WILLKIE FARR & GALLAGHER LLP

NEW YORK WASHINGTON HOUSTON PARIS LONDON FRANKFURT BRUSSELS MILAN ROME

CLIENT MEMORANDUM

SEC Approves FINRA Rule Set for Capital Acquisition Brokers

September 23, 2016

AUTHORS

James E. Anderson | Scott A. Arenare | P. Georgia Bullitt | James R. Burns | Martin R. Miller | Christopher S. Petito | Jason R. Rosenthal

The Securities and Exchange Commission (the "SEC") has approved a new set of rules proposed by the Financial Industry Regulatory Authority, Inc. ("FINRA"), that creates a new category of FINRA member broker-dealer ("Capital Acquisition Broker") with a separate, somewhat more streamlined rule set.[1] Firms that qualify as Capital Acquisition Brokers, and choose to be governed as such, will be subject to this more limited set of rules tailored to the business activities of a Capital Acquisition Broker. In proposing these rules, FINRA indicated that "[t]he proposed rule change would reduce the regulatory burden for [Capital Acquisition Brokers] by decreasing the range and scope of current FINRA rules that would be applicable to them given their limited activities and institutional business model."[2]

However, even though Capital Acquisition Brokers are only allowed to engage in a limited range of activities, they will still be subject to many of the more burdensome requirements applicable to other FINRA members.

---

1 *See* Securities Exchange Act Rel. No. 78617 (Aug. 18, 2016), 81 FR 57948 (Aug. 24, 2016) (Order Approving File No. SR-FINRA-2015-054).

2 Securities Exchange Act Rel. No. 76675 (Dec. 17, 2015), 80 FR 79969 (Dec. 23, 2015) (proposing rule change to adopt the Capital Acquisition Broker rules).

Permitted Activities for "Capital Acquisition Brokers"

In proposing the Capital Acquisition Broker Rules, FINRA focused on firms that do not engage in many of the activities traditionally associated with broker-dealers, but that nonetheless may be required to register as broker-dealers due to corporate finance and similar activities involving transactions in securities and their receipt of transaction-based compensation.[3]

FINRA defines a "Capital Acquisition Broker" as any broker that solely engages in one or more enumerated activities,[4] including:

- advising an issuer, including a private fund, regarding its securities offerings or other capital-raising activities;
- advising a company regarding a purchase or sale of a business or assets or regarding a corporate restructuring;
- advising a company in its selection of an investment banker;
- assisting an issuer in the preparation of its offering documents;
- providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;
- qualifying, identifying, soliciting or acting as placement agent or finder (i) for 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[5] in connection with a change of control of a privately-held company.[6] (Notably, Institutional investor" for purposes of the Capital Acquisition Broker Rules also includes any person (including an individual) that meets the definition of "qualified purchaser," as defined in Section 2(a)(51) of the Investment Company Act of 1940. However, the definition would not include "knowledgeable employees" as defined in Rule 3c-5 under the Investment Company

---

3 Compensation based on the amount of securities sold or the success of a securities offering.

4 *See* Capital Acquisition Broker Rule 016(c)(1).

5 For purposes of the rules, a "Control Person" is a person that 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.

6 For purposes of the rules, 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.

Act of 1940, nor investors that merely qualify as "accredited investors" as defined in Regulation D under the Securities Act of 1933) [7]; or

- effecting securities transactions solely in connection with the transfer of ownership or control of a privately-held company through the purchase, sale, exchange, issuance, repurchase or redemption of securities or assets to a buyer that will actively operate the company or the business conducted with the assets, in accordance with SEC guidance that permits a person to do so without having to register as a broker.[8]

Significantly, a broker engaged in any activities other than the permitted activities listed in the Capital Acquisition Broker rules will not be permitted to register as a Capital Acquisition Broker.

Additionally, FINRA provided a list of prohibited activities for any firm that would want to qualify as a Capital Acquisition Broker. A Capital Acquisition Broker may not:

- carry or act as introducing broker for customer accounts;
- hold or handle customer funds or securities;
- accept orders from customers to purchase or sell securities as principal or agent except as expressly permitted in the last two bullet points above;
- have investment discretion on behalf of any customer;
- engage in proprietary trading of securities or market-making activities;
- 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; or
- effect securities transactions that must be reported by the broker or dealer under FINRA Rules 6300 Series, 6400 Series, 6500 Series, 6600 Series, 6700 Series, 7300 Series or 7400 Series.[9]

---

[7] "Institutional investor" also includes (i) a bank, savings and loan association, insurance company or registered investment company, (ii) a governmental entity or subdivision, (iii) employee benefit plan(s) that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and that have at least 100 participants, (iv) qualified plan(s), as defined in Section 3(a)(12)(C) of the Exchange Act that have at least 100 participants, (v) any other person (whether a natural person, corporation, partnership, trust, family office or otherwise) with total assets of at least $50 million, or (vi) any person acting solely on behalf of any such institutional investor. *See* Capital Acquisition Broker Rule 016(i).

[8] *See, e.g.*, M&A Brokers, SEC No-Action Letter (Jan. 31, 2014).

[9] *See* Capital Acquisition Broker Rule 016(c)(2). Those FINRA Rules require reporting of publicly traded securities, including those traded on NASDAQ, NYSE, OTC Equity and OTC Bulletin Board, non-exchange OTC securities, and TRACE reported debt securities.

Further, Capital Acquisition Broker Rule 240 provides that if a Capital Acquisition Broker or its associated person conducts an activity that would require registration as a broker-dealer and is inconsistent with the limitations imposed on Capital Acquisition Brokers, FINRA may enforce all FINRA rules against such Capital Acquisition Broker or associated person, including any rules that would not otherwise be applicable to a Capital Acquisition Broker.

Comparison of Rule Sets

Although Capital Acquisition Brokers are not subject to all of the FINRA rules, the Capital Acquisition Broker rules incorporate a great many of the standard FINRA member rules. For example, a firm applying for treatment as a Capital Acquisition Broker must generally follow the same procedures to apply for membership as any other FINRA applicant.[10]

Significantly, individuals who would act as principals and representatives associated with Capital Acquisition Brokers are subject to the same registration, examination and continuing education requirements that are applicable to other member firms' principals and representatives.[11]

Additionally, a number of the conduct rules applicable to Capital Acquisition Brokers incorporate by reference, or are substantially similar to, the FINRA conduct rules applicable to other member firms, such as obligations to act in accordance with commercial standards and know-your-customer and suitability obligations.[12] However, certain conduct rules applicable to other member firms governing trading securities with or for customers are inapplicable to Capital Acquisition Brokers.[13]

Supervisory rules applicable to Capital Acquisition Brokers are somewhat limited in comparison to the rules applicable to other member firms. Capital Acquisition Broker Rule 311 incorporates by reference certain parts of FINRA Rule 3110,[14]

---

[10] Capital Acquisition Broker Rules 111-115.

[11] Capital Acquisition Broker Rules 121-125.

[12] *See* Capital Acquisition Broker Rules 209, 211; *see also* Capital Acquisition Broker Rules 201, 202, 204, 207 and 208, which make Capital Acquisition Brokers subject to FINRA Rules 2010, 2020, 2040, 2070, 2080 and 2081.

[13] The following FINRA rules applicable to other member firms are inapplicable to Capital Acquisition Brokers: (i) FINRA Rule 2121, which provides that a member buying or selling securities for his own account to a customer must do so at a fair price; (ii) FINRA Rule 2122, which provides that charges for services performed must be reasonable and not unfairly discriminatory; and (iii) FINRA Rule 2124, which provides that member firms must obtain customer consent prior to executing "net" transactions.

[14] Under Rule 311, Capital Acquisition Brokers must, among other things, (i) establish and maintain written procedures, (ii) designate appropriately registered principal(s) to carry out supervisory responsibilities, (iii) designate branch offices and Offices of Supervisory Jurisdiction ("OSJ"), (iv) designate appropriately registered principal(s) in each OSJ and representative(s) or principal(s) in each branch office to carry out supervisory responsibilities at such location, (v) assign each registered person to a supervisor, (vi) review and retain correspondence and internal communications, and (vii) review customer complaints.

but excludes a number of requirements under the rule, such as annual compliance meetings,[15] review and reporting of transactions relating to the firm's investment banking or securities business[16] and prohibitions against supervisors supervising their own activities and having their compensation determined by persons they supervise.[17] Further, Capital Acquisition Brokers are not required to conduct internal inspections of their businesses.[18]

Under Capital Acquisition Broker Rule 313, each Capital Acquisition Broker must designate and identify to FINRA one or more principals serving as chief compliance officer. However, Capital Acquisition Brokers are not subject to the other requirements contained in FINRA Rule 3130, which mandates that each member firm shall have its chief executive officer certify annually that the member firm has in place appropriate compliance policies and written supervisory procedures designed to achieve compliance.

However, Capital Acquisition Broker rules incorporate by reference FINRA Rules 3220 (Influencing or Rewarding Employees of Others), 3240 (Borrowing from or Lending to Customers) and 3270 (Outside Business Activities of Registered Persons). Additionally, associated persons of Capital Acquisition Brokers are prohibited from engaging in most securities transactions outside their regular employment, "private securities transactions" as defined in FINRA Rule 3280, in any manner, where associated persons of other FINRA members are permitted to do so with notice to and approval of their firm under FINRA Rule 3280.[19] Capital Acquisition Brokers also must implement an anti-money laundering program, which is substantially similar to the program detailed in FINRA Rule 3310.

---

15 *See* FINRA Rule 3110(a)(7).

16 *See* FINRA Rule 3110(b)(2) and (d).

17 *See* FINRA Rule 3110(b)(6).

18 *See* FINRA Rule 3110(c). Other member firms must conduct inspections: (i) for each OSJ and branch office that supervises one or more non-branch locations, at least annually; (ii) for each branch office that does not supervise a non-branch location, at least every three years; and (iii) for each non-branch location, on a regular periodic schedule.

19 See Capital Acquisition Broker Rule 328. "Private securities transaction" is defined in FINRA Rule 3280(e) as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of NASD Rule 3050, transactions among immediate family members (as defined in FINRA Rule 5130), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded."

Capital Acquisition Brokers, like other member firms, are subject to audit, books and records and reporting requirements.[20] Capital Acquisition Broker Rule 411 provides that such brokers must comply with certain capital requirements.[21]

A Capital Acquisition Broker is not required to (i) maintain a business continuity plan[22] or (ii) participate in FINRA business continuity and disaster recovery testing.[23]

Conclusion

As outlined above, Capital Acquisition Brokers remain subject to many of the standard FINRA Rules applicable to FINRA members, including registration, testing and continuing education requirements for individuals and many of the supervisory, recordkeeping, reporting and net capital requirements applicable to broker-dealer firms. So firms considering registration as a broker-dealer may in many cases opt for standard FINRA membership rather than Capital Acquisition Broker status in light of the limitations on the types of business they would be permitted to engage in as Capital Acquisition Brokers. The Capital Acquisition Broker rule set had been discussed as potentially providing limited relief for private equity firms that receive transaction-based fees and may be considering broker-dealer registration,[24] though the registration, reporting and oversight requirements, together with the limitations on the methods and types of business allowed, make it unclear how helpful the Capital Acquisition Broker rules would be to such firms in practice.

FINRA is required to issue a Regulatory Notice on the new Capital Acquisition Broker Rule set by October 17, 2016. That Notice must provide for an effective date for the new rules no later than 180 days thereafter.

---

[20] They are subject to less burdensome customer information requirements, which include maintaining each customer's name and residence, whether the customer is of legal age (if applicable), and the names of any persons authorized to transact business on behalf of the customer. *See* Capital Acquisition Broker Rules 414, 451, 452 and 453.

[21] Under Rule 411, (i) a Capital Acquisition Broker must suspend its business operations when it is not in compliance with Exchange Act Rule 15c3-1, (ii) no equity capital of a Capital Acquisition Broker may be withdrawn for a period of one year from the date such equity capital was contributed, (iii) any subordinated loans or notes collateralized by securities must meet specified standards, and (iv) if a Capital Acquisition Broker is a partnership and its general partner enters into any secured or unsecured borrowing, the Capital Acquisition Broker must submit to FINRA such information as would allow FINRA to determine whether such capital qualifies for inclusion in the firm's computation of net capital.

[22] *See* FINRA Rule 4370.

[23] *See* FINRA Rule 4380.

[24] *See* *SEC Enforcement Action Relating to Private Equity Transaction Fees and Broker-Dealer Registration*, Willkie Farr & Gallagher LLP Client Memorandum (June 2, 2016).

If you have any questions regarding this memorandum, please contact James E. Anderson (202-303-1114, janderson@willkie.com), Scott A. Arenare (212-728-8252, sarenare@willkie.com), P. Georgia Bullitt (212-728-8250, gbullitt@willkie.com), James R. Burns (202-303-1241, jburns@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), Christopher S. Petito (202-303-1117, cpetito@willkie.com), Jason R. Rosenthal (212-728-8734, jason.rosenthal@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

September 23, 2016