

Client Update

SEC Approves FINRA's "Capital Acquisition Broker" Rules

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On August 18, 2016, the Securities and Exchange Commission approved new Financial Industry Regulatory Authority ("FINRA") rules governing the registration and regulation of "capital acquisition brokers" ("CABs").¹ In broad terms, a CAB is a broker-dealer that limits the scope of its business to certain narrow activities (e.g., private placements; certain M&A activities) and, as such, becomes subject to a more streamlined rule book. FINRA appears to have sought to design the CAB category of membership in an attempt to appeal to private equity fund managers, placement agents and certain M&A advisory firms. Broker-dealers that limit their activities to soliciting investors for private funds or that are affiliated with private fund sponsors may find CAB status attractive, particularly for the ability to include projections in marketing materials. However, these benefits may be outweighed by the limitations imposed by CAB status, such as the inability to solicit certain types of accredited investors, engage in secondary transactions in fund interests or act as a chaperoning broker for foreign affiliates.

WHAT IS A CAB?

In order to qualify as a CAB, a broker-dealer must limit its operations to 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 (i) its purchase or sale of a business or assets or (ii) 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;

¹ FINRA's CAB rules can be found at https://www.finra.org/sites/default/files/notice_other_file_ref/CAB-Rules_RegulatoryNotice-16-37.pdf. The Securities and Exchange Commission order approving these rules can be found at <https://www.sec.gov/rules/sro/finra/2016/34-78617.pdf>.

- Providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;
- 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 control person² in connection with a change of control of a privately held company; or
- Effecting securities transactions solely in connection with certain types of M&A transactions involving private companies that will be acquired by a buyer that will actively operate the company.

FINRA estimates that approximately 650 to 750 existing FINRA member firms may be eligible to register as CABs.

A broker-dealer that engages in one or more of the following businesses **cannot** be a CAB:

- Carrying customer accounts or acting as an introducing broker;
- Holding or handling customer funds or securities;
- Accepting orders from customers to purchase or sell securities as principal or agent for the customer;
- Having investment discretion on behalf of any customer;
- Engaging in proprietary trading or market-making activities;
- Participating in or maintaining an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding or Regulation A under the Securities Act of 1933; or
- Effecting securities transactions covered by FINRA's trade reporting rules.

FOUR ISSUES WHEN CONSIDERING CAB ELECTION

When considering whether to elect a CAB registration instead of the more general FINRA membership, firms may wish to think carefully about four points.

² A "control person" is any person who has the power to direct the management or policies of a company through ownership of securities, by contract or otherwise. Control will be presumed to exist if, before the transaction, a person has the right to vote or the power to sell or direct the sale of 25% or more of a class of voting securities or, in the case of a partnership or limited liability company, has the right to receive upon dissolution or has contributed 25% or more of the capital.

- A CAB will not be subject to the prohibition on the use of projections or predictions of investment performance contained in FINRA Rule 2210(d)(1)(F). Placement agents for private funds will find this difference attractive, as will the fund sponsors. One of the most common questions we receive concerns the use of projections or predictions in private fund marketing materials, which FINRA rules generally prohibit (in contrast to “target” returns as an investment objective, which are permitted). Private fund sponsors using an affiliated or unaffiliated CAB as placement agent will no longer be subject to the prohibition; rather, the focus will be on whether the projections are accompanied by sufficient disclosures to assure that they are not misleading.
- A CAB may only solicit certain types of investors: various financial institutions; governmental investors; any person or entity with total assets of \$50 million or more; and any “qualified purchaser,” as defined in the Investment Company Act of 1940—that is, investors that are eligible to invest in private funds that rely on Section 3(c)(7). Thus, while a CAB should be able to act as a placement agent for most private funds, it may be precluded from doing so for private funds that rely on Section 3(c)(1) of the Investment Company Act or other private placements that seek a broader investment base.
- Soliciting or assisting with secondary market transactions in private fund shares (or—really—any security) would seem to fall outside the permissible activities of a CAB.
- A CAB also may not act as a “chaperone” for foreign broker-dealers soliciting investors in the United States. We expect certain potential CABs to elect full FINRA membership instead because, in our experience, having Rule 15a-6 chaperoning capabilities is a feature often sought by placement agents and smaller investment banks, particularly when they have non-U.S. affiliates.

CONCLUSION

CAB registration presents a potentially interesting possibility for certain firms planning to register with FINRA, if their intended business lines are limited to the permissible activities. As with any registration, it bears careful consideration.

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Please do not hesitate to contact us with any questions.