

FINRA's Capital Acquisition Broker Rules Face Tough Sell

By Tom Zanki

Law360, New York (September 12, 2016, 8:48 PM EDT) -- Under newly approved Financial Industry Regulatory Authority rules, brokerages that engage in limited activity, such as advising certain private placements or private mergers and acquisitions, can benefit from lighter regulation, but attorneys doubt the relief goes far enough to make a splash.

On Aug. 18, the U.S. Securities and Exchange Commission approved the FINRA rules, which carve a separate category of “capital acquisition brokers,” exempting them from certain, more rigorous requirements that apply to full-fledged broker-dealers. The idea is certain firms that handle a limited scope of activity do not require the same supervision that applies to large brokerages, like Charles Schwab or Fidelity, that manage customer accounts and trade securities.

But attorneys say the relaxation, while an incremental step in the right direction, only alleviates a few requirements in the FINRA rule book while significantly curtailing the range of transactions CABs can advise. Some broker-dealers may not find the tradeoff worthwhile, attorneys say.

“I think there are going to be very few firms that find it useful to opt in to this rule set because it is going to limit their ability to do business in certain areas without a lot of upside,” Latham & Watkins LLP partner Stephen Wink said.

A big sticking point is that CABs who advise private placements are prohibited from soliciting so-called accredited investors, who represent a large constituency of private investors. FINRA’s rules limit CABs to doing business with “institutional investors,” a much narrower segment than accredited investors.

FINRA largely defined institutional investors by using the same criteria that establishes a “qualified purchaser” under the Investment Company Act of 1940, generally meaning natural persons who own at least \$5 million in investments or entities that own \$25 million in investments.

By comparison, accredited investors must only have \$200,000 in annual income, or \$300,000 for a couple, or \$1 million in investments excluding the value of their home. Thus, the FINRA restriction significantly limits the population that CABs can solicit for investment in private funds.

“Had the rules been tweaked a bit to change the definition of institutional investor to include accredited investors, not only qualified purchasers, then I think this would potentially be attractive to a much larger number of broker-dealers,” Day Pitney LLP counsel Eliza Fromberg said.

FINRA resisted such an expansion on grounds that significantly broadening the scope of eligible investors could invite fraud. According to the SEC's order approving the rule change, FINRA said investors with less than \$5 million in investments "may not have the requisite investment acumen to understand or assume the risks associated with investments sold by CABs."

"FINRA's regulatory programs have uncovered significant concerns associated with the ways in which firms sell private placements to accredited investors," the self-regulatory agency said when it unveiled its proposal in December. "Accordingly, FINRA does not believe it is appropriate to lower the institutional investor threshold for the CAB rules to the accredited investor standard."

For a broker-dealer to meet the CAB definition, it has to limit its activities to advising issuers on raising debt and equity capital through private placements with institutional investors, advising private companies on mergers and acquisitions and advising companies on a consulting basis regarding strategic or financial matters, among other things.

Such firms were previously required to register as broker-dealers even though they don't handle many activities normally associated with full-scale brokerages. That can include managing customer accounts, accepting orders to buy or sell securities or engaging in proprietary trading of securities or market-making activities, to name a few.

FINRA has estimated that about 650- to 750-member firms now limit their activities to those permitted for a CAB, or between 16 percent and 19 percent of the agency's member firms. But given the narrow range of activities permitted for a CAB, attorneys say it is not clear that such a percentage will find the designation appealing.

"In terms of the utility of this, we question how many firms are actually going to go this route," Sutherland Asbill & Brennan LLP partner Michael Koffler said. "There is limited value for a firm to go this route as opposed to just being a full-blown broker-dealer."

Firms that qualify as CABs will be relieved of certain mandates in the existing FINRA rule book, including the requirement they conduct annual compliance meetings. CABs will also be subject to streamlined conduct rules and abbreviated communications rules. Certain requirements related to the investigation of securities transactions and increased reporting requirements that apply to FINRA firms that engage in investment banking also won't apply to CABs.

But attorneys note that many exemptions spelled out in the new rules, such as exemption from trade reporting requirements, wouldn't apply to a CAB anyway. At the same time, much of the FINRA rule book remains in place for CABs and full-service broker-dealers.

CABs will still be required to maintain an anti-money laundering program — though the program will be subject to testing every two years rather than annually as is the case for full-service broker dealers. They will also still be subject to the same diligence obligations when conducting private placements and will need to provide audited financial statements and comply with net capital requirements, among other FINRA bylaws and core rules that apply to full-service broker dealers.

"From our view, the things that they cut back are not nearly as important as the things that they maintained," Koffler said.

But attorneys added that FINRA's acknowledgement that a one-size-fits-all policy is not appropriate

given the varied size and structure of broker-dealers is encouraging. It is unlikely that the CAB rules, whose effective date has yet to be announced by FINRA, will make an impact in the near term, they say. But the change could set a precedent that improves regulations in the long run.

“Outside of the Dodd-Frank era, the regulatory world moves at a glacial pace, so it’s disappointing we didn’t get something more usable at this point,” Wink said. “Nonetheless, it’s an incremental step, and it could mean that a next step in a more useful direction is easier to take.”

--Editing by Christine Chun and Kelly Duncan.

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