capable of negotiating fair prices or (2) the sale of a business as a going concern. However, CAB Rule 201 (Standards of Commercial Honor and Principles of Trade) may apply in situations in which a CAB charges a commission or fee that clearly is unreasonable under the circumstances.

Supervision

- **Supervisory Responsibilities:** CABs will be subject to some, but not all, of the requirements under FINRA Rule 3110 and will retain the flexibility to tailor their supervisory systems to their business models. CABs will be subject to the provisions of Rule 3110 concerning the supervision of offices, personnel, customer complaints, correspondence, and internal communications.
 - CABs will **not** be subject to the provisions of Rule 3110 that require annual compliance meetings, review and investigation of transactions, specific documentation and supervisory procedures for supervisory personnel, and internal inspections.
- **Responsibilities Relating to Associated Persons:** CABs will be subject to FINRA Rules 3220 (Influencing or Rewarding Employees of Others), 3240 (Borrowing from or Lending to Customers), and 3270 (Outside Business Activities of Registered Persons).
- **Chief Compliance Officer (CCO) Designation:** CABs must designate and identify one or more principals to serve as a firm's CCO.
- **Anti-Money Laundering (AML):** CABs will still have to adopt and implement a written AML program, because FINRA lacks the authority to exempt broker-dealers from such requirement imposed by the Bank Secrecy Act and the US Department of the Treasury's implementing regulations. A CAB must also ensure that its AML program provides for independent testing for compliance no less frequently than every two years.
- **Carve-Outs:** CABs are **not** required to obtain a CEO certification pursuant to FINRA Rule 3130(c). In addition, persons associated with a CAB will **not** be permitted to participate in any manner in a private securities transaction as defined in FINRA Rule 3280(e). However, such persons may invest in securities on their own behalf or engage in securities transactions with their immediate family members, provided that the associated person receives no selling compensation.

3. FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed), and 2124 (Net Transactions with Customers).

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Financial and Operational Rules

- **Financial Condition and Books and Records:** CABs will be subject to 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).
- **Net Capital:** A CAB will be required to suspend business operations during any period that the firm is not in net capital compliance as set forth in Exchange Act Rule 15c3-1, and a CAB will be subject to requirements concerning withdrawal of capital, subordinated loans, notes collateralized by securities, and capital borrowings.
- **Customer Information:** CABs will be subject to reduced customer information requirements, such that each CAB will be required to maintain only 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 behalf of the customer.
- **Carve-Outs:** CABs will **not** be required to maintain a business continuity plan, given a CAB's limited activities.

Private Placement Rules

CABs will be subject to FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5150 (Fairness Opinions).

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

- **Investigations and Sanctions:** CABs will be subject to the entire FINRA Rule 8000 Series that governs investigations and sanctions of FINRA member firms **except** 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).
- **Disciplinary and Other Proceedings:** CABs will be subject to the entire FINRA Rule 9000 Series that governs disciplinary and other proceedings involving firms **except** Rule 9700 (Procedures on Grievances Concerning the Automated Systems).
- **Arbitration:** CABs will be subject to the entire Rule 12000 Series (Code of Arbitration Procedure for Customer Disputes), Rule 13000 Series (Code of Arbitration Procedures for Industry Disputes), and Rule 14000 Series (Code of Mediation Procedure).

OBSERVATIONS

Although FINRA's development of the CAB Rules is commendable, it is unclear whether the rules' "lite" nature will provide sufficient incentive to market participants to opt in to the CAB regime.

No Obvious Time or Cost Savings

The time and resources required to register with the SEC and apply for FINRA membership as a CAB do not appear to be reduced to reflect a CAB's limited activities. Indeed, FINRA has expressly reserved itself equal time for approval of new CAB member applications as it has for non-CAB applications and explicitly

rejected calls to establish an abbreviated process for CABs, meaning that the NMA process is likely to remain arduous and expensive.⁴

In addition, many of the rules applicable to full FINRA members will also apply in a substantially similar—if not the same—manner to CABs. These include, for example, FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability), as well as the registration, qualification examination, and continuing education requirements applicable to associated persons. Further, certain of the rules FINRA has stated will not apply to CABs would likely not apply to FINRA firms engaging in CAB-like activities in the first instance.⁵

Unpalatable Restrictions in the Private Placement Market?

It is unclear whether firms acting as private placement agents—whether currently registered or not—will find palatable the CAB Rules' restrictions on solicitation (i) to the more "retail" segment of the private placement market and (ii) in connection with secondary market transactions. Under the CAB Rules, a CAB may act as a private placement agent for private offerings targeted to natural persons so long as those persons have at least \$5 million in investments and the offering is either a primary issuance or is in connection with a change of control of a privately held company.

These limitations will disqualify from the CAB framework any firm that markets both private funds that rely on Section 3(c)(1) of the 1940 Act (3(c)(1) Funds) and 3(c)(7) Funds unless the firm limits its solicitation of 3(c)(1) Funds to "institutional investors" as defined under the CAB Rules. These limitations would likely also disqualify from the CAB framework any firm that engages in resales or "secondaries" (i.e., secondary market transactions) of privately placed securities to qualified institutional buyers pursuant to Rule 144A under the Securities Act.⁶ In light of these restrictions, it is unclear whether firms will be willing to forgo the flexibility to offer such services.

FINRA's Private Placement Rules Will Apply—or Will They?

Although CABs would be subject to FINRA Rule 5122 regarding private placements of securities issued by a CAB or control affiliates of the CAB, CABs that act as private placement agents to 3(c)(7) Funds—and market only to qualified purchasers or other institutional investors as defined under the CAB Rules—would appear exempt from such requirements pursuant to Rule 5122. This is because Rule 5122(c) expressly exempts from the rule's requirements offerings sold solely to, among others, institutional accounts (as defined in FINRA Rule 4512(c)) and qualified purchasers, as defined in Section 2(a)(51)(A) of the 1940 Act. It is also unclear why the CAB Rules fail to incorporate FINRA Rule 5123 regarding private placements of unaffiliated third-party offerings.

4. Firms will also be required to expend resources navigating uncertainties involving the relationship between the new CAB registration category and state broker-dealer registration requirements. *See, e.g.*, Letter from Judith M. Shaw, President, North American Securities Administrators Association, to Brent J. Fields, Secretary, US Securities and Exchange Commission (Jan. 15, 2016) (commenting on the CAB Rules proposal), <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/FINRA-CAB-Comment-Letter.pdf>.

5. For example, a firm that effects no principal trades would not be subject to FINRA Rule 2121's provisions regarding fair mark-ups and mark-downs in principal transactions. Also, firms that already limit themselves to CAB-like activities would likely not be subject to testing under Regulation SCI (FINRA Rule 4380) or to many of the requirements applicable to the marketing and distribution of registered investment companies (e.g., FINRA Rules 2210 and 2341). Although CABs will not be required to have business continuity plans, much of the burden of having such plans revolves around the management, handling, and possession of customer funds and securities, which are activities generally not engaged in by current FINRA members that already limit their activities to those that fall within the CAB definition.

6. Rule 144A capital raises under which a dealer purchases securities directly from an issuer and then resells to qualified institutional buyers also appear to be problematic under the CAB Rules based on their prohibition against proprietary trading and the handling of customer funds or securities.

Why Become a CAB if Not a “Broker” (or if Relying on No-Action Letters)?

The definition of a CAB appears to contemplate activities that, by themselves, may not necessarily cause the person engaging in those activities to come within the meaning of the term “broker” as defined in Section 3(a)(4) of the Exchange Act.⁷ For example, some of the activities in which CABs are permitted to engage appear to come within existing SEC staff no-action letters.⁸

Further, although the CAB definition contemplates that persons may provide M&A advisory services to buyers and sellers of privately held companies, it is unclear why FINRA would include such activities within the CAB definition in the first instance, given that persons who provide such services do not have to register as brokers (or become FINRA members) if they conduct their activities in compliance with the requirements of the SEC staff’s so-called M&A Brokers letter.⁹ In describing the new rules, FINRA even stated that the CAB Rules “would permit CABs to engage, among other activities, in M&A transactions to the same extent as firms relying on the M&A Brokers no-action letter.”¹⁰

Some may suggest that CAB activities cannot be conducted in exchange for transaction-based compensation without the person receiving such compensation registering as a broker, but we note that the M&A Brokers letter expressly permits persons to receive transaction-based compensation without having to register as brokers under the Exchange Act. In addition, courts and even the SEC’s own administrative law judges have also begun to reject the notion that the receipt of transaction-based compensation by itself is determinative of broker status.¹¹

CONCLUSION

Considering that the CAB Rules do not appear to offer any appreciable substantive reduction in a CAB’s regulatory obligations and that many CAB activities appear to be covered by SEC staff no-action letters, it is unclear what incentive a current or prospective FINRA member firm would have to be regulated as a CAB. Nonetheless, to the extent that market participants view SEC approval of the CAB Rules as indicative of a shifting regulatory landscape with respect to broker registration policies, FINRA may yet attract some firms into the CAB field.

7. A broker is defined as “any person engaged in the business of effecting transactions in securities for the account of others.”

8. See, e.g., Benjamin and Lang, Inc., SEC Staff No-Action Letter (Aug. 1, 1978) (taking a no-action position where a municipal broker would withdraw from registration and only act as a financial consultant by analyzing the financial operations of an issuer, making pertinent suggestions, and recommending methods of financing); The Knight Group, SEC Staff No-Action Letter (Nov. 13, 1991) (taking a no-action position for a business that assisted states and municipalities in structuring, timing, and providing the terms of a new issue of bonds).

9. View the no-action letter: <https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf>.

10. Letter from Joseph P. Savage, Vice President & Counsel, Office of Regulatory Policy, FINRA, to Brent J. Fields, Secretary, US Securities and Exchange Commission (Aug. 16, 2016) (responding to comments received by the SEC on the proposed rules), http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2015-054-response_to_comments.pdf.

11. See, e.g., *SEC v. Kramer*, 778 F. Supp. 2d 1320, 1341 (M.D. Fla. 2011) (“an array of factors determines the presence of broker activity”). See also *Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P. II, LLC*, 2011 WL 2342734, at *4 (“[a]lthough one of the hallmarks of being a broker is receiving transaction-based compensation, . . . this is by no means dispositive”); *SEC v. M & A West, Inc.*, No. C-01-3376, 2005 WL 1514101 (rejecting SEC claims that a business broker for shell companies was acting as a broker despite the business broker’s receipt of fees conditioned on the consummation of deals); *In the Matter of 3C Advisors & Assocs., Inc.*, Admin. Proc. Rulings Release No. 4013, 2016 SEC LEXIS 2534, at *28 (ALJ July 22, 2016) (denying the SEC Division of Enforcement’s motion for summary judgment and stating, “[e]ven the unequivocal evidence that 3C received substantial transaction-based compensation—which is a strong but not dispositive indicator of brokering activity—is only one factor to consider among many”).

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