ROPES & GRAY

ALERT

Asset Management

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New FINRA Capital Acquisition Broker Rule Set May Be of Interest to Private Fund Sponsors

The SEC recently approved a set of FINRA rules for Capital Acquisition Brokers ("CABs"), described as corporate financing firms that generally limit their businesses to advising companies on mergers and acquisitions, advising issuers on raising debt and equity capital in private placements with institutional investors, and providing advisory services on a consulting basis to companies seeking assistance analyzing their strategic and financial alternatives.[1] Under the rule set, CABs are subject to a streamlined set of conduct and compliance rules in recognition of the limited business activities CABs can undertake. The CAB rule set may be of interest to certain private fund sponsors because CABs are authorized to engage in certain types of activity in which some private fund sponsors engage but that the SEC has indicated could require broker-dealer registration. As we have discussed in previous alerts, recent SEC staff comments, as well as SEC settlements with Ranieri Partners in 2013 and Blackstreet Capital Management in 2016, have raised questions about whether certain private fund sponsors should register with the SEC as broker-dealers, either in the Ranieri case because of their fund-raising activities, or in the Blackstreet case because they receive transaction-based compensation in connection with acquisitions and dispositions of their portfolio companies.

Private Placement Activity. CABs may advise a private fund concerning its securities offerings and may engage in qualifying, identifying, soliciting, or acting as placement agent on behalf of an issuer such as a private fund in connection with private placements with "institutional investors," generally defined under the CAB rule set to include certain institutions, any person with total assets of $50 million, and "qualified purchasers" as defined in the Investment Company Act of 1940 (the "1940 Act"). For that reason, a CAB may act as placement agent in offerings of interests in private funds relying on the exception from the definition of "investment company" set forth in Section 3(c)(7) of the 1940 Act and therefore pay transaction-based compensation to its associated persons engaged in that fundraising activity. Institutional investors for this purpose do not include "accredited investors" as defined in Regulation D under the Securities Act of 1933. For that reason, there are limitations on a CAB's ability to act as placement agent for funds that are excepted from the definition of "investment company" under Section 3(c)(1) of the 1940 Act.

In Regulatory Notice 16-37 on the CAB rules, FINRA noted that a CAB could solicit institutional investors to invest in a private fund (such as a 3(c)(1) fund) even if the fund had separately issued interests to non-institutional investors.

[1] The complete definition of "Capital Acquisition Broker" is any broker that solely engages in one or more of the following activities: (i) advising an issuer, including a private fund, concerning its securities offerings or other capital-raising activities; (ii) 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; (iii) advising a company regarding its selection of an investment banker; (iv) assisting in the preparation of offering materials on behalf of an issuer; (v) providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services; (vi) qualifying, identifying, soliciting, or acting as a placement agent or finder on behalf of an issuer in connection with a sale of newly issued (i.e., not secondary market), unregistered securities to "institutional investors" or on behalf of an issuer or control person in connection with a change in control of a privately held company; and (vii) 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 a dealer under the Securities Exchange Act of 1934.

Moreover, in the process of qualifying investors to determine whether they are institutional investors, a CAB may contact and receive information from persons who do not meet that qualification, as long as the CAB does not solicit, offer, act as a placement agent or receive compensation in connection with the sale of interests to non-institutional investors.

M&A and Other Financial Advisory Activity. CABs are authorized to advise a company regarding its purchase or sale of a business or its restructuring, including a going-private transaction, divestiture or merger.[2] Although the scope of permissible CAB activity will doubtless be clarified by FINRA over time and many are hopeful that the SEC eventually will clarify the implications on the private equity industry of the Blackstreet settlement, some private fund sponsors may elect not to wait for any such clarifications and instead register affiliated broker-dealers under the CAB rule set to address concerns arising from the current uncertainty about the receipt of transaction fees in connection with portfolio company acquisitions and dispositions.

CAB Rule Set Compliance Considerations

CABs will be subject to the same SEC rules that apply to all FINRA members, including net capital compliance, preparation of annual audited financial statements, recordkeeping, and SIPC membership. However, the CAB rule set does reduce or eliminate a number of requirements that apply to all other FINRA members.

Notably, the general FINRA prohibition of predictions or projections of investment performance in communications with the public does not apply to CABs, presumably because of the sophistication of the institutional investors CABs are permitted to solicit. To date, placement agents for private funds have struggled with this prohibition, as many institutional investors expect to review the sponsor's projections before making an investment decision.

CABs will also operate under somewhat relaxed FINRA supervision requirements. In particular, principal review of communications and annual internal inspections are not required, and the chief executive officer of a FINRA member operating as a CAB need not certify annually to the effectiveness of the firm's supervisory processes. Moreover, CABs will not be required to hold an annual compliance meeting with associated persons, fidelity bonds and business continuity plans are not required for CABs, and procedures for transaction review and investigation and the supervision of supervisory personnel are not necessary. Anti-money-laundering audits can be conducted every two years rather than annually.

Conclusion

Even under the new CAB rule set, registering and operating a broker-dealer will be a time- and compliance-intensive process. However, for private fund sponsors concerned about the implications of the Ranieri and Blackstreet enforcement actions and the uncertainty surrounding the SEC's current position on these issues, registering an affiliate as a broker-dealer subject to the CAB rule set could be considered alongside other options for reducing risk in this area. And for those private fund sponsors that already have an affiliated broker-dealer, operating as a CAB could reduce the compliance burden somewhat.

The CAB rules generally become effective on April 14, 2017, but FINRA will begin accepting CAB applications from firms that are not broker-dealers, and from FINRA members electing CAB status, on January 3, 2017. Current FINRA members can convert to CAB status using a streamlined process and need not file a New Member Application or a Continuing Membership Application.

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[2] CABs may also provide financial advisory services in connection with a change of control transaction of a private company to a buyer that will actively operate the company in accordance with applicable SEC requirements, such as those set forth in the M&A Brokers no-action letter. Although private fund sponsors may not fit within the SEC's definition of an M&A Broker, and may find it difficult to satisfy some of the conditions in the letter, it is unclear why a firm operating within the confines of the M&A Brokers no-action letter would subject itself to the CAB regime rather than conduct its activities as an unregistered broker, as permitted by the letter. Similarly, some of the other activities permitted to a CAB, such as expert testimony and litigation support, do not require broker-dealer registration.