

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY GROUP | September 20, 2016

## FINRA Capital Acquisition Broker Proposal Approved

### Broker-Dealers Conducting Only Certain Private Fund Placement Services or Corporate Finance or Investment Banking Advisory Activities May Elect to Be Governed by More Limited FINRA Rule Set

#### Introduction

In August 2016, the SEC approved FINRA's proposal to permit firms conducting only enumerated corporate financing activities ("capital acquisition brokers" or "CABs") to operate under a more limited FINRA rule set, a move intended to relieve those limited purpose firms from certain regulatory burdens.<sup>1</sup> The implementation date of the CAB rule set will be no later than February 14, 2017.

The more limited CAB rule set described below may be of interest to firms, depending on their business model. While CABs are limited in their permitted functions, and while CABs are not eligible for any specialized exemption from SEC or FinCEN regulation of securities broker-dealers, broker-dealers that limit their business to investment banking advisory and certain private placement businesses may benefit from the certain aspects of the rule set.<sup>2</sup> In particular, private fund placement agents may include predictions or projections of performance in communications sent to prospective investors, and certain compliance responsibilities are not applicable to CABs, including holding an annual compliance meeting, maintaining a business continuity plan or fidelity bond, conducting internal inspections, and CEO certification of supervisory processes.

One hurdle for certain firms will be the CAB rule set's prohibition on CAB associated persons engaging in securities transactions away from the firm, which will limit firms' ability to use dual-hatted personnel, depending on their responsibilities away from the CAB.

#### Who May Register as a CAB

CABs are permitted to engage in the following activities:

- A. Advising an issuer, including a private fund, concerning its securities offerings or other capital raising activities;
- B. 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;

<sup>1</sup> The SEC order granting approval to the rule change can be accessed at <https://www.sec.gov/rules/sro/finra/2016/34-78617.pdf>. This rule change follows years-long industry calls for a more limited FINRA rule set for firms engaging only in certain types of corporate finance advisory activities (see, for example, the ABA's 2005 Report and Recommendations of the Task Force on Private Placement Broker-Dealers, available at <https://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf>), and a February 2014 FINRA proposal for a "limited corporate financing broker" rule set (available at <http://www.finra.org/industry/notices/14-09>).

<sup>2</sup> Full CAB rule set may be found at page 9 of Amendment 2 to the rule proposal, available at <http://www.finra.org/sites/default/files/SR-FINRA-2015-054-amendment-2.pdf>.

- C. Advising a company regarding its selection of an investment banker;
- D. Assisting in the preparation of offering materials on behalf of an issuer;
- E. Providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;
- F. 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 that term is defined in CAB Rule 16(i), which includes Qualified Purchasers)<sup>3</sup> or (ii) on behalf of an issuer or a control person in connection with a change of control of a privately-held company;
  - Because the CAB definition of institutional investor does not include accredited investors, CABs' private fund placement activity will need to be limited to funds that come within Section 3(c)(7) of the Investment Company Act of 1940, or other private issuers that limit their investors to the CAB-specific definition of "institutional investor."
- G. Effecting securities transactions in connection with the transfer of ownership and control of a privately-held company to an active buyer, in accordance with the terms and conditions of the 2014 private M&A broker SEC no-action letter.

On the other hand, CABs may not:

- Act as an introducing broker with respect to customer accounts;
- Hold or handle customers' funds or securities;<sup>4</sup>
- Accept orders from customers to purchase or sell securities either as principal or as agent for the customer (except as permitted in connection with (F) or (G) above);
- 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;
- Effect securities transactions that would require the broker or dealer to report the transaction under FINRA Rules 6300 Series, 6400 Series, 6500 Series, 6600 Series, 6700 Series, 7300 Series or 7400 Series;<sup>5</sup>

<sup>3</sup> FINRA declined a request to expand the definition to also include accredited investors or persons who would be "knowledgeable employees" under Investment Company Act Rule 3c-5. "Qualified Purchaser" is a standard defined for purposes of Section 3(c)(7) of the Investment Company Act that includes, among others, natural persons with at least \$5 million in investments. See CAB Rule 16(i) for other entities meeting the definition of institutional investor under the rule.

<sup>4</sup> Including the handling of any customer stock certificate as part of placement agent services. See, FINRA Response to Comments dated August 16, 2016, available at <https://www.sec.gov/comments/sr-finra-2015-054/finra2015054-21.pdf>, at page 9 [hereinafter, "FINRA Response to Comments"].

<sup>5</sup> The limitation preventing CABs from effecting transactions requiring reporting prohibits most broker-dealer activities in respect of listed securities, and in respect of OTC fixed income (other than certain private placements of fixed income). In this respect, we note that any

- Produce research<sup>6</sup> for the investing public; or,
- Act as Rule 15a-6 chaperone.<sup>7</sup>

CAB Rule 240 states that upon a finding that a CAB or a CAB associated person has engaged in activities outside of those permitted to a CAB, FINRA may examine for and enforce the full set of FINRA rules (i.e., those applicable to non-CABs) against the CAB or the CAB associated person. In response to comments requesting a formal grace period, FINRA, in declining the request, noted that “unintentional violations during a transition period are best handled through the examination and enforcement process on a case-by-case basis.”<sup>8</sup> FINRA noted that it agreed it would be useful to provide additional guidance to CABs concerning the scope of permissible activities, and that it may do so through FAQs or other means.

### Registration Process for CABs

CAB registration is voluntary. The registration process depends on whether an existing FINRA member will be registering as the CAB, or it will be a new registrant:

- CAB applicants that are not currently FINRA members must file a FINRA New Membership Application (“NMA”). Certain CAB applicants may qualify for “fast track” treatment in the NMA process, which otherwise can require as much as 180 days.
- Existing FINRA members that wish to change their status to that of a CAB, and that in so doing will not intend to change its existing ownership, control, or business operations, will not be required to file an NMA or CMA. Instead, such firms must file a request to amend their membership agreement to limit permissible activities to those permitted for CABs.

For existing FINRA members, for a one-year period following their registration as a CAB the firm may switch back to being a general FINRA member without filing a continuing membership application (“CMA”) or materiality consultation. The firm’s membership agreement will revert to its form immediately prior to the switch

future broadening of transaction reporting rules will now create additional limitations for CABs. For an example of recent changes to the transaction reporting rules that broaden such requirements, please see “*FINRA Proposes to Publicly Disseminate Transaction Information Regarding Rule 144A Corporate Debt Securities*,” currently available at <http://www.shearman.com/en/newsinsights/publications/2013/07/finra-proposes-to-publicly-disseminate-transacti>.

<sup>6</sup> Research is defined for purposes of the FINRA research rules as any written (including electronic) communication distributed to more than 15 or more persons that includes an analysis of securities of individual companies or industries and that provides information reasonably sufficient upon which to base an investment decision, subject to the exclusions set forth in FINRA Rule 2241(a)(11) for equity research and FINRA Rule 2242(a)(3) for debt research. Firms distributing notes and commentary to clients, depending on the content and the number of recipients, will need to bear in mind this prohibition.

<sup>7</sup> It is curious that FINRA chose to prohibit CABs from acting as a so-called “chaperone” for purposes of Rule 15a-6, since the provisions of that Rule permit broker-dealers to intermediate transactions based on SEC registration and regulation without reference to SRO rules: See Rule 15a-6(a)(3). For more information regarding SEC Rule 15a-6, please see for example our client publication regarding the Rule 15a-6 SEC FAQs, available at <http://www.shearman.com/en/newsinsights/publications/2013/03/sec-releases-responses-to-frequently-asked-quest>.

<sup>8</sup> See FINRA Response to Comments at page 19.

to CAB status. For a CAB that was not previously a FINRA member firm, to become a full FINRA member will require a CMA.

### **Restrictions on Use of Dual-Hatted Personnel**

CAB Rule 328 prohibits any CAB associated person from engaging in a private securities transaction as defined in FINRA Rule 3280(e), thereby prohibiting CAB associated persons from engaging in any securities transaction away from the CAB, other than transactions for which no compensation is received. The CAB rule set will therefore prohibit CAB associated persons from also carrying out functions for other (including affiliated) broker-dealers, investment advisers, or banks, if the services the person would provide would be engaging in a securities transaction. This may present a significant hurdle for firms to be able to make use of the new CAB registration.

### **Benefits of CAB Registration**

CABs will be subject only to FINRA by-laws and a CAB rule set that is significantly smaller than the broader FINRA rule set. The following are some of the differences between the CAB and broader FINRA rule set that benefit CABs:

- *Predictions or projections of performance permissible*: Importantly for placement agents of private funds, the CAB version of FINRA Rule 2210 (CAB Rule 221) does not incorporate the rule's prohibitions on predictions or projections of performance.<sup>9</sup>
- The CAB communication rule imposes certain content standards, but does not prescribe principal review procedures or require FINRA filing of certain communications. CABs must adopt their own supervisory procedures to ensure that communications comply with the content standards and other applicable rules.
- Certain compliance responsibilities lessened:
  - No requirement for annual compliance meeting;
  - No requirement for fidelity bond;
  - No requirement for BCP;
  - AML independent audit required only every two years, rather than annually;
  - No requirement for procedures for review and investigation of transactions by a registered principal (FINRA Rule 3110(b)(2)) or transaction review for firms engaged in investment banking business (FINRA Rule 3110(d));
  - No requirement for procedures prohibiting supervisory personnel from supervising their own activities or reporting to or having their compensation or continued employment determined by a person the supervisor is supervising (FINRA Rule 3110(b)(6));
  - No requirement for internal inspections (FINRA Rule 3110(c)); and,

<sup>9</sup> In its proposal, FINRA noted that it "recognizes that firms may need to include projections of an issuer's performance in communications that are sent to prospective investors, such as pro forma financial statements related to a business acquisition or combination."

- No requirement for CEO certification of effectiveness of supervisory processes (FINRA Rule 3110(b) and (c)).
- Customer information requirement of FINRA Rule 4512 lessened—under CAB Rule 451, CABs will 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 behalf of the customer.

### **Other Significant Rules Apply to CABs**

Among the rules that do apply to CABs are:

- All provisions of the securities laws, SEC rules, and state securities law and regulation, including all AML requirements (other than, as noted above, that the independent AML audit can occur every two years instead of annually). CAB status only impacts the applicability of the FINRA rulebook.
- SEC Rule 15c3-1. CABs do not receive any relief from the Net Capital Rule. For CABs, we would expect a \$5,000 regulatory net capital requirement.
- Annual audit requirement.
- SIPC dues.
- Licensing requirements. Whether an associated person carries out a function at a standard FINRA broker-dealer or a CAB does not impact which licenses they will need.
- FINRA Rule 3220 (Influencing or Rewarding Employees of Others), 3240 (Borrowing from or Lending to Customers), and 3270 (Outside Business Activities of Registered Persons).

### **Conclusion**

CAB status may be of interest especially to firms serving as institutional fund placement agent (for the greater flexibility the CAB rule set provides to communications with predictions or projections of performance), and to M&A and other corporate finance advisory firms whose activities come within those permitted to CABs (for the lessened compliance burdens). That said, the restrictions described above on the use of dual-hatted personnel who carry out securities-related functions for other entities will pose a significant challenge to some firms considering CAB status. Firms will be considering the costs and benefits of CAB registration, and will monitor for any further guidance from FINRA on the CAB rule set. For more information on broker-dealer regulation and registration, please see [brokerdealer.shearman.com](http://brokerdealer.shearman.com).

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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