WINSTON & STRAWN LLP

CLIENT ALERT

SEC Approves FINRA Capital Acquisition Broker Rules

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The Securities and Exchange Commission ("SEC") recently approved FINRA's capital acquisition broker rules. A copy of the approval order is available here. These rules apply to broker-dealers that have been approved for membership in FINRA as "capital acquisition brokers" and elect to be governed under the capital acquisition rule set (collectively, the "CAB Rules"), which offers a somewhat simpler, more streamlined alternative to FINRA's general rulebook.

A capital acquisition broker is a broker-dealer that limits its business to a narrow range of permitted activities. These activities include advising companies on mergers and acquisitions, private placements, or strategic and financial alternatives. A capital acquisition broker can also effect securities transactions in connection with a transfer of ownership and control of a privately held company or, subject to certain limitations, act as a placement agent or finder. The range of activities available to capital acquisition brokers is discussed further at Section I below.

As discussed at Section II, capital acquisition brokers and their associated persons are also subject to several prohibitions that impose significant limitations on their activities. Accordingly, brokers that are considering capital acquisition broker status should consider these limitations carefully before committing to such an election.

Capital acquisition brokers must be approved for membership in FINRA specifically as a "capital acquisition broker." This process will vary depending upon whether a firm is currently a FINRA member. Section III provides an overview related to electing and terminating status as a capital acquisition broker.

As discussed in Section IV below, the CAB Rules are tailored to the limited scope of activities engaged in by capital acquisition brokers and relieve capital acquisition brokers from compliance with a variety of FINRA rules.

I. What Is a Capital Acquisition Broker and What Can it Do?

As stated above, a capital acquisition broker must limit its business to certain permitted activities. As a general matter, these activities fall within two categories. The first involves providing advice to companies and issuers. The second involves effecting securities transactions in connection with a transfer of ownership and control of a privately held company or acting as a placement agent or finder in certain limited situations.

a. Provision of Advice

Capital acquisition brokers may engage in 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; and
- providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services.

B. Change of Control, Private Placement, and Finders Activity

Capital acquisition brokers may also effect securities transactions in connection with the transfer of ownership and control of a privately held company in accordance with the terms and conditions of any 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. Currently, the only relief offered in this respect is found in the SEC's no-action letter that provides exemptive relief to M&A Brokers from broker-dealer registration. The M&A Broker no-action letter, however, imposes a number of restrictions, which are summarized in a Winston client briefing available here. A copy of the no-action letter is available here.

Capital acquisition brokers may also qualify, identify, or solicit investors or otherwise act as a placement agent or finder but only (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 person" in connection with a "change of control" of a "privately-held company."

For purposes of the foregoing, the term "institutional investor" includes 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 persons (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[1]; and
- person acting solely on behalf of any such institutional investor.

Significantly, the term "institutional investors" does not include an "accredited investor" as defined at Rule 501 of Regulation D. To be clear, however, the institutional investor definition is only relevant to private placement activities and is not relevant to transactions involving a change of control.

In the case of a transaction involving a "change of control," placement and finders' activity must be limited to activity involving a "privately-held company." For this purpose, a "control person" is a person who has the power to direct

the management or policies of a company through ownership of securities, by contract, or otherwise. Control is presumed to exist if, before the transaction, the 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 “privately-held company” is a company that does not have any class of securities registered, or required to be registered, with the SEC under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”), or with respect to which the company files, or is required to file, periodic information, documents, or reports under Section 15(d) of the Exchange Act.

II. Prohibitions and Limitations Applicable to Capital Acquisition Brokers

Firms that elect status as a capital acquisition broker are subject to a number of restrictions. For the most part, these restrictions are consistent with the activities permitted to a capital acquisition broker. Accordingly, a capital acquisition broker cannot:

- carry or act as an introducing broker with respect to customer accounts;
- hold or handle customer funds or securities;
- accept orders from customers to purchase or sell securities either as principal or as agent for the customer (except in connection with permitted transactions involving private placements or a change of control);
- exercise investment discretion on behalf of any customer; 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.

Perhaps of more significance, firms that elect status as a capital acquisition broker are prohibited from engaging in proprietary trading of securities or market-making activities and cannot chaperone foreign associated persons under Exchange Act Rule 15a-6. In addition, persons associated with a capital acquisition broker are prohibited from participating in any manner in a private securities transaction, i.e., as defined in FINRA Rule 3280(e) a transaction effected away from the broker-dealer.

Firms that elect status as a capital acquisition broker are also prohibited from effecting securities transactions that require reporting under FINRA Rule 6300 Series, 6400 Series, 6500 Series, 6600 Series, 6700 Series, 7300 Series, or 7400 Series. This includes over-the-counter transactions in NMS stocks, transactions in OTC equity securities, and Restricted Equity Securities as well as TRACE reportable debt securities.

III. Electing and Terminating Capital Acquisition Broker Status

New FINRA members that elect capital acquisition broker status will generally follow the same procedures as any other applicant for FINRA membership, except that the applicant will need to indicate that it intends to elect capital acquisition broker status. An existing member already approved to engage in the activities of a capital acquisition broker may file a request with FINRA to amend its membership agreement to provide that the firm’s activities will be limited to those permitted for capital acquisition brokers.

Existing members that elect status as a capital acquisition broker will have one year in which they can terminate such status and convert back to their pre-election status without having to file an application for approval of a material change in business operations pursuant to NASD Rule 1017. Instead, a member firm will only have to file a request to amend its membership agreement to provide that the firm agrees to comply with all FINRA rules and execute an amended membership agreement that imposes the same limitations on the firm’s activities that existed prior to the firm’s capital acquisition broker election.

This conversion option is not available to new members that elect capital acquisition status or existing members after the expiration of the one-year grace period. Instead, such firms will have to file a continuing membership

application seeking approval of any activities beyond those permitted to capital acquisition brokers.

IV. Streamlined Rules for Capital Acquisition Brokers

The CAB Rules subject capital acquisition brokers to the FINRA By-Laws "unless the context requires otherwise," as well as FINRA rules specifically identified in the CAB Rules. The following is a summary of the key rules to which capital acquisition brokers will be subject.

Conduct Rules (CAB Rule 200 Series)

The CAB Rules establish a more limited set of conduct rules to which capital acquisition brokers must adhere, which include "know your customer" and suitability obligations, similar to FINRA Rules 2090 and 2111, including an exception to the customer-specific suitability obligations for institutional investors similar to the exception found in FINRA Rule 2111(b). The CAB Rules also include an abbreviated version of FINRA Rule 2210 (Communications with the Public), which prohibit false and misleading statements, including any implication that past performance will recur or making any exaggerated or unwarranted claim, opinion or forecast. Capital acquisition brokers will not be subject to FINRA's rules relating to fair prices and commissions or charges for services performed.

Supervision and Responsibilities Related to Associated Persons (CAB Rule 300 Series)

The CAB Rule 300 Series establishes a limited set of supervisory rules for capital acquisition brokers. Capital acquisition brokers are subject to FINRA Rules 3220 (Influencing or Rewarding Employees of Others), 3240 (Borrowing from or Lending to Customers), and 3270 (Outside Business Activities of Registered Persons). CAB Rule 311 subjects capital acquisition brokers to some, but not all, of the requirements of FINRA Rule 3110 (Supervision). Capital acquisition brokers will have more flexibility to tailor their supervisory systems to conform more precisely to their limited business activities. For example, capital acquisition brokers will not be subject to the provisions of Rule 3110 that require annual compliance meetings, review and investigation of transactions; specific documentation and supervisory procedures for supervisory personnel, and internal inspections. However, capital acquisition brokers are subject to the provisions of Rule 3110 concerning the supervision of offices, personnel, customer complaints, correspondence, and internal communications.

Capital acquisition brokers are required to designate one or more principals to serve as the firm's chief compliance officer. However, the CAB Rules will not require a CEO certification in accordance with FINRA Rule 3130. Capital acquisition brokers must also implement a written anti-money laundering (AML) program, but the CAB Rules allow independent testing for AML compliance every two years rather than annually. The CAB Rules prohibit any person associated with a capital acquisition broker from participating in any manner in a private securities transaction as defined in FINRA Rule 3280(e).

Financial and Operational Rules (CAB Rule 400 Series)

Capital acquisition brokers are subject to many of FINRA's rules on financial and operational requirements, including FINRA Rules 4140 (Audit), 4150 (Guarantees by, or Flow through Benefits for, Members), 4160 (Verification of Assets), 4511 (Books and Records – General Requirements), 4513 (Records of Written Customer Complaints), 4517 (Member Filing and Contact Information Requirements), 4524 (Supplemental FOCUS Information), 4530 (Reporting Requirements), and 4570 (Custodian of Books and Records), as well as Rule 4523(a) (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts). Capital acquisition brokers will not be subject to FINRA rules regarding business continuity plans or testing under SEC Regulation SCI and will have limited customer information requirements. Under CAB Rule 411, which is modeled after FINRA Rule 4110, capital acquisition brokers must suspend business operations when they do not meet the applicable net capital requirements under Exchange Act Rule 15c3-1.

Securities Offerings (CAB Rule 500 Series)

Capital acquisition brokers will be subject to a limited subset of the rules governing securities offerings, specifically FINRA Rule 5122 (Private Placements of Securities Issued by Members) and FINRA Rule 5150 (Fairness Opinions).

Investigations and Sanctions, Code of Procedure (CAB Rule 800 and 900 Series)

Capital acquisition brokers will be subject to the FINRA rules governing investigations and sanctions of firms, other than FINRA Rules 8110 (Availability of Manual to Customers), 8211 (Automated Submission of Trading Data Requested by FINRA), and 8213 (Automated Submission of Trading Data for Non-Exchange-Listed Securities Requested by FINRA).

Capital acquisition brokers will be subject to the FINRA rules governing disciplinary and other proceedings involving firms except Rule 9700 (Procedures on Grievances Concerning the Automated Systems).

Arbitration and Mediation (CAB Rule 1000 Series)

Capital acquisition brokers will be subject to all FINRA rules governing arbitration and mediation for customer and industry disputes.

FINRA has not announced an effective date for the new rules but will do so no later than 60 days following SEC approval, and the implementation date will be no later than 180 days following FINRA's announcement. Please contact a member of the Winston and Strawn LLP Financial Services Group listed below or your normal Winston and Strawn LLP attorney with questions regarding the new rules.

[1] A qualified purchaser that is a natural person must satisfy a minimum investments test of $5 million.

10 Min Read

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