January 26, 2016

FINRA Proposes New Category Of Broker-Dealer For "Capital Acquisition Brokers"

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

In December, 2015, FINRA proposed rules for a whole new category of broker-dealer, called "Capital Acquisition Brokers" ("CABs"), which limit their business to corporate financing transactions. In February 2014 FINRA sought comment on the proposal, which at the time referred to a CAB as a limited corporate financing broker (LCFB). Following many comments that the LCFB rules did not have a significant impact on the regulatory burden for full member firms, the new rules modify the original LCFB proposal in more than just name. The new rules will take effect upon approval by the SEC and are currently open to public comments.

A CAB will generally be a broker-dealer that engages in M&A transactions, raising funds through private placements and evaluating strategic alternatives and that collects transaction based compensation for such activities. A CAB will not handle customer funds or securities, manage customer accounts or engage in market making or proprietary trading.

As with all FINRA rules, the proposed CAB rules are designed to comply with Section 15A of the Exchange Act related to FINRA rules and, in particular, that such rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals of trade, and in general to protect investors and the public interest.

What is a Capital Acquisition Broker ("CAB")?

There are currently FINRA registered firms which limit their activities to advising on mergers and acquisitions, advising on raising debt and equity capital in private placements or advising on strategic and financial alternatives. Generally these firms register as a broker because they may receive transaction-based compensation as part of their services. However, they do not engage in typical broker-dealer activities, including carrying or acting as an introducing broker for customer accounts, accepting orders to purchase or sell securities either as principal or agent, exercising investment discretion over customer accounts or engaging in proprietary trading or market-making activities.

The proposed new rules will create a new category of broker-dealer called a Capital Acquisition Broker ("CAB"). A CAB will have its own set of FINRA rules but will be subject to the current FINRA bylaws and will be required to be a FINRA member. FINRA estimates there are approximately 750 current member firms that would qualify as a CAB and that could immediately take advantage of the new rules.

FINRA is also hopeful that current firms that engage in the type of business that a CAB would, but that are not registered as they do not accept transaction-based compensation, would reconsider and register as a CAB with the new rules. In that regard, FINRA's goal would be to increase its regulatory oversight in the industry as a whole. I think that on the one hand, many in the industry are looking for more precision in their allowable business activities and compensation structures, but on the other hand, the costs, regulatory burden, and a distrust of regulatory organizations will be a deterrent to registration. It is likely that businesses that firmly act within the purview of a CAB but for the transactional compensation and that intend to continue or expand in such business, will consider registration if they believe they are "leaving money on the table" as a result of not being registered. Of course, such a determination would include a cost-benefit analysis, including the application fees and ongoing legal and compliance costs of registration. In that regard, the industry, like all industries, is very small at its core. If firms register as a CAB and find the process and ongoing compliance reasonable, not overly burdensome and ultimately profitable, word will get out and others will follow suit. The contrary will happen as well if the program does not meet these business objectives.

A CAB will be defined as a broker that solely engages in one or more of the following activities:

Advising an issuer on its securities offerings or other capital-raising activities;

Advising a company regarding its purchase or sale of a business or assets or regarding a corporation restructuring, including going private transactions, divestitures and mergers;

Advising a company regarding its selection of an investment banker;

Assisting an issuer in the preparation of offering materials;

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 respect to the purchase or sale of unregistered securities (see below for the FINRA definition of institutional investor, which is much different and has a much higher standard than an accredited investor);

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, in accordance with the SEC rules, rule interpretations and no action letters. For more information on this, see my blog HERE regarding the SEC no action letter granting a broker registration exemption for certain M&A transactions.

Since placing securities in private offerings is limited to institutional investors, that definition is also very important. Moreover, FINRA considered but rejected the idea of including solicitation of accredited investors in the allowable CAB activities. Under the proposed CAB Rules, an institutional investor is defined to include any:

Bank, savings and loan association, insurance company or registered investment company;

Government entity or subdivision thereof;

Employee benefit plan that meets the requirements of Sections 403(b) or 457 of the Internal Revenue Code and that has a minimum of 100 participants;

Qualified employee plans as defined in Section 3(a)(12)(C) of the Exchange Act and that have a minimum of 100 participants;

Any person (whether a natural person, corporation, partnership, trust, family office or otherwise) with total assets of at least $50 million;

Persons acting solely on behalf of any such institutional investor; and

Any person meeting the definition of a “qualified purchaser” as defined in Section 2(a)(51) of the Investment Company Act of 1940 (i.e., any natural person that owns at least $5 million in investments; family offices with at least $5 million in investments; trusts with at least $5 million in investments; any person acting on their own or as a representative with discretionary authority, that owns at least $25 million in investments).

A CAB will not include any broker that does any of the following:

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 agent for the customer;

Has investment discretion on behalf of any customer;

Produces research for the investing public;

Engages in proprietary trading or market making;

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 (interesting that FINRA would include Regulation A in this, as currently no license is required at all to maintain such a platform – only platforms for Regulation Crowdfunding require such a license).

Application; Associated Person Registration; Supervision

A CAB firm will generally be subject to the current member application rules and will follow the same procedures for membership as any other FINRA applicant with four main differences. In particular: (i) the application has to state that the applicant will solely operate as a CAB; (ii) the FINRA review will consider whether the proposed activities are limited to CAB activities; (iii) FINRA has set out procedures for an existing member to change to a CAB; and (iv) FINRA has set out procedures for a CAB to change its status to regular full-service FINRA member firm.

The CAB rules also set out registration and qualification of principals and representatives, which incorporate by reference to existing NASD rules, including the registration and examination requirements for principals and registered representatives. CAB firm principals and representatives would be subject to the same registration, qualification examination and continuing education requirements as principals and representatives of other FINRA firms. CABs will also be subject to current rules regarding Operations Professional registration.

CABs would have a limited set of supervisory rules, although they will need to certify a chief compliance officer and have a written anti-money laundering (AML) program. In particular, the CAB rules model some, but not all, of current FINRA Rule 3110 related to supervision. CABs will be able to create their own supervisory procedures tailored to their business model. CABs will not be required to hold annual compliance meetings with their staff. CABs are also not subject to the Rule 3110 requirements for principals to review all investment banking transactions or prohibiting supervisors from supervising their own activities.

CABs would be subject to FINRA Rules 3220 – Influencing or Rewarding Employees of Others, Rule 3240 – Borrowing form or Lending to Customers, and Rule 3270 – Outside Activities of Registered Persons.

Conduct Rules for CABs

The proposed CAB rules include a streamlined set of conduct rules. This is a brief summary of some of the conduct rules related to CABs. CABs would be subject to current rules on Standards of Commercial Honor and Principals of Trade (Rule 2010); Use of Manipulative, Deceptive or Other Fraudulent Devices (Rule 2020); Payments to Unregistered Persons (Rule 2040); Transactions Involving FINRA Employees (Rule 2070); Rules 2080 and 2081 regarding expungement of customer disputes; and the FINRA arbitration requirements in Rules 2263 and 2268. CABs will also be subject to know-your-customer and suitability obligations similar to current FINRA rules for full-service member firms, and likewise will be subject to the FINRA exception to that rule for institutional investors. CABs will be subject to abbreviated rules governing communications with the public and, of course, prohibitions against false and misleading statements.

CABs are specifically not subject to FINRA rules related to transactions not within the purview of allowable CAB activities. For example, CABs are not subject to FINRA Rule 2121 related to fair prices and commissions. Rule 2121 requires a fair price for buy or sell transactions where a member firm acts as principal and a fair commission or service charge where a firm acts as an agent in a transaction. Although a CAB could act as an agent in a buy or sell transaction where a counter-party is an institutional investor or where it arranges securities transactions 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 SEC rules, rule interpretations and no action letters on such M&A deals, FINRA believes these transactions are outside the standard securities transactions that typically raise issues under Rule 2121.

Financial and Operational Rules for CABs

CABs would be subject to a streamlined set of financial and operational obligations. CABs would be subject to certain existing FINRA rules including, for example, audit requirement, maintenance of books and records, preparation of FOCUS reports and similar matters.

CABs would also have net capital requirements and be subject to suspension for non-compliance. CABs will be subject to the current net capital requirements set out by Exchange Act Rule 15c3-1.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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