

## Capital Acquisition Brokers

### SEC Approves FINRA's Capital Acquisition Broker (CAB) Rules

Effective Dates: January 3, 2017 (CAB Member Application and Associated Person Registration Rules) and April 14, 2017 (All Other CAB Rules)

#### Summary

The Securities and Exchange Commission (SEC) approved<sup>1</sup> FINRA's rule set for firms that meet the definition of "capital acquisition broker" (CAB) and that elect to be governed under this rule set. CABs are firms that engage in a limited range of activities, essentially advising companies and private equity funds on capital raising and corporate restructuring, and acting as placement agents for sales of unregistered securities to institutional investors under limited conditions. Firms that elect to be governed under the CAB rule set are not permitted, among other things, to carry or maintain customer accounts, handle customers' funds or securities, accept customers' trading orders, or engage in proprietary trading or market-making.

The CAB rules become effective on April 14, 2017. In order to provide new CAB applicants with lead time to apply for FINRA membership and obtain the necessary qualifications and registrations, CAB Rules 101-125 will become effective on January 3, 2017. FINRA will begin accepting applications for firms that are not broker-dealers but wish to register as CABs, for existing member firms requesting to elect CAB status, and for CAB associated person registration and qualification, on January 3, 2017.

The text of the CAB rules is available on [FINRA's website](#).

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#### Background and Discussion

Some firms, which may or may not be registered as broker-dealers, engage solely in corporate financing activities such as advising companies on mergers and acquisitions, advising issuers on raising debt and equity capital in private

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#### Notice Type

- ▶ New Rule

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

#### Key Topics

- ▶ Capital Acquisition Brokers
- ▶ Corporate Restructuring
- ▶ Mergers & Acquisitions
- ▶ Private Equity Funds

#### Referenced Rules & Notices

- ▶ CAB Rules
- ▶ FINRA By-Laws
- ▶ FINRA Rule 1000 Series
- ▶ FINRA Rule 2000 Series
- ▶ FINRA Rule 3000 Series
- ▶ FINRA Rule 4000 Series
- ▶ FINRA Rule 5122
- ▶ FINRA Rule 5123
- ▶ FINRA Rule 8000 Series
- ▶ FINRA Rule 9000 Series
- ▶ FINRA Rule 10000 Series
- ▶ FINRA Rule 12000 Series
- ▶ FINRA Rule 13000 Series
- ▶ FINRA Rule 14000 Series
- ▶ NASD Rule 1000 Series
- ▶ NASD Rule 2000 Series
- ▶ NASD Rule 3000 Series

placements with institutional investors, and providing advisory services to companies that need assistance analyzing their strategic and financial alternatives. Those firms that are registered as broker-dealers typically do so because they may receive transaction-based compensation.

These firms do not engage in many of the types of activities typically associated with traditional broker-dealers. For example, these firms typically do not carry or act as an introducing broker with respect to customer accounts, handle customer funds or securities, accept orders to purchase or sell securities either as principal or agent for the customer, exercise investment discretion on behalf of any customer, or engage in proprietary trading of securities or market-making activities.

For this reason, many FINRA rules should not apply to these firms, or should be modified to reflect their limited business activities. In order to accommodate the limited business activities of these firms while continuing to protect their customers, FINRA has established a separate, narrower set of rules that governs these firms, if they meet the CAB definition and elect to be so governed. FINRA encourages member firms that would qualify as CABs to consider converting to CAB status, to obtain greater assurance that they will be subject to a regulatory regime that is tailored to the limited nature of their business. FINRA also encourages firms that are not members to consider registering as CABs if they would meet the CAB definition. In doing so, these firms would remove any possible ambiguity about their status as non-broker-dealers while coming under a regulatory regime that is tailored to the limited nature of their business.

This *Notice* summarizes some of the significant aspects of the CAB rules.

### General Standards (CAB Rule 010 Series)

CAB Rule 016 sets forth basic definitions modified as appropriate to apply to CABs. The definitions of “capital acquisition broker” and “institutional investor” are particularly important to the application of the rule set.

The term “capital acquisition broker” means 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 or (ii) on behalf of an issuer or a control person in connection with a change of control of a privately-held company. For purposes of the provision, 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 percent 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 percent or more of the capital. For purposes of the provision, 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; and
- ▶ 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 Exchange Act.

The term “capital acquisition broker” does not include any broker or dealer that:

- ▶ 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 permitted by paragraphs (c)(1)(F) and (G) of CAB Rule 016);
- ▶ has investment discretion on behalf of any customer;
- ▶ engages in proprietary trading of securities or market-making activities;
- ▶ 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; or
- ▶ effects 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>2</sup>

The term “institutional investor” has the same meaning as that term has under FINRA Rule 2210 (Communications with the Public), with one exception: the term “institutional investor” in CAB Rule 016, but not FINRA Rule 2210, includes any 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).<sup>3</sup>

A CAB may act as a placement agent for an issuer in a manner consistent with the CAB rules even if the issuer has, on its own, sold its securities to non-institutional investors. For example, a CAB would be permitted to solicit institutional investors to invest in a private fund that is excluded from the definition of “investment company” pursuant to Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, even if the fund has issued shares to persons who do not meet the definition of “institutional investor” under CAB Rule 016(i). In the process of qualifying investors to determine whether they meet the definition of “institutional investor,” a CAB may contact and receive information from persons who do not meet this definition. In either case, however, the CAB would not be permitted to solicit, offer, act as a placement agent or receive compensation in connection with the sale of shares to any person who is not an institutional investor.

### **Member Application and Associated Person Registration (CAB Rule 100 Series)**

CAB Rules 101-118 set forth the requirements for new firms that wish to register as a CAB and existing FINRA member firms that wish to elect CAB status.

#### **Existing Members Electing CAB Status**

CAB Rule 116(b) sets forth streamlined procedures for an existing FINRA member firm to elect CAB status if the firm is already approved to engage in CAB activities. If a member firm is approved to engage in private placement or finder activities, intends to continue engaging in these activities as a CAB, and does not intend to change its existing ownership, control or business operations, it is not required to file either a New Member Application (NMA) or a Continuing Membership Application (CMA). Rather, the firm must file a request to amend its membership agreement or obtain a membership agreement (if none exists currently).<sup>4</sup> In the membership agreement, the firm would need to represent that its activities will be limited to those permitted for CABs and that it agrees to comply with the CAB rules. There would be no application fee associated with this request.<sup>5</sup>

A member firm that is not already approved to engage in CAB activities, or that intends to change its ownership, control or business operations as described in NASD Rule 1017(a), must file a CMA in order to elect CAB status.<sup>6</sup>

### **New Applicants**

A firm that is not registered as a broker-dealer and that wishes to become a CAB generally must follow the same registration and application procedures as any other broker-dealer applicant, by using the NMA. An applicant should indicate within the application that it intends to operate solely as a CAB pursuant to the FINRA CAB Rules. In reviewing an application for membership as a CAB, FINRA will consider, in addition to the standards for admission set forth in NASD Rule 1014, whether the applicant's proposed activities are consistent with the limitations imposed on CABs under CAB Rule 016(c).

### **Terminating CAB Status**

FINRA has established streamlined procedures under CAB Rule 116(d) to permit a full-service broker-dealer to convert to CAB status, and then return to its former status within a year. The firm must notify FINRA of this change through Firm Gateway, but does not have to file an application for approval of a material change in business operations under NASD Rule 1017. The CAB need only file a request to amend its membership agreement in order to effect this change. In its membership agreement, the firm must agree that it will comply with all FINRA rules, and the membership agreement must impose the same limitations on the firm's activities that existed before the firm converted to CAB status.<sup>7</sup>

Beyond the one-year period following conversion to CAB status, in order for a CAB to convert to the status of a full-service broker-dealer, it must file a CMA with FINRA and execute an amended membership agreement to provide that it will comply with all FINRA rules. If a CAB desires to terminate its registration as a broker-dealer, the CAB must follow the same procedures as any other broker-dealer.

### **Associated Person Registration**

CAB Rules 119-125 govern the registration and qualification examinations of principals and representatives who are associated with CABs. CAB principals and representatives are subject to the same registration, qualification and continuing education requirements as principals and representatives of other FINRA firms. As with any other broker-dealer, CAB registered principals will need to obtain qualifications commensurate with the activities in which they engage. As a general matter, depending on the types of activities in which a particular principal will engage, these registrations may include the General Securities Principal (Series 24),<sup>8</sup> Limited Principal – Financial and Operations (Series 27), Limited Principal – Introducing Broker/Dealer Financial and Operations (Series 28), and Limited Principal – Direct Participation Programs (Series 39).<sup>9</sup>

Associated persons of CABs who are included within the definition of representative in NASD Rule 1031 also must be registered.<sup>10</sup> Depending on the types of activities in which a particular representative will engage, these registrations may include the General Securities Representative (Series 7), Limited Representative – Direct Participation Programs (Series 22), Limited Representative – Corporate Securities (Series 62), Limited Representative – Investment Banking (Series 79), Limited Representative – Private Securities Offerings (Series 82), and Operations Professional (Series 99).

### **Duties and Conflicts (CAB Rule 200 Series)**

The CAB Rule 200 Series establishes a streamlined set of conduct rules. For example, CABs are not subject to FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed), and 2124 (Net Transactions with Customers), since CABs' business model does not raise the same concerns that Rules 2121, 2122 and 2124 are intended to address. Even those rules that do apply have been simplified in many cases. For example, CAB Rule 221 is a streamlined version of FINRA Rule 2210 (Communications with the Public), essentially prohibiting false and misleading statements.

### **Supervision and Responsibilities Related to Associated Persons (CAB Rule 300 Series)**

The CAB Rule 300 Series establishes a limited set of supervisory rules for CABs. CABs are 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). CAB Rule 311 subjects CABs to some, but not all, of the requirements of FINRA Rule 3110 (Supervision) and, consistent with Rule 3110, is designed to provide CABs with the flexibility to tailor their supervisory systems to their business models. For example, CABs are not subject to the provisions of Rule 3110 that require annual compliance meetings (paragraph (a)(7)), review and investigation of transactions (paragraphs (b)(2) and (d)), specific documentation and supervisory procedures for supervisory personnel (paragraph (b)(6)), and internal inspections (paragraph (c)).

CAB Rule 313 requires CABs to designate and identify one or more principals to serve as a firm's chief compliance officer, similar to the requirements of FINRA Rule 3130(a). However, it does not require chief executive officer certification about its compliance supervisory procedures, which is required for non-CAB firms under FINRA Rules 3130(b) and (c).

CAB Rule 328 prohibits any person associated with a CAB from participating in any manner in a private securities transaction as defined in FINRA Rule 3280(e).<sup>11</sup> This restriction would not prohibit associated persons from investing in securities on their own behalf, or engaging in securities transactions with immediate family members, provided that the associated person does not receive selling compensation.

CAB Rule 331 requires each CAB to implement a written anti-money laundering program, similar to FINRA Rule 3310, but permits CABs to conduct the required independent testing every two years rather than every year as required by Rule 3310.

### **Financial and Operational Rules (CAB Rule 400 Series)**

CAB Rule 400 Series establishes a streamlined set of rules concerning firms' financial and operational obligations. CABs are not subject to FINRA Rules 4370 (Business Continuity Plans and Emergency Contact Information) or 4380 (Mandatory Participation in FINRA BC/DR Testing Under Regulation SCI).

CAB Rule 411 includes some, but not all, of the capital compliance requirements of FINRA Rule 4110. In particular, CAB Rule 411 excludes the provisions of FINRA Rule 4110 that apply to carrying or clearing member firms, including the provisions authorizing FINRA to prescribe greater net capital or net worth requirements than those otherwise applicable, and the provisions regarding sale-and-leasebacks, factoring, financing, loans and similar arrangements.<sup>12</sup>

CAB Rule 452(a) establishes a limited set of requirements for the supervision and review of a firm's general ledger accounts.

### **Securities Offerings (CAB Rule 500 Series)**

The CAB Rule 500 Series applies to CABs FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5150 (Fairness Opinions).

### **Investigations and Sanctions, Code of Procedure, and Arbitration and Mediation (CAB Rules 800, 900 and 1000)**

CABs are subject to a narrower rule set than the FINRA Rule 8000 Series governing investigations and sanctions of firms. For example, CABs are not subject to 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 a narrower rule set than the FINRA Rule 9000 Series governing disciplinary and other proceedings involving firms. CABs are not subject to the FINRA Rule 9700 Series (Procedures on Grievances Concerning the Automated Systems).

CABs are subject to the FINRA Rule 12000 Series (Code of Arbitration Procedure for Customer Disputes), 13000 Series (Code of Arbitration Procedure for Industry Disputes) and 14000 Series (Code of Mediation Procedure).

## Endnotes

1. See Securities Exchange Act Release No. 78617 (August 18, 2016), 81 FR 57948 (August 24, 2016) (Order Approving Rule Change as Modified by Amendment Nos. 1 and 2 to Adopt FINRA Capital Acquisition Broker Rules; File No. SR-FINRA-2015-054).
2. See CAB Rule 016(c)(2).
3. See CAB Rule 016(i).
4. If an existing FINRA member firm is already approved to engage in the activities permitted for a CAB, but is also approved to engage in activities not permitted for a CAB, the firm may terminate those lines of business not permitted for a CAB as part of its election of CAB status without having to file an NMA or CMA. The firm's request to amend its membership agreement would have to indicate that the firm will no longer engage in these impermissible activities once it becomes a CAB.
5. The firm also would need to amend Item 12 of its Form BD to indicate that it intends to operate solely as a CAB. The firm should check "Z. Other" and in Schedule D, Page 1 of Section II of the Form BD, indicate that it intends to operate solely as a CAB pursuant to the FINRA Capital Acquisition Broker Rules.
6. The firm also would need to amend Item 12 of its Form BD to indicate that it intends to operate solely as a CAB, in the manner indicated in endnote 5.
7. The firm also would need to amend its Form BD to reflect that it no longer intends to operate as a CAB. To the extent that the rules applicable to the firm had been amended since it had changed its status to a CAB, FINRA would have the discretion to modify any limitations to reflect any new rule requirements.
8. A General Securities Principal may also need to register in a specific prerequisite representative category depending on the scope of his or her activities. For instance, NASD Rule 1022(a)(1)(B) requires that a General Securities Principal with responsibility over the investment banking activities specified in NASD Rule 1032(i) also satisfy the Limited Representative—Investment Banking registration requirement.
9. A CAB would be permitted to qualify, identify, solicit, or act as a placement agent or finder on behalf of a direct participation program only in connection with securities transactions described in CAB Rules 016(c)(1)(F) and (G).
10. See NASD Rules 1031(b) and 1032(a); see also CAB Rules 121(d) and 123(b), which provide that all CABs are subject to NASD Rules 1031 and 1032, respectively.
11. 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 which are not registered with the Commission, 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."
12. See FINRA Rules 4110(a) and (d).