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Capital Acquisition Brokers: Should You Play by the New Rules?

Just in time for back-to-school season, the SEC has approved FINRA's new rule book for "capital acquisition brokers" (CABs) – firms that are solely engaged in advising companies on mergers and acquisitions, advising issuers on raising debt and equity capital in private placements with institutional investors, or providing strategic and financial advisory services. If you've done your summer reading, you'll recognize that FINRA's Capital Acquisition Broker Rules (the CAB Rules), which were approved by the SEC on August 18, 2016, are an improvement over prior proposals and a positive step toward "right-sized" regulation for corporate financing firms that conduct limited activities. The new rule book is a lot lighter than the book containing the full FINRA rule set, but unfortunately it still contains some of the toughest chapters, e.g., the more onerous FINRA requirements. FINRA has not yet announced an effective date for the CAB Rules. Before electing to be governed by the CAB Rules, registered broker-dealers and firms contemplating registration should sharpen their pencils and take this short quiz.

Question 1: Are CABs permitted to effect sales of unregistered securities with investors who qualify as "accredited investors" as defined in Regulation D under the Securities Act of 1933 (the Securities Act), but do not meet the definition of "qualified purchaser" as that term is defined in Section 2(a)(51) of the Investment Company Act of 1940 (the Investment Company Act)?

Answer: No. CABs may act as a placement agent or finder on behalf of an issuer in connection with a sale of newly issued, unregistered securities to "institutional investors" or on behalf of an issuer or control person in connection with a change of control of a privately held company. The term "institutional investor" is defined in CAB Rule 016[1] to include "qualified purchasers"[2] but not "accredited investors."[3] In FINRA's view, accredited investors may not have the requisite investment acumen or financial means to understand or assume the risks associated with investments sold by CABs. This limitation will likely dissuade many placement agents engaged by startups and smaller issuers, and sponsors of Section 3(c)(1) funds[4], from becoming CABs.

Question 2: Which of the following activities are permissible for a CAB?

a. Handling customer funds or securities

b. Accepting orders to buy or sell securities either as principal or agent for the customer

c. Exercising investment discretion on behalf of any customer

d. Carrying or acting as an introducing broker with respect to customer accounts

e. Producing research for the investing public

f. Engaging in proprietary trading of securities or market-making activities

g. Participating in an online platform to offer securities pursuant to the SEC's Regulation Crowdfunding or Regulation A under the Securities Act

h. Acting as an agent in a securities transaction that would trigger the FINRA trade reporting rules

Answer: None of the above. A CAB is a 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 with respect to institutional investors in connection with purchasers or sales of unregistered securities; and
- effecting M&A transactions solely in connection with the transfer of ownership and control of a privately held company to a buyer that will actively operate the company, in accordance with the terms of the SEC's M&A Brokers no-action letter, or similar SEC rule, release or interpretation that permits a person to engage in such activities without having to register as a broker-dealer.[5]

Question 3: Are CABs permitted to participate in secondary market transactions? For example, can a CAB facilitate the resale of unregistered securities?

Answer. No. CABs may participate only in the sale of newly issued unregistered securities, with the exception of securities transactions in connection with a change of control of a privately held company. This limitation on a CAB's activities, along with the prohibition on engaging in proprietary trading, will make it difficult for CABs that receive compensation in the form of issuer options or warrants from selling those restricted securities.

Question 4: Does FINRA intend to establish new examinations specifically for the registered representatives and supervisory principals of CABs that would test only that subject matter relevant to the business of CABs?

Answer: No. The principals and representatives of a CAB are subject to the same registration, qualification examination and continuing education requirements as principals and representatives of other FINRA member firms. FINRA has stated that it is premature to establish new examinations at this point and may monitor the need in the future.

Question 5: Which of the following FINRA requirements will apply to CABs?

a. Annual compliance meetings

b. Specific documentation and supervisory procedures for supervisory personnel

c. Chief executive officer's annual certification as to the firm's compliance program

d. Business continuity plan

e. Annual testing for compliance with written anti-money laundering program

Answer: None of the above. CABs are required to develop and implement a written anti-money laundering program that provides for independent testing for compliance no less frequently than every two years (rather than at least annually as required of most other broker-dealers).

Question 6: The new membership approval process to register as a CAB is expected to take:

a. 30 days

b. 60 days

c. 180 days

d. 365 days

Answer: c. Firms applying to FINRA for membership as a CAB are required to follow the same procedures as any other FINRA applicant. Although CAB applicants may have an easier time drafting their policies and procedures, the CAB Rules do not establish a "fast track" process for CAB registration.

Question 7: Are associated persons of CABs permitted to engage in private securities transactions away from the firm or register with an affiliated or unaffiliated full-service broker-dealer?

Answer: No. FINRA's position is that CABs are not well-positioned to supervise and keep records of private securities transactions. The prohibition on engaging in private securities transactions encompasses the investment advisory activities of associated persons who are also employees or supervised persons of a registered investment adviser or employees of a bank or trust company engaged in securities activities permissible for such entities. This limitation may deter affiliates of registered investment advisers from electing to become CABs.

Question 8: Of all of the CAB Rules, which is likely to impose the most onerous compliance obligations?

Answer: There's no right answer here, but CABs are required to comply with the applicable net capital requirements, file supplemental FOCUS reports as FINRA may deem necessary, obtain annual audited financial statements, and employ an operations principal.

Pencils down! Do the CAB Rules seem to be a good fit for your firm? If so, get your highlighters out and start reviewing the new rule book to make sure that you have a thorough understanding of the limitations imposed on CABs. Keep in mind that if a CAB engages in brokerage activities that are inconsistent with the limitations imposed on CABs, FINRA may examine for and enforce all FINRA rules against the CAB. You don't want to end up in detention, do you?

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[1] Institutional investors also include any bank, savings and loan association, insurance company or registered investment company; governmental entity or subdivision thereof; employee benefit plan or qualified plan that meets certain requirements; person acting solely on behalf of any such institutional investor; and person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.

[2] "Qualified purchasers" are natural persons or family-owned companies who own not less than $5 million in investments, and institutions who own not less than $25 million in investments.

[3] "Accredited investors" are natural persons with an annual income of at least $200,000 (or $300,000 with spouse), or a net worth in excess of $1 million (excluding value of one's primary residence).

[4] Section 3(c)(1) of the Investment Company Act excepts from the definition of investment company an issuer whose outstanding securities are beneficially owned by not more than 100 persons. Typically, Section 3(c)(1) funds seek capital from investors who may not meet the "qualified purchaser" standards, in contrast to Section 3(c)(7) funds, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers."

[5] See M&A Brokers no-action letter (Jan. 31, 2014).

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