

August 16, 2016

Mr. Brent J. Fields  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

**Re: File No. SR-FINRA-2015-054 (Proposed Rule Change to Adopt the Capital Acquisition Broker Rules)**

Dear Mr. Fields:

This letter responds to comments received by the Securities and Exchange Commission (“SEC” or “Commission”) to the above-referenced rule filing that would establish a separate rule set that applies exclusively to firms that meet the definition of “capital acquisition broker” (“CAB”) and that elect to be governed under this rule set. CABs would be subject to the FINRA By-Laws, as well as core FINRA rules that FINRA believes should apply to all firms. The rule set would include other FINRA rules that are tailored to address CABs’ business activities.

The Commission published the proposed rule change for public comment in the Federal Register on December 23, 2015.<sup>1</sup> The Commission received 17 comment letters directed to the rule filing.<sup>2</sup> Four commenters supported the proposal to

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<sup>1</sup> See Securities Exchange Act Release No. 76675 (December 17, 2015), 80 FR 79969 (December 23, 2015) (Notice of Filing of File No. SR-FINRA-2015-054).

<sup>2</sup> See Letter from Roger W. Mehle, Achates Capital Advisers LLC, to Brent J. Fields, Secretary, SEC, dated December 29, 2015 (“Achates”); letter from Daniel H. Kolber, Intellivest Securities, Inc., to Brent J. Fields, Secretary, SEC, dated December 30, 2015 (“Intellivest”); letter from Arne Rovell, Coronado Investments, LLC, to Brent J. Fields, Secretary, SEC, dated January 6, 2016 (“Coronado”); letter from Donna Di Maria and Lisa Roth, Third Party Marketers Association, to Brent J. Fields, Secretary, SEC, dated January 12, 2016 (“3PM”); letter from Frank P.L. Miard, XT Capital Partners, LLC, to Brent J. Fields, Secretary, SEC, dated January 12, 2016; letter from Mark Fairbanks, Foreside Distributors, to Brent J. Fields, Secretary, SEC, dated January 13, 2016 (“Foreside”); letter from Howard Spindel and Cassondra E. Joseph, Integrated Management Solutions, to Brent J. Fields, Secretary, SEC, dated January 13, 2016 (“IMS Letter 1”); letter from Lisa Roth, Monahan & Roth, LLC, to Brent J. Fields, Secretary, SEC, dated January 13, 2016

establish a separate rule set for CABs.<sup>3</sup> Two commenters generally opposed the proposal on the ground that it fails to reduce the administrative burdens currently imposed on CABs, while at the same time requiring them to significantly limit their activities.<sup>4</sup> Three commenters did not express support or opposition, but had comments on specific provisions of the proposal.<sup>5</sup> Seven commenters wrote short emails or letters endorsing the comments of 3PM (which supported the proposal).<sup>6</sup> NASAA urged the SEC to delay acting on the proposal until the SEC, FINRA and state securities regulators could resolve issues regarding state and federal regulation of brokers engaged in mergers and acquisition activities.<sup>7</sup>

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(“Monahan”); letter from Michael S. Quinn, Q Advisors, LLC, to Brent J. Fields, Secretary, SEC, dated January 13, 2016 (“Q Advisors”); letter from Timothy Cahill, Compass Securities Corporation, to Brent J. Fields, Secretary, SEC, dated January 13, 2016; letter from Ron Oldenkamp, Genesis Marketing Group, to Brent J. Fields, Secretary, SEC, dated January 13, 2016; letter from Richard A. Murphy, North Bridge Capital, to Brent J. Fields, Secretary, SEC, dated January 13, 2016; letter from Dan Glusker, Perkins Fund Marketing, to Brent J. Fields, Secretary, SEC, dated January 13, 2016; letter from Steven Jafarzadeh, Stonehaven LLC, to Brent J. Fields, Secretary, SEC, dated January 13, 2016; letter from Sajan K. Thomas and Stephen J. Myott, Thomas Capital Group, to Brent J. Fields, Secretary, SEC, dated January 13, 2016; letter from Judith M. Shaw, North American Securities Administrators Association, Inc., to Brent J. Fields, Secretary, SEC, dated January 15, 2016 (“NASAA”); and letter from Peter W. LaVigne, Chair, Securities Regulation Committee, Business Law Section, New York Bar Association, to Brent J. Fields, Secretary, SEC, dated January 22, 2016 (“NY State Bar Committee”).

<sup>3</sup> See 3PM, Foreside, Monahan, and NY State Bar Committee.

<sup>4</sup> See Achates and IMS Letter 1.

<sup>5</sup> See Coronado, Intellinvest, and Q Advisors.

<sup>6</sup> See Compass Securities Corporation, Genesis Marketing Group, North Bridge Capital LLC, Perkins Fund Marketing LLC, Stonehaven LLC, Thomas Capital Group, and XT Capital Partners, LLC.

<sup>7</sup> See NASAA.

On March 17, 2016, the Commission issued an order instituting proceedings to determine whether to approve or disapprove the proposed rule change.<sup>8</sup> The Commission received one comment letter which generally opposed the proposal.<sup>9</sup>

On April 11, 2016, the Commission published a Notice of Filing of Partial Amendment No. 1 to the proposal to clarify that the definition of “capital acquisition broker” does not include any broker or dealer that effects securities transactions that would require the broker or dealer to report the transaction under the FINRA Rules 6300 Series, 6400 Series, 6500 Series, 6600 Series, 6700 Series, 7300 Series or 7400 Series.<sup>10</sup> The Commission received one comment letter that simply said “Good.”<sup>11</sup>

On July 1, 2016, the Commission published a Notice of Filing of Partial Amendment No. 2 to the proposal to amend proposed CAB Rule 016(c)(1)(F) regarding a CAB’s authority to engage in qualifying, identifying, soliciting, or acting as a placement agent or finder in connection with unregistered securities transactions.<sup>12</sup> The Commission received one comment letter that opposed Partial Amendment No. 2.<sup>13</sup>

The following are FINRA’s responses, by topic, to the commenters’ material concerns.

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<sup>8</sup> See Securities Exchange Act Release No. 77391 (March 17, 2016), 81 FR 15588 (March 23, 2016) (Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change to Adopt FINRA Capital Acquisition Broker Rules).

<sup>9</sup> See letter from Howard Spindel and Cassondra E. Joseph, Integrated Solutions, to Brent J. Fields, Secretary, SEC, dated April 8, 2016 (“IMS Letter 2”).

<sup>10</sup> See Securities Exchange Act Release No. 77581 (April 11, 2016), 81 FR 22333 (April 15, 2016) (Notice of Filing of Partial Amendment No. 1 to Proposed Rule Change to Adopt FINRA Capital Acquisition Broker Rules).

<sup>11</sup> See letter from Anonymous dated May 3, 2016.

<sup>12</sup> See Securities Exchange Act Release No. 78220 (July 1, 2016), 81 FR 44372 (July 7, 2016) (Notice of Filing of Partial Amendment No. 2 to Proposed Rule Change to Adopt FINRA Capital Acquisition Broker Rules).

<sup>13</sup> See letter from Kent J. Lund, SDR Capital Markets, Inc., to Secretary, SEC, dated July 15, 2016 (“SDR”).

### **Application of the By-Laws and the Capital Acquisition Broker Rules**

Proposed CAB Rule 014 would provide that all persons that have been approved for membership in FINRA as a capital acquisition broker and persons associated with capital acquisition brokers shall be subject to the FINRA By-Laws (including the schedules thereto) “unless the context requires otherwise” and the CAB Rules. Proposed CAB Rule 014 further states that the terms used in the CAB Rules, if defined in the FINRA By-Laws, shall have the same meaning as defined in the FINRA By-Laws, unless a term is defined differently in a CAB Rule, “or unless the context of a term within a Capital Acquisition Broker Rule requires a different meaning.”

IMS objected to both provisions qualifying the application of the By-Laws if the context requires a different meaning. IMS stated that there is no guidance as to what “context” may “require otherwise” and when and under what circumstances. IMS argued that this language “sets up an interpretive nightmare” and makes it “impossible to advise a client as to what the actual definition is and, more significantly, whether it applies in a particular context.”<sup>14</sup>

FINRA disagrees with these criticisms. As a general matter, the FINRA By-Laws’ provisions would apply as written, without the need to interpret them differently as applied to CABs. There may be on occasion situations in which reading a By-Law provision literally would lead to a clearly incorrect result due to the differences between the CAB Rules and FINRA Rules governing non-CAB firms. FINRA does not believe that this qualification for context creates an “interpretive nightmare,” nor would it be impossible to advise clients on how to comply with the FINRA By-Laws. The Commission approved similar qualifying language regarding application of the FINRA By-Laws in the recently adopted Funding Portal Rules.<sup>15</sup> Additionally, FINRA is open to further discussion of any specific interpretive issues should the context arise.

### **Definition of “Capital Acquisition Broker”**

As initially filed with the Commission, the term “capital acquisition broker” would have meant 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;

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<sup>14</sup> See IMS Letter 2.

<sup>15</sup> See FINRA Funding Portal Rule 100(a).

- 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 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.<sup>16</sup>

A firm would be permitted to register as, or change its status to, a CAB *only* if the firm solely engages in one or more of these activities.

The term “capital acquisition broker” would 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; or

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<sup>16</sup> See proposed CAB Rule 016(c)(1). The last two permitted activities would be codified as CAB Rule 016(c)(1)(F) and (G).

- 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.<sup>17</sup>

IMS commented that FINRA should allow CABs to chaperone foreign associated persons under Securities Exchange Act (“Exchange Act”) Rule 15a-6, since other broker-dealers that are subject to a \$5000 net capital requirement are permitted to engage in this activity. IMS also commented that the definition is problematic because it allows CABs to provide services only to institutional investors as defined by the proposal, which is too restrictive.<sup>18</sup>

The NY State Bar Committee requested confirmation that CABs may execute secondary market transactions of unregistered securities. Q Advisors noted that the definition appears to permit CABs to act as agent in the purchase or sale of debt, equity and equity-linked instruments, and not solely one category of securities. 3PM supported the definition in its current form.

FINRA does not agree that CABs should be permitted to engage in chaperoning activities under Exchange Act Rule 15a-6. The CAB rule set as currently proposed did not contemplate that CABs would engage in these activities, and FINRA does not believe that most firms that would consider registering as a CAB currently engage in them. Accordingly, FINRA declines to make this change.

FINRA disagrees with the assertion that CABs may only provide services to institutional investors as defined by the proposal. For example, CABs may provide a wide array of negotiation, consulting and advisory services to issuers, companies and their owners without regard to whether these parties fall within the definition of institutional investor.<sup>19</sup>

In addition, CABs may effect securities transactions with persons other than institutional investors 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 activity 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

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<sup>17</sup> See proposed CAB Rule 016(c)(2).

<sup>18</sup> See IMS Letter 1.

<sup>19</sup> See proposed CAB Rule 016(c)(1)(A)-(E).

person to engage in such activities without registering as a broker or dealer under Section 15(b) of the Exchange Act.<sup>20</sup>

The only institutional investor limitation appears in CAB Rule 016(c)(1)(F), which, as proposed, permitted CABs to qualify, identify, solicit or act as placement agent or finder with respect to institutional investors in connection with purchases or sales of unregistered securities. Due to concerns that permitting CABs to act as agent in a wide array of secondary market transactions would be inconsistent with the purpose of the proposed rule set, however, FINRA amended proposed CAB Rule 016(c)(1)(F) to narrow the range of permitted secondary market activities.<sup>21</sup> As amended, a CAB would be permitted to engage in 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. “Control” and “privately-held company” would have the same meanings as those terms had in the SEC staff’s 2014 M&A Brokers no-action letter.<sup>22</sup>

A CAB may offer other types of services and engage in other types of transactions permitted by other provisions of Rule 016(c)(1) on behalf of investors that do not meet the definition of “institutional investor.” However, the definition does not allow CABs to act as introducing broker, accept orders from customers to purchase or sell securities as principal or agent except as permitted in CAB Rules 016(c)(F) or (G), to engage in proprietary trading of securities or market-making activities, or 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.

In addition, the proposed CAB rules do not incorporate the trade reporting rules that apply to some secondary market transactions involving unregistered securities.<sup>23</sup> Since those rules do not apply to CABs, FINRA clarified the definition to specify that a CAB may not act as agent in a securities transaction that would

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<sup>20</sup> See proposed CAB Rule 016(c)(1)(G).

<sup>21</sup> See Securities Exchange Act Release No. 78220 (July 1, 2016), 81 FR 44372 (July 7, 2016) (Notice of Filing of Partial Amendment No. 2 to Proposed Rule Change to Adopt FINRA Capital Acquisition Broker Rules).

<sup>22</sup> See M&A Brokers, 2014 SEC No-Act LEXIS 92 (January 31, 2014).

<sup>23</sup> See FINRA Rule 6300 Series, 6400 Series, 6500 Series, 6600 Series, 6700 Series, 7300 Series, and 7400 Series.

trigger the FINRA trade reporting rules.<sup>24</sup> For example, if a broker-dealer buys at a discount a large block of previously restricted securities in a company from a company insider in compliance with SEC Rule 144, and then sells the block in pieces into the marketplace at market price, and if all applicable conditions of SEC Rule 144 are satisfied, the sale from the insider to the broker-dealer should be reported under the trade reporting rules.<sup>25</sup> FINRA does not believe that most firms that would seek to become a CAB engage in these kinds of secondary market activities. Consequently the rule set does not include trade reporting rules that would apply to them.

In response to Partial Amendment No. 2 (which narrowed the range of CABs' permitted secondary market activities), SDR commented that CAB Rule 016(c)(1)(F) should be written expressly to permit CABs to engage in secondary market transactions. In particular, SDR recommended that CABs be permitted to sell subsequent to a private placement any securities that the CAB receives as compensation for acting as a placement agent in a private placement securities transaction. SDR also recommended that CABs be permitted to act as an agent to assist the owner of securities purchased in a private placement to sell them subsequent to such private placement.

SDR noted that it is not uncommon for placement agents to receive compensation in the form of restricted stock, options or warrants, and for the owner of securities purchased in a private placement to desire sometime later to sell those securities in a private secondary market transaction. SDR argued that, without these recommended changes, it is likely many firms will decline to elect CAB status due to fears of engaging in impermissible activities.

FINRA disagrees that proposed CAB Rule 016(c)(1)(F) should be amended as recommended. Other provisions of the proposal that preceded the filing of Partial Amendment No. 2 would prohibit some of the activities that SDR recommends. For example, the proposed definition of a CAB would prohibit a CAB from engaging in proprietary trading. Allowing a CAB to dispose of securities that it receives as compensation for placement agent services might in some cases be inconsistent with this prohibition, and could be interpreted as allowing trading activities that do not fall within a CAB's business model.

The proposed definition of a CAB also would prohibit a CAB from holding or handling customer funds or securities. To the extent that a CAB would handle a

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<sup>24</sup> See Securities Exchange Act Release No. 77581 (April 11, 2016), 81 FR 22333 (April 15, 2016) (Notice of Filing of Partial Amendment No. 1 to Proposed Rule Change to Adopt FINRA Capital Acquisition Broker Rules).

<sup>25</sup> See Trade Reporting Frequently Asked Questions, Question 106.1, available at <http://www.finra.org/industry/trade-reporting-faq#106>.



customer's stock certificate as part of its services, a CAB could not act as agent on behalf of an owner who is disposing privately placed securities. Amendment of these various provisions to accommodate these activities at this time would not be prudent, particularly given the risk that these amendments would inadvertently allow some firms that do not fall within the intended business model to elect CAB status. Of course, FINRA will consider proposed changes to the CAB Rules after FINRA and the industry have gained experience with their application to CABs.

### **Definition of "Institutional Investor"**

The term "institutional investor" would include any:

- bank, savings and loan association, insurance company or registered investment company;
- governmental entity or subdivision thereof;
- 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;
- 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;
- other person (whether a natural person, corporation, partnership, trust, family office or otherwise) with total assets of at least \$50 million;
- 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"); and
- person acting solely on behalf of any such institutional investor.<sup>26</sup>

Achates and IMS objected to this proposed definition because it does not include accredited investors as defined under Securities Act Regulation D.<sup>27</sup> Noting

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<sup>26</sup> See proposed CAB Rule 016(i). This term is similar to the definition of "institutional investor" under FINRA Rule 2210, except that the Rule 2210 definition does not include "qualified purchaser."

<sup>27</sup> See Achates and IMS Letter 1.

that FINRA had stated it purposely did not propose to define “institutional investor” to include accredited investors due to serious concerns with the manner in which firms market and sell private placements to accredited investors, Achates recommended that FINRA should address any potential sales practice problems by incorporating any other rules needed for this purpose, rather than prohibiting the solicitation of accredited investors.

Three commenters recommended that FINRA add to the definition of “institutional investor” knowledgeable employees, and permit CABs to effect sales of unregistered securities in de minimis transactions with persons not otherwise meeting the definition of “institutional investor.”<sup>28</sup> The NY State Bar Committee in particular suggested incorporating the definition of “knowledgeable employee” in Investment Company Act Rule 3c-5, except that for purposes of the institutional investor definition, “covered company” would mean either the CAB or the issuer of the securities sold in the transaction. The NY State Bar Committee also recommended including any person designated by the issuer of the securities in the transaction, provided that the CAB did not solicit the person or make a recommendation to the person with respect to the purchase of the securities. Intellivest also recommended that the asset threshold for institutional investors be lowered to \$5 million or even less.

As discussed above, the term “institutional investor” is relevant only with respect to CAB Rule 016(c)(1)(F), which would permit CABs to qualify, identify, solicit or act as placement agent or finder with respect to institutional investors in connection with purchases or sales of unregistered securities. A CAB could offer other types of services and engage in other types of transactions permitted by other provisions of Rule 016(c)(1) on behalf of investors that do not meet the definition of “institutional investor.”

For example, CABs would be permitted to effect securities transactions on behalf of accredited investors that do not meet the definition of institutional investor in transactions involving the transfer of control of a business or company, as permitted by an SEC rule, release or no-action letter pursuant to CAB Rule 016(c)(1)(G). CABs also would be permitted to provide various negotiation, advisory and consulting services to persons who are not institutional investors pursuant to CAB Rule 016(c)(1)(A) through (E). In addition, by adding qualified purchasers to the definition of “institutional investor,” FINRA has proposed to permit CABs to solicit investors that have at least \$5 million in investments pursuant to CAB Rule 016(c)(1)(F).<sup>29</sup>

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<sup>28</sup> See Coronado, Intellivest and NY State Bar Committee.

<sup>29</sup> See Section 2(a)(51) of the Investment Company Act.

However, FINRA does not believe it is either necessary or appropriate to extend the definition to include accredited investors who have less than \$5 million in investments, since those investors may not have the requisite investment acumen or financial means to understand or assume the risks associated with investments sold by CABs. Investors in the private placement market have been harmed by widespread fraud and abuse in recent years, and FINRA believes that the CAB rule set would not be an appropriate model for the broader, more retail, private placement marketplace.

For example, the SEC has settled cases involving fraud or abuse in the private placement market.<sup>30</sup> FINRA also has many formal investigations involving broker-dealer conduct in private placements. In 2015, FINRA conducted over 650 reviews involving private placements from sources including customer complaints, tips, referrals, and firm filings. Approximately 100 of these matters are currently open and under review.<sup>31</sup> In addition, FINRA has recently settled many cases regarding private placements.<sup>32</sup>

In July 2009, the SEC brought actions involving two high-profile private placements, Medical Capital Holdings Inc. and Provident Royalties LLC.<sup>33</sup> Thousands of investors lost millions of dollars, including, for some, their life

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<sup>30</sup> See, e.g., In the Matter of Natural Blue Resources, Inc., et al., SEC Initial Decision Release No. 863, 2015 SEC LEXIS 3395 (August 18, 2015); In the Matter of Donald J. Anthony, et al., SEC Initial Decisions Release No. 745, 2015 SEC LEXIS 707 (February 25, 2015).

<sup>31</sup> For example, in 2015, FINRA initiated formal disciplinary proceedings through the filing of a complaint in a number of investigations that involved problematic private placements. See, e.g., ARI Financial Services, Inc., FINRA Case No. 2010023883601 (2015); Halcyon Cabot Partners, Ltd., FINRA Case No. 2012033877802 (2015).

<sup>32</sup> See e.g., Fuad Ahmed and Success Trade Securities, Inc., FINRA Case No. 2012034211301 (2015); John Carris Investments, LLC, FINRA Case No. 2011028647101 (2015); In the Matter of the Application of Mitchell H. Fillet, Securities Exchange Act Release No. 75054 (May 27, 2015), 2015 SEC LEXIS 2142.

<sup>33</sup> SEC v. Provident Royalties, LLC., SEC Litigation Release No. 21118, 2009 SEC LEXIS 2241 (July 7, 2009); SEC v. Medical Capital Holdings, Inc., SEC Litigation Release No. 21141, 2009 SEC LEXIS 2390 (July 20, 2009).

savings.<sup>34</sup> FINRA also brought multiple cases against firms that participated in these offerings and their relevant employees.<sup>35</sup> State securities regulators also are bringing many enforcement cases involving private placements. The North American Securities Administrators Association (“NASAA”) reported that in 2014, Regulation D, Rule 506 offerings were the second most frequently investigated matters as reported by states.<sup>36</sup>

In addition to concerns about potential fraud that may occur if the definition of “institutional investor” were expanded to include accredited investors, FINRA notes that the SEC is also looking at whether the definition of accredited investor should be revised.<sup>37</sup> Moreover, expanding the definition of “institutional investor” to include accredited investors would be substantially inconsistent with similar definitions of “institutional investor” or “institutional account” in other FINRA Rules.<sup>38</sup>

For these reasons, FINRA also does not believe it is appropriate at this time to revise the definition of institutional investor to include knowledgeable employees as that term is defined in Investment Company Act Rule 3c-5 as suggested by the NY State Bar Committee. FINRA may consider revising this definition at a later date, depending on the need to expand it, as well as CABs’ investment activities.

FINRA believes that any firm that wishes to engage in private placement activities beyond that contemplated for CABs should be registered as a non-CAB broker-dealer and be subject to all FINRA rules, not just the more limited rule set applicable to CABs. For example, FINRA believes that non-CAB rules that are more oriented to business conducted with retail investors, such as FINRA Rule 2210

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<sup>34</sup> See Alexis Leondis, *The Hidden Hazards of Private Placements, Investment Vehicles Intended for Sophisticated Wealthy Investors are Being Sold to Retirees Who Often Don’t Understand the Risk*, Bloomberg Businessweek, (December 9, 2010).

<sup>35</sup> See, e.g., *Provident Asset Management, LLC*, FINRA AWC No. 2009017497201 (2010); *Mark Mercier*, FINRA AWC No. 2009019070901 (2011); and *Securities America, Inc.*, FINRA AWC No. 2010022518101 (2011).

<sup>36</sup> See NASAA 2015 Enforcement Report on 2014 Data, prepared by the NASAA Enforcement Section (September 2015).

<sup>37</sup> See U.S. Securities and Exchange Commission, *Report on the Review of the Definition of “Accredited Investor”* (December 18, 2015), available at [www.sec.gov](http://www.sec.gov).

<sup>38</sup> See, e.g., FINRA Rules 2210(a)(4) and 4512(c).

(Communications with the Public) should apply to these types of private placement firms, rather than the CAB rules.

### **Application Process**

CAB Rules 101 through 115 generally would apply the same standards for new member applications (NMAs) by proposed CABs as those that apply to non-CAB FINRA member firm applicants. CAB Rule 116 would apply the same standards regarding changes in ownership, control or business operations to CABs as those that apply to non-CAB firms,<sup>39</sup> subject to three exceptions.

First, CAB Rule 116 would permit an existing FINRA member that seeks to change its status to a CAB and is already engaged in the activities of a CAB, but which does not intend to change its existing ownership, control or business operations, to file a request to amend its membership agreement or obtain a membership agreement to reflect its new status, rather than having to file a change in membership application (CMA) or NMA.<sup>40</sup>

Second, if during the first year following an existing FINRA member's amendment to its membership agreement to become a CAB, the CAB sought to terminate its status as such and continue as a FINRA member, the CAB would be allowed to notify FINRA of this change without having to file a CMA. Instead, the CAB would have to file a request to amend its membership agreement to provide that the member agrees to comply with all FINRA Rules, and execute an amended membership agreement that imposes the same limitations on the member's activities that existed prior to the member's change of status to a CAB.<sup>41</sup>

Third, if a CAB sought to terminate its status as such and continue as a FINRA member more than one year after it converted to a CAB from a non-CAB member, the CAB would have to file a CMA pursuant to NASD Rule 1017, and amend its membership agreement to provide that the member agrees to comply with all FINRA Rules.<sup>42</sup>

IMS commented that the one-year grace period to revert back to non-CAB status was not a sufficient amount of time for a firm to determine if CAB status is appropriate for its business model. IMS recommended that this time period be

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<sup>39</sup> See NASD Rule 1017 (Application for Approval of Change in Ownership, Control or Business Operations).

<sup>40</sup> See proposed CAB Rule 116(b).

<sup>41</sup> See proposed CAB Rule 116(d).

<sup>42</sup> See proposed CAB Rule 116(c).

extended to 24 months, or better yet, there should be no grace period. IMS also commented that if a CAB decides to terminate its status as such, FINRA should allow the firm to continue to operate as a CAB while its CMA or request to amend its membership agreement is pending.<sup>43</sup>

The NY State Bar Committee recommended that FINRA establish a program to approve new CAB membership applications within 60 days of filing of an application, provided that certain conditions are met, including a completed application, the required supervisory personnel have taken and passed the applicable examinations, and there are no significant disciplinary history or other red flags of potential compliance problems.

The NY State Bar Committee also recommended that FINRA should allow a new CAB applicant that is operating as an unregistered broker in reliance on the SEC staff's M&A Brokers no-action letter to continue to engage in the activities allowed by that letter during the application process. Once the applicant becomes a member, it would be required to operate in compliance with CAB rules and SEC rules applicable to registered firms.

FINRA does not agree that it should lengthen the grace period during which a CAB may revert back to its prior non-CAB status beyond 12 months. FINRA believes that 12 months would give CABs sufficient time to make the determination of whether this status works for a firm's business model. Moreover, a CAB may still change its status to a full FINRA member firm after 12 months by filing a CMA.

FINRA agrees that a CAB that determines to terminate its status as such and revert back to a non-CAB firm should be permitted to continue to operate as a CAB while its CMA or application to amend its membership agreement is pending, barring unusual circumstances.

FINRA does not agree that it should revise its proposed rules to require it to act on a proposed CAB's NMA within 60 days of filing an application that meets certain conditions. FINRA believes that its Membership Application Program staff often will need more than 60 days to conduct a proper investigation of an applicant and complete other tasks associated with broker-dealer applications, such as a membership interview.

FINRA does agree, however, that if an applicant is appropriately relying on the SEC staff's M&A Brokers no-action letter in conducting its business as an unregistered broker, FINRA would not require the applicant to cease conducting activities permitted by the letter while its NMA is pending. FINRA also agrees that, once an applicant becomes a CAB member, the member would be required to follow all CAB Rules and all applicable SEC rules.

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<sup>43</sup> See IMS Letter 1.

## **Registration Requirements and Categories of Registration**

Proposed CAB Rules 121 through 125 would subject all CABs to NASD Rules 1021 (Registration Requirements – Principals), 1022 (Categories of Principal Registration), 1031 (Registration Requirements – Representatives), 1032 (Categories of Representative Registration), 1060 (Persons Exempt from Registration), 1070 (Qualification Examinations and Waiver of Requirements), 1080 (Confidentiality of Examinations), IM-1000-2 (Status of Persons Serving in the Armed Forces of the United States), IM-1000-3 (Failure to Register Personnel) and FINRA Rules 1230(b)(6) (Operations Professional) and 1250 (Continuing Education Requirements).

3PM commented that it is not clear that a CAB's associated persons could maintain all registrations and licenses that they held once they began working for the CAB. Monahan recommended that FINRA exempt CAB chief compliance officers from the proposed requirement to obtain and maintain a Series 14 Chief Compliance Officer registration because of the broad and comprehensive scope of that registration.<sup>44</sup> Similarly, 3PM argued that CABs should not be subject to FINRA Rule 1230(b)(6) because of the scope and nature of the Operations Professional examination.

As FINRA stated in its proposed rule filing, associated persons would only be permitted to retain registrations that are appropriate to their functions under the registration rules. This standard applies to non-CAB member firms as well as it would to CABs. The proposal to establish a new stand-alone registration category for compliance officers is still under review and subject to filing with the SEC, followed by publication in the Federal Register for comment and SEC approval or disapproval. Given that this proposed rule change has not yet been filed with the SEC, FINRA believes that it is premature to exempt CABs from this proposal.

FINRA does not agree that CABs should be exempt from FINRA Rule 1230(b)(6). FINRA believes that many of the functions for which an Operations Professional is responsible apply to all types of broker-dealers, including CABs. For example, firm account management and reconciliation, maintaining a general ledger and treasury, and preparing and filing regulatory reports apply to CABs as well as other broker-dealers. Accordingly, FINRA declines to eliminate this requirement for CABs.

## **Standards of Commercial Honor and Principles of Trade**

Proposed CAB Rule 201 would subject CABs to FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), which requires members to observe high standards of commercial honor and equitable principles of trade. In its proposed rule filing, FINRA stated that, depending on the facts, Rule 201 may

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<sup>44</sup> See Regulatory Notice 09-70 (December 2009).

apply in situations in which a CAB charged a commission or fee that clearly is unreasonable under the circumstances.<sup>45</sup>

IMS commented that this policy may create interpretive issues in situations in which a CAB is deemed to impose an unreasonable fee, particularly in cases in which FINRA Rule 2121 (Fair Prices and Commissions) would apply had the firm not been a CAB. IMS expressed concern that FINRA would create a new standard for unreasonable prices or commissions that would differ from the standards that exist today for brokers and dealers under Rule 2121.<sup>46</sup>

FINRA does not agree that the proposed rule set would create interpretive issues in relation to FINRA Rule 2121. Many of the specific provisions of Rule 2121 apply to markups and markdowns by firms acting as principal. Because CABs would not be permitted to act as principal in customer transactions, these provisions would be inapplicable. Moreover, CABs would be permitted to act as agent only in very narrow circumstances<sup>47</sup> that would involve either institutional parties that negotiate the terms of the permitted securities transactions without the need for the conditions set forth in Rule 2121, or involve the sale of a business as a going concern, which differs in nature from the types of transactions that typically raise issues under Rule 2121.

FINRA also does not agree that the CAB rule set will create interpretive issues where a CAB charges unreasonable commissions. FINRA will apply the principles of CAB Rule 201 in the same manner as it currently interprets FINRA Rule 210. Should interpretive issues arise with regard to the application of CAB Rule 201 to CAB commissions or fees, FINRA is open to further discussion of any specific interpretive issues should the context arise, and would consider whether any further rulemaking in this area is necessary.

### **Know Your Customer and Suitability**

Proposed CAB Rules 209 and 211 would subject CABs to provisions that are substantially similar to those contained in FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability). Proposed CAB Rule 209 states in part that a CAB must use reasonable diligence to know and retain the essential facts concerning a customer. Facts essential to knowing the customer include those required to effectively service the customer's account and understand the authority of each person acting on behalf of the customer. Proposed CAB Rule 211 specifies that a CAB or associated person fulfills the customer-specific suitability obligation for an institutional investor, if (1)

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<sup>45</sup> See 80 FR at 79972.

<sup>46</sup> See IMS Letter 1 and IMS Letter 2.

<sup>47</sup> See proposed CAB Rule 016(c)(1)(F) and (G).



the broker or associated person has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional investor affirmatively indicates that it is exercising independent judgment in evaluating the broker's or associated person's recommendations. Where an institutional investor has delegated decision-making authority to an agent, these Rule 211 factors will be applied to the agent.

Monahan and 3PM requested that FINRA clarify what it meant when it said that a CAB may look to an institutional investor's agent for suitability, and whether this statement means that a CAB's responsibility under proposed Rule 209 is limited to learning the essential facts from the agent.

3PM also commented that FINRA needs to recognize that a CAB may not have access to some information about an investor, particularly where the investor is represented by an agent. As an example, 3PM posits that a CAB may have little information about an investor's overall investment portfolio. 3PM requested that FINRA clarify how Rules 209 and 211 would apply in these circumstances. 3PM stated that Rule 211 should emphasize the point that the process of diligence is ongoing, and encourage registered representatives to periodically review their suitability analysis throughout the offering process. In particular, 3PM recommended that the proposed rules address some type of minimum compliance standards that would be appropriate to these situations, and that a demonstrable best efforts basis may be a satisfactory alternative in such instances.

FINRA recognizes that firms that elected CAB status often would be dealing with customers that are represented by agents. Both CAB Rules 209 and 211 contemplate situations in which a customer is represented by an agent.

For instance, the type of information necessary to satisfy the requirements of Rule 209 will depend on the facts and circumstances. FINRA has explained that the Rule 2090 "know your customer" obligation [is] flexible and that the extent of the obligation generally should depend on a particular firm's business model, its customers, and applicable regulations."<sup>48</sup> This same flexibility applies to CAB Rule 209, which is modeled on FINRA Rule 2090.

Furthermore, although a CAB must understand, *inter alia*, the essential facts about a *customer* that are necessary to effectively service the *customer's* account and the *authority of each person acting on behalf of the customer*, the rule does not prescribe the exact information that should be assessed or the process by which it should be obtained. Depending on the facts and circumstances, a CAB could comply

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<sup>48</sup> Securities Exchange Act Release No. 62718 (Aug. 13, 2010), 75 FR 52562 (Aug. 26, 2010) (Notice of Filing of File No. SR-FINRA-2010-039).

with Rule 209 by reasonably relying on the assistance of a customer's agent in obtaining the essential facts about the customer.

FINRA Rule 2111 applies the suitability rule on a recommendation-by-recommendation basis. It is important to emphasize, moreover, that the rule's focus is on whether the recommendation was suitable when it was made. A recommendation to hold securities, maintain an investment strategy involving securities or use another investment strategy involving securities—as with a recommendation to purchase, sell or exchange securities—normally would not create an ongoing duty to monitor and make subsequent recommendations.<sup>49</sup> Likewise, CAB Rule 211 would not create an ongoing duty to monitor and make subsequent recommendations.

As noted above, moreover, Rule 211 states in part that, where an institutional investor has delegated decision-making authority to an agent, such as an investment adviser or a bank trust department, the factors in determining whether a CAB has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently and indicates that it is exercising independent judgment apply to the agent rather than to the investor.

In light of the foregoing, FINRA does not believe it would be appropriate to suggest minimum compliance standards in situations in which a CAB may have limited information about a customer. Determining the “essential facts” needed to effectively service a customer's account and the information necessary to form a reasonable basis to believe that a recommendation is suitable for a non-institutional customer or that an institutional customer (or its agent) is capable of evaluating investment risks independently will always vary depending on the facts and circumstances.

### **Engaging in Impermissible Activities**

Proposed CAB Rule 240 would provide that, upon a finding that a CAB or associated person of a CAB has engaged in activities that require the firm to register as a broker or dealer under the Exchange Act, and that are inconsistent with the limitations imposed on CABs under CAB Rule 016(c), FINRA may examine for and enforce all FINRA rules against such a broker or associated person, including any rule that applies to a broker-dealer that is not a CAB or to an associated persons who is not a person associated with a CAB.

3PM commented that FINRA should incorporate a grace period into this rule, especially in regards to unintended activities. 3PM also recommended that FINRA publish frequently asked questions to educate CABs during the grace period which would outline the most common misunderstanding FINRA and the SEC may be seeing. IMS argued that this rule is unnecessary due to FINRA's “power and

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<sup>49</sup> See Regulatory Notice 12-25 (May 2012), Question 7.

authority to enforce its conduct rules,” finding that this rule “confirm[s] the obvious.”<sup>50</sup>

FINRA does not believe it is necessary to include within the rule a grace period during which CABs would not be subjected to all FINRA rules if a CAB engaged in impermissible activities. FINRA believes that unintentional violations during a transition period are best handled through the examination and enforcement process on a case-by-case basis. Accordingly, FINRA is not proposing to amend this rule. FINRA agrees that it would be useful to provide additional guidance to CABs concerning the scope of permissible activities, and may do so through FAQs or other means.

FINRA also disagrees that proposed CAB Rule 240 is unnecessary and “confirms the obvious.” The purpose of this rule is to clarify that the full FINRA Rulebook would apply if a CAB engaged in brokerage activities that are inconsistent with the limitations imposed on CABs. FINRA believes that, without proposed CAB Rule 240, it might be unclear which rules would apply to a firm that elected CAB status and yet engaged in brokerage activities that are impermissible for a CAB.

### **Capital Acquisition Broker Compliance and Supervision**

Proposed CAB Rule 311 would apply some, but not all of the requirements of FINRA Rule 3110 (Supervision). Rule 311 also would require a CAB to permit the examination and inspection of its premises, systems, platforms, and records by representatives of FINRA and the SEC, and to cooperate with the examination, inspection or investigation of any persons directly or indirectly using its platform.

Foreside commented that the supervision rules should permit a CAB to tailor its review of emails according to the CAB’s business and that such expectations should not be as stringent as those for non-CAB broker-dealers.

IMS noted that the elimination of the annual compliance meeting requirement, which applies to non-CAB broker-dealers, offers little incentive to convert to a CAB, since the requirement is not very burdensome in the first place.<sup>51</sup> 3PM supported the elimination of the annual compliance meeting requirement.

Proposed CAB Rule 311 incorporates by reference FINRA Rule 3110(b)(4), which requires members to adopt procedures for the review of incoming and outgoing written (including electronic) correspondence and internal communications relating to a member’s investment banking business. The supervisory procedures must be

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<sup>50</sup> See IMS Letter 2.

<sup>51</sup> See IMS Letter 1.

appropriate for the member's business, size, structure and customers.<sup>52</sup> FINRA believes that these standards offer the kind of flexibility that Foreside seeks in its comments, since they recognize that the procedures may be tailored based on a firm's business, size, structure and customers.

FINRA believes that the elimination of the requirement to host an annual compliance meeting is appropriate given the nature of CABs' business model and structure. FINRA has observed that most current FINRA member firms that would qualify as CABs tend to be small and often operate out of a single office. In addition, the range of rules that CABs would be subject to is narrower than the rules that apply to other broker-dealers. Moreover, CABs would be subject to both the Regulatory and Firm Element continuing education requirements.

Accordingly, FINRA does not believe that CABs need to conduct an annual compliance meeting as required under FINRA Rule 3110(a)(7). The fact that the annual compliance meeting requirement would not apply to CABs or their associated persons in no way would reduce their responsibility to have knowledge of and comply with applicable securities laws and regulations and the CAB rule set.

### **Operational Rules**

Foreside recommended that the final rules include a requirement to have appropriate cybersecurity and information security programs in place that are tailored to a CAB's business. FINRA currently reviews a firm's ability to protect the confidentiality, integrity and availability of sensitive customer information. This includes reviewing each firm's compliance with applicable SEC regulations.<sup>53</sup> Likewise, FINRA would examine CABs' operations to determine compliance with all applicable SEC rules.

IMS noted that, unlike non-CAB broker-dealers, CABs would not be required to have business continuity programs (BCPs). IMS commented that BCPs should be unnecessary for many other broker-dealers. Given that this proposal does not address

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<sup>52</sup> The supervisory procedures must require the member's review of (A) correspondence to identify and handle in accordance with firm procedures, customer complaints, instructions, funds and securities, and communications that require review under FINRA rules and federal securities laws; and (B) internal communications to properly identify those communications that are of a subject matter that require review under FINRA rules and federal securities laws. It also requires review of correspondence and internal communications to be conducted by a registered principal and evidenced in writing. See FINRA Rule 3110(b)(4).

<sup>53</sup> See, e.g., SEC Regulation S-P (17 CFR § 248.30) and Regulation S-ID (17 CFR §§ 248.201-202); see also Exchange Act Rule 17a-4(f).

rules applicable to other broker-dealers, IMS's comment is outside the scope of the proposed rule change.<sup>54</sup>

### **Private Securities Transactions**

Proposed CAB Rule 328 prohibits any person associated with a CAB from participation in any manner in a private securities transaction as defined in FINRA Rule 3280(e). FINRA Rule 3280 (Private Securities Transactions of an Associated Person) prohibits any person associated with a FINRA member firm from participating in a private securities transaction except in accordance with the rule's requirements. The rule requires an associated person to provide written notice to the member with which he or she is associated prior to participating in any private securities transaction, including details regarding the proposed transaction, the associated person's role and whether the associated person has received or may receive selling compensation in connection with the transaction.<sup>55</sup>

If the associated person has received or may receive selling compensation,<sup>56</sup> the member must advise the person in writing whether it approves or disapproves the associated person's participation in the transaction, and if it approves the associated person's participation in the transaction, the member must record the transaction in the member's books and records, and must supervise the person's participation in the transaction as if it were executed on behalf of the member.<sup>57</sup> If the associated person has not received and will not receive selling compensation, the member must provide

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<sup>54</sup> FINRA does not propose to apply to CABs, at this time, the BCP requirements of FINRA Rule 4370. FINRA is not requiring a CAB to maintain a BCP, given that, among other things, a CAB may not hold, manage, possess, or otherwise handle customer funds or securities. FINRA, however, recognizes that CABs are broker-dealers, and it will also monitor, as part of FINRA's examination and surveillance process, the development and operation of CABs' business to identify emergency or business disruptions at CABs that affect the ability of the members to meet their existing obligations to investors and issuers. These efforts will assist in assessing whether additional rulemaking in this area is required.

<sup>55</sup> See FINRA Rule 3280(b).

<sup>56</sup> "Selling compensation" is defined as "any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements." See FINRA Rule 3280(e)(2).

<sup>57</sup> See FINRA Rule 3280(c).

the associated person with prompt written acknowledgement of the notice and may require the person to adhere to specified conditions in connection with participation in the transaction.<sup>58</sup>

The rule 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....”<sup>59</sup>

In 1994, FINRA published a Notice to Members that clarified the applicability of the predecessor rule to Rule 3280 to the investment advisory activities of registered representatives.<sup>60</sup> The Notice focused on situations where an individual is registered both as a representative (“RR”) of a FINRA member firm and with the SEC as an investment adviser (“RIA”), and who conducts his or her advisory activities away from the member firm.

The Notice stated that Rule 3280 applies to any transaction in which the RR/RIA participated in the execution of the trade. An example of an RR/RIA clearly participating in the execution of trades is where the individual enters an order on behalf of the customer for particular securities transactions either with a brokerage firm other than the member they are registered with, directly with a mutual fund, or with any other entity, including another adviser, and receives any compensation for the overall advisory services. As a result, Rule 3280 would apply. The Notice further clarified that “selling compensation” includes not only commission-type compensation, but also asset-based management fees, wrap fees, hourly, yearly, or per-plan fees, as long as the fees paid include execution services provided by the

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<sup>58</sup> See FINRA Rule 3280(d).

<sup>59</sup> The definition excludes transactions subject to the notification requirements of NASD Rule 3050 (Transactions for or by Associated Persons), transactions among immediate family members, for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities. See FINRA Rule 3280(e)(1).

<sup>60</sup> See Notice to Members 94-44. The Notice discussed the applicability of Article III, Section 40 of the NASD Rules of Fair Practice. Section 40 was subsequently amended and designated as NASD Rule 3040 before being amended and moved to the FINRA Rulebook as FINRA Rule 3280. Many of the core requirements remained substantially similar, however.

RR/RIA. The Notice gave additional examples of situations in which Rule 3280 would or would not apply.<sup>61</sup>

The NY State Bar Committee recommended that FINRA revise proposed CAB Rule 328 to exclude: (1) the investment advisory activities of associated persons who are also employees or supervised persons of an RIA; and (2) employees of a bank or trust company engaged in securities activities permitted for banks under the Exchange Act and Regulation R. IMS objected to proposed CAB Rule 328 on the ground that a CAB should be permitted to set its own policies to supervise private securities transactions.<sup>62</sup>

FINRA does not agree that CAB Rule 328 should be revised to exclude transactions engaged in by associated persons in their capacities as RIA or bank employees, nor does it believe CABs should be allowed to supervise private securities transactions as a business decision. As discussed further in Notice to Members 96-33, compliance with Rule 3280 would require CABs to maintain many of the same recordkeeping and supervisory systems that firms engaged in retail securities activities maintain. In contrast, CABs would engage only in a limited range of institutional securities activities, generally involving either advice to companies and issuers regarding private equity or merger and acquisition transactions, or acting as agent in connection with purchases or sales of unregistered securities. Given the limited nature of CABs' permissible business activities, CABs generally would not be well-positioned to supervise and keep records of private securities transactions, particularly if a CAB employee conducted business with retail investors through an RIA or bank. Accordingly, FINRA believes that prohibitions in Rule 328 should remain as written.

### **Anti-Money Laundering Compliance Program**

Proposed CAB Rule 331 would require CABs to develop and implement a written anti-money laundering program reasonably designed to achieve and monitor its compliance with the requirements of the Bank Secrecy Act and the Department of Treasury's implementing regulations. Rule 331 imposed additional requirements, including that the program provide for independent testing for compliance no less frequently than every two years, to be conducted by CAB personnel or a qualified outside party.

IMS commented that, while the requirement to conduct independent testing of a firm's AML program no less frequently than every two years (rather than at least

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<sup>61</sup> In 1996, FINRA published a follow-up Notice that discussed a member's recordkeeping and supervisory responsibilities under Rule 3280. See Notice to Members 96-33 (May 1996).

<sup>62</sup> See IMS Letter 1.

annually as required of most other broker-dealers) is welcome, it is not very burdensome for most broker-dealers whose transactional activities are quite limited.<sup>63</sup> 3PM suggested that the SEC work with the appropriate authorities to revise CABs' AML responsibilities and require registered entities such as RIAs to share data with FINRA member firms so that all registered participants may satisfy their respective compliance obligations in the most complete and accurate manner possible.

As FINRA stated in its proposed rule filing, because the Bank Secrecy Act imposes AML obligations on all broker-dealers, FINRA does not believe it has the authority to exempt CABs from the requirements to adopt and implement an AML program. To the extent commenters are making suggestions directly to the SEC staff, FINRA would be willing to work with the staff if asked.

### **Capital Compliance and FOCUS Reports**

Proposed CAB Rule 411 would require a CAB to suspend all business operations during any period in which it is not in compliance with applicable net capital requirements as set forth in Exchange Act Rule 15c3-1, and would authorize FINRA to issue a notice pursuant to FINRA Rule 9557 directing a CAB that is not in compliance with applicable net capital requirements to suspend all or a portion of its business. Rule 411 also limits CABs' abilities to withdraw equity capital, and imposes conditions on the use of subordinated loans, notes collateralized by securities, and capital borrowings.

Proposed CAB Rule 452 would impose obligations on CABs regarding the responsibility for general ledger accounts, and subject them to FINRA Rule 4524, which authorizes FINRA to require members to file supplemental FOCUS reports as FINRA may deem necessary.

IMS commented that the proposal is deficient because the net capital requirements are the same for CABs and other FINRA registered firms. IMS disagreed that FINRA is unable to persuade the SEC to alter these requirements for CABs.<sup>64</sup> 3PM similarly argued that the SEC should modify CABs' net capital requirements, since they offer little if any investor protection.

Achates commented that FINRA should make an effort to have the SEC eliminate the quarterly Form Custody FOCUS report for CABs. 3PM argued that CABs should not be subject to FINRA Rule 4524, and that FINRA should revise the Supplemental Statement of Income (SSOI) requirements for CABs so that appropriate information from CAB firms is requested. 3PM also recommended that FINRA

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<sup>63</sup> See IMS Letter 1.

<sup>64</sup> See IMS Letter 1.



convene a working committee of CAB representatives to help write appropriate questions that accurately reflect a CAB's business model.

FINRA does not have the authority to alter a CAB's capital requirements, which are set by the SEC, nor can it alter the information required in CAB Focus reports. While FINRA is not prepared to amend the SSOI at this time to create a separate form for CABs, FINRA would be willing to work with CABs on interpretive issues regarding the SSOI to the extent they arise.

### **Audit Rule**

Proposed CAB Rule 414 would subject CABs to FINRA Rule 4140, which authorizes FINRA to direct a member to cause an audit to be made by an independent public accountant of its accounts, or cause an examination to be made in accordance with the attestation, review or consultation standards prescribed by the AICPA. It also allows FINRA to impose a late fee for members that fail to file an audited report or examination report.

Four commenters stated that the proposal is deficient because there is no relief from the annual audit requirement for registered broker-dealers.<sup>65</sup> These commenters argued that the audit requirement offers little consumer benefit and is excessive. Commenters urged the SEC and FINRA to work with the PCAOB to exempt CABs from the annual audit requirement.<sup>66</sup>

As previously stated, FINRA does not have the authority to exempt CABs from the requirements to obtain audited financial statements.

### **SIPC Dues**

Although the proposed rule set does not address dues payable to the SIPC, three commenters argued that FINRA should make more of an effort to request that the SIPC either exempt or change its dues schedule for CABs.<sup>67</sup> As FINRA stated in its proposed rule filing, FINRA does not have the authority to exempt any CAB or other broker-dealer from SIPC membership or dues payment requirements.

### **Other Comments**

IMS objected to creating a separate rulebook for CABs, on multiple grounds. First, IMS argued that creating a separate rulebook would be confusing and result in

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<sup>65</sup> See Exchange Act Rule 17a-5(d); see also Section 17(e) of the Exchange Act.

<sup>66</sup> See comments from Achates, IMS Letter 1, Monahan and 3PM.

<sup>67</sup> See comments from Achates, Q Advisors and 3PM.

difficult interpretive issues for compliance personnel. Second, IMS argued that the proposed rules, as written, defy the Commission's policy that rules be written in plain English. Third, IMS argued that the better solution would be simply to include the CAB definition in the FINRA Rule 5000 Series (Securities Offerings and Trading Standards and Practices) without adding a separate rulebook.<sup>68</sup>

FINRA disagrees with these arguments. FINRA believes that the current separate rulebook structure is understandable and not confusing. Some CAB Rules incorporate existing FINRA Rules. By incorporating existing rules, CABs will understand which rules that currently apply to FINRA member firms apply to them, and which do not. To the extent the CAB rule set adopts new rules, it was done for two reasons. First, some rules (such as the CAB or institutional investor definitions) do not have corresponding rules in the current FINRA rulebook. Second, FINRA purposely chose to reduce compliance burdens by adopting shorter and less detailed versions of existing FINRA rules, such as CAB Rule 221, which governs CABs' communications with the public, in light of the limited permissible activities of CABs.

FINRA also disagrees that simply adding the definition of CAB to the FINRA Rule 5000 Series would be a preferred approach. This suggestion would simply create a new defined term without tailoring the rules to better reflect the limited permissible activities of CABs.

IMS also asserted that FINRA will force existing FINRA members and new applicants that are subject to a \$5000 net capital requirement to become CABs in order to vindicate FINRA's "questionable" estimates of current firms that would fall within the CAB definition. It also asserted that having two separate rule sets – one for CABs and one for non-CAB firms – is needlessly complicated, will prove confusing and will result in difficult interpretive issues. IMS also asserted that a separate rule set will be a prelude for spinning off regulatory supervision of CABs into a separate self-regulatory organization comparable to the Municipal Securities Rulemaking Board (MSRB), adding yet another layer of regulatory oversight and compliance burdens for firms.<sup>69</sup>

FINRA disagrees with these comments. The proposed rule set will not require any new or existing member firm to operate as a CAB; only those firms that elect CAB status on a voluntary basis would be subject to the CAB rules. While the proposal would create two rule sets, most CAB rules incorporate or closely resemble existing FINRA rules. FINRA also disagrees that the proposal would cause CABs to be regulated by a separate SRO, since the rule set does not call for a separate SRO for CABs.

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<sup>68</sup> See IMS Letter 2.

<sup>69</sup> See IMS Letter 1.

Monahan and 3PM recommended that the SEC and FINRA communicate with the MSRB regarding the extent to which the MSRB would be willing to adopt a similar regulatory scheme for municipal advisors. While FINRA appreciates the suggestion, it feels that this request is premature given that the CAB proposal has yet to be approved by the SEC.

The NY State Bar Committee recommended that FINRA establish new examinations for registered representatives and supervisory personnel of CABs that will test only for subject matter relevant to a CAB's business model. Given that the SEC has not yet approved the proposed CAB rule set, FINRA believes that this suggestion is premature.

NASAA requested that the SEC delay acting on the proposal until there has been an opportunity to more fully explore issues regarding differences between the SEC's M&A Brokers no-action letter, the CAB proposal, NASAA's model rule that would exempt M&A brokers from state broker registration requirements, and Senate Bill 1010, which would exempt M&A brokers meeting specific conditions from federal broker registration.

FINRA disagrees that the SEC should delay acting on this proposal. The proposed definition of CAB 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.

While FINRA acknowledges that NASAA has adopted a model rule for M&A brokers, it does not believe that any differences between the NASAA model rule and the proposed CAB rules should preclude the SEC from approving the proposal. NASAA's model rule and Senate Bill 1010 would exempt M&A brokerage firms from registering under state and federal law; the CAB rules would permit firms meeting the CAB definition to operate under a more streamlined, and appropriately tailored, FINRA rule set. Moreover, the United States Senate has not taken any action on Senate Bill 1010 since it was introduced on April 20, 2015.<sup>70</sup>

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See <https://www.congress.gov/bill/114th-congress/senate-bill/1010>.

Mr. Brent J. Fields

August 16, 2016

Page 28

FINRA believes that the foregoing responds to the material issues raised by the commenters to the rule filing. If you have any questions, please contact me at (240) 386-4534, email: [joe.savage@finra.org](mailto:joe.savage@finra.org). The fax number of the Office of Regulatory Policy is (240) 386-4572.

Best regards,

/s/ Joseph P. Savage

Joseph P. Savage  
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Office of Regulatory Policy