

FINRA Establishes New Limited Registration Regime for “Capital Acquisition Brokers,” Including Private Fund Placement Agents

September 13, 2016

The SEC recently [approved](#) a Financial Industry Regulatory Authority (“**FINRA**”) proposal to establish a new limited membership category for broker-dealers engaged solely in certain corporate financing advisory and capital raising activities, referred to as “capital acquisition brokers” or “CABs.” Under the new regime, firms that engage only in these limited activities can elect to be regulated as CABs, subject to a streamlined set of FINRA rules, including significantly less burdensome and restrictive rules governing communications with the public. Notably, unlike FINRA’s 2014 [proposal](#) to establish a “limited corporate financing broker” category, certain firms that act as placement agents for private investment funds may be eligible to be CABs.

According to FINRA, the new registration category is designed to “improve efficiency and reduce regulatory burden by reducing the range of rules that apply to capital acquisition brokers given their limited activities and institutional business model, while maintaining necessary investor protections.” In its proposal, FINRA estimated that approximately 650 to 750 existing FINRA member firms, between 16% and 19% of FINRA’s membership, could be eligible to become CABs. In light of some of the reduced burdens of operating as a CAB, particularly for private fund sponsors, some firms may consider whether to convert their full FINRA member broker-dealers to CABs, or establish one or more new broker-dealers as CABs.

A comparison of select FINRA rules applicable to full FINRA members and those applicable to CABs is attached to this memorandum.

Capital Acquisition Broker Definition

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” (as specially defined for these purposes, as noted below) or (ii) on behalf of an issuer or a control person in connection with a change of control of a privately-held company; and
- effecting certain merger and acquisition transactions involving privately held companies in accordance with the terms of the SEC staff’s [2014 “M&A Broker” no-action letter](#), which 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.

A broker-dealer meeting the above definition will nonetheless be prohibited from registering as a CAB if it:

- 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 in the last two bullets of the previous paragraph);
- 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 any transaction that it is required to report under FINRA's trade reporting rules for certain debt or SEC-registered equity securities.

CABs may also not produce research for the investing public or chaperone non-U.S. broker-dealers pursuant to Exchange Act Rule 15a-6.

If a CAB or one of its associated persons engages in broker-dealer activities that are inconsistent with the CAB rules, then FINRA may examine for and enforce all FINRA rules against such broker-dealer or associated person, including any rule that applies to a FINRA member that is not a CAB or to an associated person who is not a person associated with a CAB. Additionally, an associated person of a CAB may not register with any full-service broker-dealer (affiliate or not). This prohibition on "dual-hatting" of associated persons of CABs may limit the practical ability of multiservice firms to use CABs, since persons associated with a CAB will not be able to engage in securities activities that are not permitted to be engaged in by a CAB.

Relationship to Existing FINRA Rules and Other Requirements

As noted above, CABs will be subject to a more streamlined set of FINRA rules. The **attached chart** compares some FINRA rules applicable to full FINRA members with those applicable to CABs. Although CABs will be subject to fewer FINRA requirements, CABs will remain subject to all of the provisions under the Exchange Act, SEC rules and relevant state law otherwise applicable to full-service broker-dealers.

Impact on the Marketing and Distribution of Private Funds

As noted above, the new rules permit CABs to facilitate placements of newly-issued, unregistered securities (e.g., acting as a placement agent or finder), but only with respect to sales to "institutional investors." The term "institutional investor" has the same meaning as under current FINRA rules,¹ with one important modification: a "qualified purchaser" as defined in the Investment Company Act of 1940 (the "**40 Act**")—which includes, among others, natural persons who own at least \$5 million in investments—would also be an institutional investor for purposes of the CAB rules.

The expansion of the definition of institutional investors to include qualified purchasers will allow broker-dealers that engage in sales of investment funds exempt from registration under the '40 Act pursuant to Section 3(c)(7) to be eligible for CAB status. This may be particularly attractive for broker-dealers established to sell private funds in light of the streamlined version of FINRA's communications with the public rule that will apply to CABs.

¹ FINRA Rule 2210 generally defines "institutional investor" as any bank, savings and loan association, insurance company, registered investment company, governmental entity or subdivision thereof, employee benefit plan, qualified plan with at least 100 participants (but not including the participants themselves), *any other person with at least \$50 million in assets*, and any person acting on an institutional investor's behalf.

New CAB Rule 221, unlike FINRA Rule 2210, does not include a specific prohibition on communications that “predict or project performance,” a restriction that has been **particularly challenging** for broker-dealers marketing private funds. FINRA explained in its proposal that it “recognizes that firms may need to include projections of an issuer’s performance in communications that are sent to prospective investors, such as pro forma financial statements related to a business acquisition or combination.” However, CABs will still be prohibited from, among other things, implying that past performance will recur or making any exaggerated or unwarranted claim, opinion or forecast. In addition, unlike FINRA Rule 2210, CAB Rule 221 will also not specifically require principal approval or FINRA filing of any communications, but will simply require CABs to determine their own supervisory requirements.

Converting to CAB Status or Registering a New CAB

An existing FINRA member firm already permitted to engage in CAB business activities will be able to convert to CAB status by requesting to amend its membership agreement. In this case, no new membership application (“**NMA**”) or continuing membership application (“**CMA**”) will be required, and the member will be permitted to convert back to a full-service broker-dealer without a CMA or NMA if it does so within one year of becoming a CAB. A non-member firm registering for the first time would follow ordinary FINRA new member application procedures, but indicate its intent to operate solely as a CAB.

Effective Date

FINRA plans to announce the implementation date for the new CAB regime in a Regulatory Notice that will be published by October 17, 2016. The implementation date for the new regime will be no later than February 20, 2017.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Comparison of FINRA Rules for Full FINRA Members with FINRA Rules for Capital Acquisition Brokers

FINRA Rule Category	FINRA Full Member Rules Applicable to CABs	FINRA Full Member Rules Modified for CABs	FINRA Full Member Rules <u>Not</u> Applicable to CABs
General Standards (FINRA Rule 0100 Series)	<ul style="list-style-type: none"> The CAB rules incorporate the FINRA By-Laws, unless the context requires otherwise. The CAB rules incorporate FINRA Rule 0150, which states that FINRA rules are not intended to be, and shall not be construed as, rules concerning municipal securities. 	<ul style="list-style-type: none"> The CAB rules include their own set of definitions, including, among others, a definition for “capital acquisition broker” and a revised definition of “institutional investor.” 	<ul style="list-style-type: none"> CABs will not be subject to FINRA Rules 0130 (Interpretation), 0160 (Definitions), 0180 (Application of Rules to Security-Based Swaps) and 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation), among others in this rule category.
Member Application Rules and Procedures (FINRA Rule 1000 Series)	<ul style="list-style-type: none"> CAB applicants will generally follow the same procedures for membership and be subject to the same filing fees as other FINRA applicants. 	<ul style="list-style-type: none"> Modifications to FINRA requirements include, among others, procedures allowing (i) an existing member firm that is already approved to engage in CAB activities to change its status to a CAB <i>without</i> filing either an NMA or CMA and (ii) a full-service broker-dealer that has converted to a CAB to convert back to a full-service broker-dealer without filing a CMA if it does so within a year of converting to a CAB. 	<ul style="list-style-type: none"> CABs will not be subject to provisions in this rule category that would generally be inapplicable to a CAB’s business, such as NASD IM-1013-1 (Membership Waive-In Process for Certain NYSE Member Organizations) and NASD IM-1013-2 (Membership Waive-In Process for Certain NYSE Alternext US LLC Member Organizations).
Registration and Qualification Examinations of Associated Persons (FINRA Rule 1200 Series)	<ul style="list-style-type: none"> CAB firm principals and representatives will be subject to the same registration, qualification examination and continuing education requirements as principals and representatives of other FINRA firms. CABs will be subject to FINRA Rule 1230(b)(6) regarding Operations Professional registration. 	<ul style="list-style-type: none"> N/A 	<ul style="list-style-type: none"> CABs will not be subject to provisions in this rule category that would generally be inapplicable to a CAB’s business, such as NASD IM-1022-1 (Limited Principal – Registered Options and Security Futures) and NASD IM-1022-2 (Limited Principal – General Securities Sales Supervisor).
Duties and Conflicts (FINRA Rule 2000 Series)	<ul style="list-style-type: none"> The CAB Rule 200 Series incorporates FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices) and 2040 (Payments to Unregistered Persons), among other rules. 	<ul style="list-style-type: none"> CAB Rules 209 and 211 are tailored to the activities of a CAB, but impose obligations similar to those imposed under FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability). CAB Rule 221 is an abbreviated version of FINRA Rule 2210 (Communications with the Public). Requirements relating to performance projections, principal approval and filing communications with FINRA (among others) do not apply to CABs. 	<ul style="list-style-type: none"> CABs will not be subject to FINRA rules requiring fair prices and commissions (FINRA Rule 2121) and reasonable and non-discriminatory charges for services performed (FINRA Rule 2122), among other provisions in this rule category.
Supervision and Responsibilities Related to Associated Persons (FINRA Rule 3000 Series)	<ul style="list-style-type: none"> The CAB Rule 300 Series establishes a limited set of supervisory rules for CABs, including by incorporating FINRA Rules 3220 (Influencing or Rewarding Employees of Others), 3240 (Borrowing from or Lending to Customers), and 3270 (Outside Business Activities of Registered Persons). 	<ul style="list-style-type: none"> CABs will be subject to many of the provisions of FINRA Rule 3110 concerning the supervision of offices, personnel, customer complaints, correspondence and internal communications. However, CABs will not be subject to the provisions of FINRA Rule 3110 that require annual compliance meetings, review and investigation of transactions, specific documentation and supervisory procedures for supervisory personnel and internal inspections. CAB Rule 313 will require CABs to designate and identify one or more principals to serve as a firm’s 	<ul style="list-style-type: none"> CABs will not be subject to FINRA Rules 3120 (Supervisory Control System), 3230 (Telemarketing) and 3250 (Designation of Accounts), among other provisions in this rule category.

FINRA Rule Category	FINRA Full Member Rules Applicable to CABs	FINRA Full Member Rules Modified for CABs	FINRA Full Member Rules <u>Not</u> Applicable to CABs
		<p>chief compliance officer, similar to the requirements of FINRA Rule 3130(a), but CAB Rule 313 will not require a CAB to have its CEO certify that the member has in place processes to establish, maintain, review, test and modify written compliance policies and WSPs reasonably designed to achieve compliance with applicable federal securities laws and regulations, and FINRA and MSRB rules, which are required under FINRA Rules 3130(b) and (c).</p> <ul style="list-style-type: none"> • CAB Rule 328 will prohibit any person associated with a CAB from participating in any manner in a private securities transaction as defined in FINRA Rule 3280(e), without the possibility of relying on a potential exception contained in FINRA Rule 3280. FINRA noted that the effect of this prohibition is that associated persons of a CAB are prohibited from being dual-hatted with a full-service broker-dealer. • CAB Rule 331 will require each CAB to implement a written anti-money laundering program, similar to the requirements in FINRA Rule 3310; however, CAB Rule 331 will permit CABs to conduct the required independent testing for compliance every two years rather than annually, as FINRA Rule 3310 requires of non-CAB members. 	
<p>Financial and Operational Rules (FINRA Rule 4000 Series)</p>	<ul style="list-style-type: none"> • The CAB Rule 400 Series establishes a limited set of financial and operational rules, including by incorporating, among others, FINRA Rules 4140 (Audit), 4150 (Guarantees by, or Flow through Benefits for, Members) and 4160 (Verification of Assets). 	<ul style="list-style-type: none"> • CAB Rule 411 includes some, but not all, of the capital compliance requirements of FINRA Rule 4110. • Similarly, CAB Rule 451(b) imposes more limited customer information requirements than are imposed under FINRA Rule 4512. 	<ul style="list-style-type: none"> • CABs will not be subject to rules relating to business continuity plans (FINRA Rule 4370) and testing under Regulation SCI (FINRA Rule 4380), among other provisions in this rule category.
<p>Securities Offerings (FINRA Rule 5000 Series)</p>	<ul style="list-style-type: none"> • CABs will be subject to FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5150 (Fairness Opinions). 	<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • CABs will not be subject to provisions in this rule category that would generally be inapplicable to a CAB's business, such as rules relating to market making, best execution and trading ahead of research reports.
<p>Quotation and Transaction Reporting Facilities (FINRA Rule 6000 Series)</p>	<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • CABs will not be subject to the FINRA Rule 6000 Series
<p>Clearing, Transaction and Order Data Requirements, and Facility Charges (FINRA Rule 7000 Series)</p>	<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • CABs will not be subject to the FINRA Rule 7000 Series

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Series)			
Investigations and Sanctions (FINRA Rule 8000 Series)	<ul style="list-style-type: none"> CABs will be subject to the entire FINRA Rule 8000 Series with three exceptions. 	<ul style="list-style-type: none"> FINRA incorporated the FINRA Rule 8000 Series directly, but also made certain definitional clarifications, for example, by stating that the terms "rules" and "FINRA rules" as used in the FINRA Rule 8000 Series will include the CAB rules. 	<ul style="list-style-type: none"> CABs will not be subject to FINRA Rule 8110 (Availability of Manual to Customers). FINRA excluded rules relating to the submission of trade data from firms engaged in securities trading, which would generally not be relevant to the activities of a CAB.
Code of Procedure (FINRA Rule 9000 Series)	<ul style="list-style-type: none"> CABs will be subject to the entire FINRA Rule 9000 Series with one set of exceptions. 	<ul style="list-style-type: none"> FINRA has made various clarifications concerning how the FINRA Rule 9000 Series will apply to CABs. In addition to definitional clarifications, CAB Rule 900(c) provides a tailored list of rules that, if violated, could result in a fine and/or censure. CAB Rule 900(d) authorizes FINRA staff to require a CAB to file communications with FINRA if the staff determines that the CAB has departed from CAB Rule 221's standards. 	<ul style="list-style-type: none"> CABs will not be subject to the FINRA Rule 9700 Series, which provides procedures for grievances concerning automated systems.
Uniform Practice Code (FINRA Rule 11000 Series)	<ul style="list-style-type: none"> N/A 	<ul style="list-style-type: none"> N/A 	<ul style="list-style-type: none"> CABs will not be subject to the FINRA Rule 11000 Series
Arbitration and Mediation (FINRA Rule 12000 – 14000 Series)	<ul style="list-style-type: none"> CABs will be 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). 	<ul style="list-style-type: none"> FINRA has made various definitional clarifications. 	<ul style="list-style-type: none"> N/A