Regulatory Notice 20-04

Capital Acquisition Brokers

FINRA Requests Comments on Proposed Amendments to the Capital Acquisition Broker (CAB) Rules

Comment Period Expires: March 30, 2020

Summary

FINRA's CAB rules provide a simplified rulebook for broker-dealers that engage only in limited capital advisory, corporate restructuring and private placement activities. FINRA is requesting comment on proposed amendments to the CAB rules to make them more useful to CABs without reducing investor protection.

The proposed rule text is available in Attachment A.

Questions regarding this *Notice* should be directed to Joseph P. Savage, Vice President and Counsel, Office of Regulatory Analysis, at (240) 386-4534 or by email at *joe.savage@finra.org*.

Questions regarding the Economic Impact Assessment in this *Notice* should be directed to: Meghan Burns, Associate Principal Analyst, Office of Chief Economist, at (202) 728-8062 or by email at *meghan.burns@finra.org*.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 30, 2020.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Jennifer Piorko Mitchell
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

January 30, 2020

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

Key Topics

- Capital Acquisition Brokers
- Institutional Investors
- Investment Advisers
- Personal Investments

Referenced Rules & Notices

- CAB Rule 016
- CAB Rule 321
- CAB Rule 328
- CAB Rule 511
- FINRA Rule 3110
- FINRA Rule 3210
- FINRA Rule 3280
- Notice to Members 91-45
- Regulatory Notice 16-22
- Regulatory Notice 16-37
- Investment Advisers Act section 202(a)(11)
- Investment Company Act section 2(a)(51)
- Investment Company Act Rule 3c-5
- Securities Act Rule 144
- Securities Act Rule 144A
- Securities Exchange Act section 15(g)

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[1]

Before becoming effective, a proposed rule change must be filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).[2]

Background and Discussion

CAB Rules

CABs are firms that engage in a limited range of activities, essentially acting as placement agents for sales of unregistered securities to institutional investors and advising companies and private equity funds on capital raising and corporate restructuring. Firms meeting the CAB criteria may elect to be governed by the CAB rules.

The benefit of electing CAB status is that CABs are subject to fewer restrictions on specified activities (such as advertising) and have less burdensome supervisory requirements. On the other hand, CABs are not permitted to engage in other broker-dealer activities, such as accepting customers' trading orders, carrying customer accounts, handling customers' funds or securities, or engaging in proprietary trading or market-making.

The CAB rules became effective on April 14, 2017.[3] Firms may elect CAB status either as a new firm applicant or by electing CAB status as a current member firm.

Proposed Changes to CAB Rules

Investment Adviser Activities

The CAB rules currently do not permit CABs to register as investment advisers. Moreover, associated persons of CABs may not participate in private securities transactions (PSTs), which include the forwarding of orders from investment adviser clients to a third-party broker-dealer for execution. The proposed changes would allow CABs to register as investment advisers, so long as the advisory services are provided only to institutional investors.[4]

Institutional Investor Definition

A CAB may act as a placement agent or finder in the sale of newly-issued unregistered securities to "institutional investors."[5] The term "institutional investor" for purposes of the CAB rules includes banks, investment companies, large employee benefit plans and "qualified purchasers" under the Investment Company Act of 1940 (ICA).[6] FINRA proposes to broaden the definition of institutional investor to include "knowledgeable employees" under ICA Rule 3c-5, a term that includes senior officers and directors of private funds and their advisers.[7] "Knowledgeable employee" also would include persons performing similar roles at other private issuers for which CABs act as placement agents.[8]

Secondary Transactions

CABs may not act as placement agents in connection with secondary transactions involving unregistered securities, except when the transaction is in connection with the change of control of a privately-held company.[9] FINRA proposes to expand the ability of a CAB to act as placement agent for secondary trades of unregistered securities.[10] A CAB would be permitted to act as a placement agent in a secondary transaction involving unregistered securities of an issuer for which the CAB had previously acted as placement agent for such securities, provided that the purchaser of such securities is an institutional investor, and the new sale falls within a Securities Act of 1933 (Securities Act) exemption from registration (*e.g.*, Securities Act Rules 144 or 144A).[11]

Compensation

FINRA recently issued a staff interpretation of the CAB rules stating that CABs may be compensated in the form of securities issued by a privately held CAB client, rather than in cash, provided that the receipt, exercise or subsequent sale of such securities will not cause the CAB to engage in activities prohibited under CAB Rule 016(c)(2) (Definitions).[12] FINRA proposes to codify this interpretation.[13]

Personal Investments

The CAB rules do not require a CAB's associated person to obtain the CAB's prior written consent before opening or otherwise establishing a securities account at another financial institution. Associated persons of non-CAB firms must do so under FINRA Rule 3210 (Accounts At Other Broker-Dealers and Financial Institutions). Nevertheless, some CABs may be involved in transactions, either as advisor or placement agent, that raise insider trading possibilities. CABs that are involved with such transactions must maintain policies and procedures required by the SEC to address insider trading risks.[14]

FINRA proposes to adopt new CAB Rule 321 (Supervision of Associated Persons' Investments), which would provide that any CAB whose business model creates potential insider trading risks is required to establish, maintain and enforce written policies and procedures that are reasonably designed to mitigate and prevent those risks. These CABs would be subject to FINRA Rule 3210 and their associated persons would be required to obtain the prior written consent of the CAB to open or otherwise establish at another firm any account in which securities transactions can be effected and in which the associated person has a beneficial interest.[15] The CAB also could request that a broker-dealer or other financial institution with which the associated person has a securities account transmit duplicate copies of confirmations and statements from the associated person's account.

In addition, CABs meeting this description would be subject to FINRA Rule 3110(d) (Supervision), which requires firms to adopt supervisory procedures for the review of securities transactions that are reasonably designed to identify trades that may violate provisions of the Securities Exchange Act of 1934 and SEC and FINRA rules prohibiting insider trading in accounts of the firm's associated persons and their immediate family members. Rule 3110(d) also requires these firms to promptly investigate such trades and file written reports of these investigations with FINRA.

The CAB rules also technically prohibit associated persons of CABs from investing in unregistered securities, since they prohibit associated persons from participating in PSTs. The PST definition in FINRA Rule 3280 (Private Securities Transactions of an Associated Person) includes direct investments in unregistered securities.[16] Proposed CAB Rule 321 would permit CAB associated persons to invest in unregistered securities notwithstanding the prohibition on PSTs, provided that they give prior written notice of all purchases and sales of unregistered securities to their CAB.

Economic Impact Assessment

Regulatory Need

FINRA created a separate rule set for CABs with the goal of reducing regulatory burdens on broker-dealer firms that engage only in limited institutional corporate financing and private placement activities and do not interact with retail investors. FINRA understands that the current CAB definition may discourage some firms for which the designation was intended from electing CAB status due to limits on CABs' permissible activities. This proposal would broaden the types of activities in which CABs may engage, and would clarify CABs' insider trading responsibilities.

Economic Baseline

The baseline is the existing CAB regulatory framework, including 55 member firms that have elected CAB status, non-CAB FINRA member firms that conduct CAB-like activities (FINRA-registered CAB-like firms),[17] and an unknown number of firms that provide services similar to CABs but are not registered with FINRA or the SEC (unregistered CAB-like firms).[18]

FINRA estimates that there are approximately 700 FINRA-registered CAB-like firms. Of these firms, 80 percent have fewer than 20 registered representatives. Of the 55 member firms currently registered as CABs, approximately 91 percent have fewer than 20 registered representatives. In total, there are approximately 548 registered representatives working across the 55 existing CAB firms.[19]

Economic Impact

Anticipated Benefits

The proposal's benefits would accrue to those firms whose business decisions or activities would be enhanced or regulatory costs reduced by the proposal. These include member firms that already have elected CAB status, member firms that have not chosen to elect CAB status due to the CAB rules' limits on their current or future activities, and firms that have not applied for FINRA membership.

Existing CAB firms that expand the scope of their activities as a result of the proposal would continue to benefit from a streamlined FINRA rulebook and would benefit from increased flexibility in their business practices. For example, they would be able to act as placement agents in secondary transactions of unregistered securities (in certain cases). They also would be permitted to register as investment advisers, and sell their unregistered securities to "knowledgeable employees" if they so desire.

The FINRA-registered CAB-like firms that could benefit from the proposal include those firms whose activities would fall within the range of permissible CAB activities under the proposed amendments and firms for which the expanded CAB definition would overlap sufficiently with their business activities that the benefits of becoming a CAB would exceed the costs. For example, any of the 700 CAB-like firms that act as placement agents in secondary transactions of unregistered securities that would be permitted for CABs would now be CAB-eligible. Similarly, FINRA estimates that there are at least 20 firms[20] that are dually registered as broker-dealers and investment advisers that provide advisory services only to institutional investors.[21] All of these firms, including those that sell unregistered securities to "knowledgeable employees" and otherwise meet the expanded CAB definition, would now be CAB-eligible and would have the potential to realize any associated cost savings from electing CAB designation.

Firms that elect CAB status as a result of this proposal would benefit from lower compliance costs associated with maintaining FINRA membership. For example, unlike non-CAB member firms, CABs are not subject to branch inspection requirements under Rule 3110, are not required to have a principal pre-approve, or file with FINRA, their communications with the public, and are only required to conduct an anti-money laundering audit every two years (versus annually for most non-CAB member firms). These firms also likely would benefit from more focused examinations that are tailored to their business activities. This should reduce compliance costs for these firms and allow them to deploy their capital more efficiently.

Some unregistered CAB-like firms may elect to become CABs as a result of the proposed amendments.[22] These firms are of two types: (1) unregistered firms that may currently engage in activities that require broker-dealer registration; and (2) unregistered firms that are not currently engaging in broker-dealer activities and that elect to enter the broker-dealer space as a CAB. Unregistered firms that may currently engage in activities that require broker-dealer registration would benefit from removing the uncertainty of being sanctioned for acting as an unregistered broker-dealer while operating under a less burdensome regulatory framework. Firms that are not currently engaging in broker-dealer activities, but that choose to enter the broker-dealer space because of the expanded CAB definition, would benefit from new business opportunities.

The clients of firms that benefit from the new proposal likely would benefit as well. They may benefit from lower costs to the extent FINRA-registered firms that become CABs pass any of their regulatory cost savings onto their customers. Clients of currently unregistered firms may benefit from the protections that come with FINRA's regulatory and supervisory framework. Clients of existing CAB firms may benefit from the expanded scope of the firms' activities, without loss of protections. Additionally, investors in general should benefit from the preventative measures against insider-trading that are included in the proposal.

Anticipated Costs

The proposal would impose certain costs on some CAB firms to the extent that they had not previously established written policies and procedures reasonably designed to prevent insider trading, and any attendant monitoring costs that arise from them. It also would impose costs on associated persons of some CAB firms because they would be required to obtain written consent from their firms before opening a securities account at another financial institution. This will slow the account opening process for employees of CAB firms.

Otherwise, the proposal would not impose any direct costs on existing CAB firms or FINRA member firms that elect to become CABs as a result of the proposal. Firms that register with FINRA as CABs would incur implementation and ongoing costs associated with applying for and maintaining FINRA membership. The implementation costs would include FINRA application fees, legal or consulting fees, and costs associated with setting up the infrastructure for regulatory reporting and developing written supervisory policies and procedures. The ongoing costs would be in the form of annual registration fees and expenses associated with ongoing compliance activities, including undergoing examinations. However, these are costs that firms may choose to incur, presumably because they conclude that the additional costs of regulation and compliance are outweighed by the benefits of FINRA membership.

Competitive Effects and Additional Considerations

To the extent that FINRA-registered CAB-like firms elect CAB status or non-FINRA members elect to register as CABs, the proposal should reduce the competitive imbalance between these groups. Overall, this should enhance competition among these groups particularly since the former group will experience reduced regulatory costs without reduction in investor protections as a result of the proposal.

FINRA considered the implications of this proposal for investor protection. Since CABs may only conduct business with corporate entities and institutional investors, FINRA has determined that retail investors should not lose any protections as a result of the proposal. Corporate entities and institutional investors often are more sophisticated than retail investors and have the resources necessary to conduct due diligence. Therefore, a moderated regulatory framework is sufficient to protect these investors from potential harm.

Alternatives Considered

In addition to the elements incorporated in this proposal, FINRA considered exempting or reducing Continuing Education (CE) requirements for CAB firm registered personnel. However, FINRA determined that this change could hinder CAB registered persons' future employment opportunities with non-CAB firms, and potentially could reduce investor protection.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues:

1. Are there other categories of activities that FINRA should consider incorporating into the CAB definition without reducing investor protection? What are those categories of activities and what are the anticipated benefits and costs of incorporating them into the CAB definition?
2. Are there unforeseen risks associated with allowing CABs to register as investment advisers that FINRA should consider? Are there unforeseen risks associated with allowing CABs to act as placement agents in certain secondary transactions involving unregistered securities?
3. Do the proposed amendments represent a reasonable incentive for eligible firms to elect CAB status?
4. Do the proposed amendments reasonably maintain strong investor protections?
5. Are there any expected economic impacts associated with the proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Endnotes

1. Persons submitting comments are cautioned that FINRA does not edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.

2. *See* SEA section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

3. *See* Regulatory Notice 16-37 (October 2016). *See also* Securities Exchange Act Release No. 78617 (August 18, 2016), 81 FR 57948 (August 24, 2016) (Order Approving Rule Change as Modified by Amendment Nos. 1 and 2 to Adopt FINRA Capital Acquisition Broker Rules; File No. SR-FINRA-2015-054).

4. *See* proposed CAB Rule 016(c)(1)(I).

5. *See* CAB Rule 016(c)(1)(F).

6. *See* CAB Rule 016(i). The term "qualified purchaser" includes, among other things, any natural person, family-owned company or specified trust that owns not less than $5,000,000 in investments, and any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments. *See* ICA section 2(a)(51), 15 USC 80a-2(a)(51).

7. *See* proposed CAB Rule 016(i)(8); *see also* ICA Rule 3c-5(a)(4). Under Rule 3c-5, shares beneficially owned by knowledgeable employees are excluded for purposes of determining whether a hedge fund is excepted from the definition of "investment company" under ICA sections 3(c)(1) or 3(c)(7). *See* ICA Rule 3c-5(b).

8. *See* proposed CAB Rule 016(m).

9. *See* CAB Rule 016(c)(1)(F).

10. *See* proposed CAB Rule 016(c)(1)(H).

11. *See* 17 CFR 230.144 and 230.144A.

12. *See* Interpretive Letter to Jonathan D. Wiley, The Forbes Securities Group (May 30, 2019).

13. *See* proposed CAB Rule 511 (Securities as Compensation).

14. *See* SEA section 15(g), 15 USC 78o(g); *see also Notice to Members 91-45* (June 21, 1991) (NASD/NYSE Joint Memo on Chinese Wall Policies and Procedures).

15. For further background on FINRA Rule 3210, *see* Regulatory Notice 16-22 (June 2016) (Accounts At Other Broker-Dealers and Financial Institutions). In addressing insider trading risk, FINRA is tailoring the proposed requirement to the limited activities of CABs as permitted under the CAB rules. FINRA has noted that the scope of Rule 3210 is not limited to reviews for insider trading risk and that reviews of the information that firms obtain pursuant to Rule 3210 could relate to other facets of conduct under applicable rules. *See* note 4 in *Notice 16-22*.

16. *See* FINRA Rule 3280(e).

17. "CAB-like" refers to activities that are similar to those in which CABs may engage, including advising companies on mergers, acquisitions and corporate restructuring, advising issuers on raising debt and equity capital, and acting as a placement agent for sales of unregistered securities to institutional investors. While FINRA estimates that there may be as many as 700 of these firms, we are unsure of the extent to which these firms would benefit from changing their activities to fit within those allowed by the proposed CAB rules.

18. For example, there may be some firms that are relying on SEC no-action relief to avoid broker-dealer registration. The staff does not have an estimate on the number of these firms.

19. As of January 10, 2020. Existing CAB firms have an average of 10 registered representatives per firm.

20. Figures are based upon FINRA's internal mapping of firms' primary business model. These estimates likely include some firms whose secondary activities make them ineligible for CAB status.

21. The proposal also would expand the range of permissible activities to include selling unregistered securities to "knowledgeable employees" and acting as a placement agent for specified secondary unregistered securities transactions.

22. In addition, it is possible that, because of the expanded CAB definition, new firms may elect to enter the broker-dealer space as CABs. FINRA is unaware of any data that would enable the staff to estimate the number of such firms.

ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined; deletions are bracketed.

010. GENERAL STANDARDS

016. Definitions

When used in the Capital Acquisition Broker Rules, unless the context otherwise requires:

(a)-(b) No change.

(c) "Capital Acquisition Broker"

(1) A "capital acquisition broker" is any broker that solely engages in any one or more of the following activities:

(A) – (E) No change.

(F) 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 or (ii) on behalf of an issuer or a control person in connection with a change of control of a privately-held company. For purposes of this subparagraph, 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 will be 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. For purposes of this subparagraph, a "privately-held company" is a company that does not have any class of securities registered, or required to be registered, with the Securities and Exchange Commission under Section 12 of 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; [and]

(G) 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 or the business conducted with the assets of the company, in accordance with the terms and conditions of an 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[.];

(H) qualifying, identifying, soliciting, or acting as a placement agent or finder on behalf of an institutional investor that seeks to sell unregistered securities that it owns, provided that:

(i) the purchaser of such securities is an institutional investor;

(ii) the capital acquisition broker previously had provided services permitted under paragraphs (c)(1)(F) and (G) of this Rule to the issuer in connection with the initial sale of such securities; and

(iii) the sale of such securities qualifies for an exemption from registration under the Securities Act; and

(I) Acting as an "investment adviser" as defined in section 202(a)(11) of the Investment Advisers Act of 1940, as amended, provided that the advisory clients of the capital acquisition broker and its associated persons consist solely of institutional investors.

(2) No change.

(d) – (h) No change.

(i) "Institutional Investor"

The term "institutional investor" means any:

(1) – (5) No change.

(6) person meeting the definition of "qualified purchaser" as that term is defined in Section 2(a)(51) of the Investment Company Act of 1940; [and]

(7) [any] person acting solely on behalf of any such institutional investor[.]; and

(8) knowledgeable employee.

(j) – (l) No change.

(m) "Knowledgeable Employee"

The term "knowledgeable employee" means:

(1) any "Knowledgeable Employee" as defined in Investment Company Act Rule 3c-5, where the capital acquisition broker has provided services permitted under Rule 016(c)(1)(F) and (G) on behalf of an issuer that is a Covered Company as defined in Investment Company Rule 3c-5;

(2) the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of an issuer on behalf of which the capital acquisition broker has provided services permitted under Rule 016(c)(1)(F) and (G); and

(3) any company owned exclusively by knowledgeable employees.

300. SUPERVISION AND RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS

321 Supervision of Associated Persons' Investments

(a) Any capital acquisition broker whose business model creates risks that an associated person of the capital acquisition broker or any related person may misuse material nonpublic information to purchase or sell securities must establish, maintain and enforce written policies and procedures that are reasonably designed to mitigate and prevent such risks.

(b) A capital acquisition broker that is subject to paragraph (a) of this Rule shall also be subject to FINRA Rules 3110(d) and 3210.

(c) Notwithstanding Rule 328, an associated person of a capital acquisition broker and any related person may purchase or sell securities that are not registered under the Securities Act of 1933, provided that the associated person shall provide prior written notice to the capital acquisition broker of any purchase or sale of unregistered securities that are for the benefit of the associated person or any related person.

Supplemental Material:

.01 Definition of "related person." For purposes of this Rule 321, "related person" shall include any of the individuals described in Supplemental Material .02 of FINRA Rule 3210.

500. SECURITIES OFFERINGS

511. Securities as Compensation.

A capital acquisition broker may receive compensation in the form of equity securities of a privately held issuer on behalf of which the capital acquisition broker provided services permitted under paragraphs (c)(1) of Rule 016, provided that the receipt, exercise or subsequent sale of such securities will not cause the capital acquisition broker to engage in any activity prohibited under Rule 016(c)(2).