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INVESTMENT MANAGEMENT

FINRA'S NEW LIMITED REGISTRATION FOR CABs HAS LIMITED USE AND APPEAL

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Many in the securities industry have called for a reduced regulatory regime for certain broker-dealers who engage in a limited scope of activities focused primarily on capital raising, mergers and acquisitions, corporate financings, and various advisory services. These broker-dealers typically do not hold, handle, or have investment discretion over customer funds, yet historically have faced the same onerous regulatory requirements as larger broker-dealers who are engaged in a much broader set of activities. In response to industry demand, on August 18, the U.S. Securities and Exchange Commission (the "SEC") approved a Financial Industry Regulatory Authority Inc. ("FINRA") rule proposal establishing a new, limited registration regime for broker-dealers who (i) meet the newly created definition of "capital acquisition broker" ("CAB"), and (ii) elect to be governed under the new CAB rule set through conversion or a new membership application.

What Are the Origins of the CAB Rules?

On the heels of the issuance by the SEC of the M&A Broker no-action letter,[1] FINRA initially proposed a limited rule set in February 2014 for what it then termed "limited corporate financing brokers" ("LCFB"). This proposal was met with much criticism by market participants and was re-proposed in December 2015 as the CAB rules. In response to the 17 comment letters that FINRA received regarding the December 2015 proposal, FINRA amended the initial CAB rules proposal this past April and then again in July. FINRA has stated that the purpose of the CAB rules is to establish a streamlined set of conduct rules and reduce the regulatory burden for CAB entities without diminishing investor protections. FINRA estimates that as many as 750 current FINRA members could be eligible to become CABs due to their limited activities. Further, FINRA believes that the reduced regulatory and compliance requirements of the CAB rules may encourage nonmember firms currently engaged in similar activities to register as CABs.

Who IS and IS NOT a Capital Acquisition Broker?

A CAB is defined as any broker who 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 its corporate restructuring, including a going-private transaction, divesture, 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;
- Effecting securities transactions solely in connection with the transfer of ownership and control of a privately held company consistent with the limitations in the SEC's M&A Broker no-action letter; and
- Qualifying, identifying, soliciting, or acting as a placement agent or finder with respect to "institutional investors" in connection with purchases or sales of newly issued unregistered securities.

It is important to note that for purposes of the CAB rules, "institutional investors" are defined consistent with FINRA Rule 2210, with one exception: While the definition includes, among other things, banks, insurance companies, registered investment companies, governmental entities, and any person with assets of at least $50 million, it also contains "qualified purchasers," as defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended (the "Company Act"). A qualified purchaser means, among other things, a natural person who owns at least $5 million in investments, or a company with not less than $25 million in investments. This definition was expanded as a result of comments from the more-limiting LCFB proposal. Notably, however, the definition was not expanded to include the lower standard of "accredited investors," where a natural person needs an

annual income of only $200,000 in the two years prior (or $300,000 joint with a spouse) or a net worth greater than $1 million (not including primary residence).

A CAB does not include any broker or dealer who:

- Carries or acts as an introducing broker with respect to customer accounts;
- Holds or handles customers' funds or securities;
- Accepts orders from customers to purchase or sell securities either as principal or as agent for the customer (except as otherwise permitted by CAB Rules);
- Has investment discretion on behalf of any customer;
- Engages in proprietary trading of securities or market-making activities; or
- Participates in or maintains an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding and Regulation A.

How Does One Become a CAB?

The FINRA membership rules will apply equally to newly formed CABs and non-CAB applicants. Presumably, the FINRA fast-track review process will be available to CAB applicants if they qualify, though the related releases are silent on this point. FINRA has not yet released a new CAB application. Those existing FINRA members already approved to engage in the business activities covered by the CAB rules will be able to convert to CAB status simply by filing with FINRA a request to amend their membership agreement. Such a CAB will have the ability to convert back to a non-CAB broker-dealer within one year through the same type of filing. Any conversion request beyond one year will require approval from FINRA through the filing of a continuing membership application pursuant to NASD Rule 1017, or any successor rule.

Will Any Firms Choose to Become a CAB?

The CAB rules represent an attempt to streamline and reduce the regulatory burdens of CABs with respect to, among other things, compliance, advertising, marketing, and communications. CABs will be subject to a reduced set of FINRA rules but will still be subject to federal securities laws and regulations and any applicable state laws. They will still be required to, among other things, (i) have registered personnel who must qualify through FINRA exams; (ii) maintain minimum net capital requirements; (iii) file quarterly FOCUS reports; (iv) have an annual audit; (v) maintain SIPC membership; (vi) undergo or subject themselves to FINRA exams, investigations, and arbitration; and (vii) maintain written supervisory procedures, including anti-money laundering ("AML") policies and procedures that require an independent AML review every two years. CABs, unlike non-CAB broker-dealers, will get relief from filing advertising material, performing annual compliance meetings, and obtaining annual CEO Certifications.

We believe the most notable limitations in the CAB rules that will have the largest impact on adoption are the definition of "institutional investors" and the exclusion of secondary transactions in the capital-raising aspect of the CAB definition, as well as the prohibition of an associated person of a CAB from engaging in private securities transactions.

M&A Advisory and Private Placement Brokers

Many M&A advisors either rely on the M&A Broker no-action letter and do not need to register as broker-dealers, or they register as broker-dealers because they may fall outside of the M&A Broker no-action letter. This most commonly occurs for private equity funds that may have possession of funds or securities; they typically have the power to bind parties and do not have an active role in management. Generally, M&A advisors who are currently registered with FINRA also want the flexibility in their business to raise capital for their investment banking clients, advise as members of an underwriting, or be paid for their services in securities of an issuer, which they can then sell into the open market. However, the definition of a CAB is very limited and prohibits certain activities such as raising capital from accredited investors who are not also qualified purchasers, and being able to sell secondary offerings of private placements. Similar obstacles will be met by smaller broker-dealers who raise capital only from accredited investors in private placement transactions; they are involved in secondary offerings and may want to participate in best efforts underwritings. For all of these reasons, becoming a CAB is not a viable option for these types of firms, many of whom FINRA had likely considered eligible adopters.

Private Fund Marketers

The private fund industry has formed part of the contingent that is calling for streamlined broker-dealer rules following SEC enforcement actions and increased scrutiny that fund sponsors may be acting as unregistered broker-dealers in marketing interests in their funds. While the CAB rules make some headway in addressing issues that have historically plagued the private fund industry, *e.g.*, CABs are exempt from FINRA Rule 2210's preclusion from communications that predict or project performance, we believe the CAB rules fall short of offering any real

alternative to current industry practices. The CAB rules provide two obstacles to the wider population of private fund sponsors that may otherwise wish to avail themselves of the CAB rules.

The first obstacle is similar to the explanation above relating to M&A advisors and general placement agents, and which emanates from the restrictive definition of "institutional investor" in the CAB rules. In the private fund context, the CAB rules will only permit CABs to market interests in funds formed under Section 3(c)(7) of the Company Act and prohibit marketing activities with respect to funds formed under Section 3(c)(1) of the Company Act.[2] The reason for this is because 3(c)(7) funds may be purchased only by people who are considered qualified purchasers, whereas 3(c)(1) funds may be purchased by people who are not qualified purchasers. Thus, as written, the CAB rules will not allow a fund sponsor registering as a CAB to engage in any broker-dealer activities with respect to 3(c)(1) funds.

The CAB rules present a second obstacle by prohibiting an associated person of a CAB from participating in any manner in private securities transactions as defined in FINRA Rule 3280. These prohibitions, for example, would preclude any CAB-associated person from associating with an affiliated fund to act as a portfolio manager or effect securities transactions in any similar way for the fund. FINRA "does not believe an associated person of a CAB should be engaged in selling securities away from the CAB … given its limited business model." Such restrictions present a practical problem for fund sponsors, especially small ones who require people to play multiple roles. Any desire or need to engage in securities activities outside of the CAB may convince a fund sponsor to abstain from forming or registering as a CAB and revert to current industry practice with respect to fund placement.

What's Next?

For the foregoing reasons, and until some of the barriers to entry are removed, we believe few new applicants or full broker-dealers will find the CAB rules so compelling as to pursue this category of registration. We believe that one must seriously question FINRA's estimate of members that could be eligible for the CAB rules. That number seems vastly overstated or the metrics used overgeneralized, when compared to the limitations on the most attractive aspects of the CAB rules. Nevertheless, we expect that fund sponsors marketing 3(c)(7) funds will find this registration very useful as a lighter touch entry to becoming a broker-dealer, and will be the most likely benefactors of the new CAB regime.

Before the CAB rules can become effective, FINRA must release a regulatory notice announcing the rule and its effective date, which will likely also contain information around CAB membership and the application process.

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[1] Available at https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[2] Private Funds formed under Section 3(c)(7) or 3(c)(1), such as hedge funds and private equity funds, are generally excluded from the definition of an investment company under the Company Act and therefore the funds are not registered, nor can the funds make a public offering of their shares.