ALERTS

FINRA Proposes Amendments to CAB Rules

February 14, 2020

On Jan. 30, 2020, FINRA solicited comments on proposed amendments to its CAB Rules designed to expand the activities in which "capital acquisition brokers," or "CABs," may engage, while also proposing additional requirements on CABs intended to increase investor protections.[1] Comments on the proposed rule changes must be received by March 30, 2020.

Background

Broker-dealers that engage in a limited range of activities, including acting as placement agent in sales of unregistered securities to "institutional investors" or providing capital advisory and corporate restructuring services, may elect to be governed by a limited FINRA ruleset (such rules, "CAB Rules," FINRA members that elect to operate under the CAB Rules, "CABs").[2] FINRA's goal in adopting the CAB Rules was to provide regulatory relief to capital acquisition brokers while continuing to provide investor protection.[3] Any firm that meets the definition of capital acquisition broker[4] (whether an existing FINRA member or new applicant) may elect CAB status.

Proposed Amendments

FINRA has proposed amendments to its CAB Rules intended to expand the scope of activities in which CABs may engage (and, relatedly, expanding the number of firms eligible for CAB status). FINRA has also proposed related amendments that would require CABs with business

models that present insider trading risks to adopt policies and procedures designed to mitigate those risks.

Among other things, FINRA's proposed amendments to the CAB Rules would:

- Allow CABs to dually-register as investment advisers, so long as advisory services are provided only to "institutional investors."[5]
- Broaden the definition of "institutional investor" under the CAB Rules to include "knowledgeable employees"[6] of an issuer to which the firm provided CAB services.
- Permit CABs to act as a placement agent in secondary transactions involving unregistered securities of an issuer for which the CAB had previously acted as a placement agent, provided that the purchaser is an "institutional investor" and the new sale qualifies for an exemption from registration under the Securities Act of 1933, as amended ("Securities Act").[7]
- Permit CAB associated persons to invest in unregistered securities, provided they give prior written notice to their CAB.[8]
- Require CABs with business models that create potential insider trading risks to establish, maintain and enforce written policies and procedures reasonably designed to mitigate and prevent those risks, including compliance with the transaction review requirements of FINRA rule 3110(d)[9] and the personal account trading requirements of FINRA rule 3210.[10]

Key Takeaways

FINRA recognizes that the current restrictions on CABs have discouraged a large number of firms that otherwise meet the definition of "capital acquisition broker" from electing to register as CABs.[11] The proposed amendments are designed to address this issue by providing CABs with increased flexibility in their business activities, including by permitting CABs to dually-register as investment advisers and by permitting CABs to engage in certain secondary transactions.

FINRA recognizes that, notwithstanding the foregoing, the proposed rule changes may provide insufficient incentives to firms considering CAB status (whether it be current FINRA members or entities not currently

registered as broker-dealers). As such, FINRA requests comment on whether there are additional activities in which CABs should be permitted to engage, and whether additional incentives would be necessary or appropriate to encourage CAB elections (e.g., further relaxation of the CAB Rules).

Importantly, any comment letter should be careful to assess the impact of any proposed change on investor protections as FINRA may view any requested expansion as requiring additional regulation.[12] Further, while FINRA may amend its CAB Rules, CAB status does not exempt the firm from any federal securities law (e.g., the Securities Act and the Exchange Act), which continue to apply in full to the activities of any broker or dealer (including any CAB).

As noted above, comments on the proposed amendments must be received by March 30, 2020.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *See* FINRA Regulatory Notice 20-04 ("Regulatory Notice 20-04"), available here.

[2] *See* Regulatory Notice 16-37 (October 2016). *See also* Securities Exchange Act Release No. 78617 (Aug. 18, 2016), 81 FR 57948 (Aug. 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).

[3] *See* FINRA Regulatory Notice 16-37.

[4] *See* CAB rule 016(c)(1).

[5] *See* proposed CAB rule 016(c)(1)(I). Note that unlike regular FINRA members, dual-registrants are currently ineligible for CAB status.

[6] "Knowledgeable employees" include senior officers and directors of private funds and their advisers, and would also include persons performing similar functions at other private issuers for which CABs act as placement agents. *See* proposed CAB rule 016(i)(8) and proposed CAB

rule 016(m). *See also* rule 3c-5(a)(4) of the Investment Company Act of 1940, as amended.

[7] *See* proposed CAB rule 016(c)(1)(H). Currently, CABs may only act as placement agents in connection with secondary transactions where the transaction is in connection with the change of control of a privately-held company (*see* CAB rule 016(c)(1)(F)).

[8] *See* proposed CAB rule 321(c).

[9] This rule requires FINRA member 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, as amended ("Exchange Act"), and SEC and FINRA rules prohibiting insider trading in accounts of the firm's associated persons and their immediate family members.

[10] *See* proposed CAB rule 321. FINRA rule 3210 requires associated persons of FINRA member firms to obtain the prior written consent of such member firm 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.

[11] For instance, Regulatory Notice 20-04 notes that while only 55 member firms have elected CAB status since FINRA adopted the CAB Rules in April 2017, approximately 700 member firms that have not elected CAB status have business models that would meet the definition of "capital acquisition broker."

[12] For instance, while the proposed amendments would allow CABs to dually-register as investment advisers, such CABs would need to adopt insider-trading policies and procedures and otherwise comply with FINRA rule 3110(d).

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