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Capital Acquisition Brokers: New and Improved

The SEC has approved changes to FINRA's rule book for capital acquisition brokers (CABs)—FINRA member firms that engage in a limited set of activities, including acting as placement agents in connection with sales of unregistered securities to institutional investors and facilitating change of control transactions for privately held companies. The CAB rules, originally adopted in 2016, were designed as right-sized regulation that would reduce the regulatory burdens on corporate financing firms while maintaining investor protections. The latest iteration of the rules, effective March 25, fixes some of the provisions that made the CAB option unattractive to many industry participants. Notably, the changes expand (incrementally) the definition of "institutional investors," broaden the circumstances in which a CAB may participate in a secondary transaction of unregistered securities, permit CABs to act on behalf of institutional investor buyers as well as sellers, allow associated persons of CABs to engage in private securities transactions, and codify a FINRA staff interpretation permitting CABs to receive compensation in the form of securities in certain circumstances.

Will these amendments spur more FINRA member firms to elect CAB status or make CAB registration an attractive option for new registrants, including firms operating as exempt M&A brokers? Back in 2016, we styled our alert on the newly adopted rules as a "back to school" quiz, and we're keeping the Q&A format for this update. A few of the answers have changed since the last time around, so make sure to double-check your work.

Question 1: Are CABs permitted to act as placement agents or finders on behalf of issuers in connection with the sale of newly issued, unregistered securities to investors who qualify as "accredited investors" as defined in Regulation D under the Securities Act of 1933, but do not qualify as "qualified purchasers" as defined in Section 2(a)(51) of the Investment Company Act of 1940?

Answer: No. CABs are limited to facilitating transactions with "institutional investors," as defined under CAB Rule 016(i).[1] While the amendments expand the definition of "institutional investor" to include eligible employees—specified officers, directors, and employees of an issuer (or a person who controls the issuer) for which the CAB has acted as a placement agent or M&A broker—CABs are not permitted to solicit accredited investors who are not eligible employees. Eligible employees are presumed to have the expertise and knowledge of the issuer and the resources to retain counsel and advisors, if necessary, to understand the risks of their investment in their employer's unregistered securities.

Question 2: Are CABs permitted to act as placement agents or finders in connection with secondary transactions involving the purchase or sale of unregistered securities?

Answer: Yes. The amendments permit a CAB to act as a placement agent or finder on behalf of an institutional investor that seeks to sell or buy unregistered securities, provided that (a) both the seller and buyer of such unregistered securities are institutional investors, and (b) the sale qualifies for an exemption from registration under the Securities Act. The ability to facilitate secondaries is a welcome change, especially considering the thriving market for shares of venture-backed private companies.

Question 3: Are associated persons of CABs permitted to engage in private securities transactions away from their firm?

Answer: Yes. The revised rules permit associated persons of CABs to participate in private securities transactions, subject to the same requirements that apply to associated persons of non-CAB broker-dealer firms.[2] This rule change will make CAB registration an option for firms whose associated persons are also acting as investment advisers, supervised persons of investment advisers, or representatives of exempt M&A brokers.[3]

Question 4: Are CABs permitted to engage in a broader range of merger and acquisition transactions than exempt broker-dealers under the M&A Brokers Exemption (Section 15(b)(13) of the Securities Exchange Act of 1934)?

Answer: Yes. The revised rule more closely aligns the CAB rules with the M&A Brokers Exemption; the amendments permit CABs (like exempt M&A brokers) to represent the buyer or the seller, or both, in a transaction involving a change of control of a privately held company, subject to providing clear written disclosure and obtaining written consent from both parties to a joint representation. However, where the M&A Brokers Exemption is available only for transactions involving small business entities (companies that in the fiscal year prior to the engagement of the M&A broker have (a) earnings of less than $25 million before interest, taxes, depreciation, and amortization, and/or (b) gross revenues of less than $250 million), CABs may facilitate change of control transactions for private companies regardless of size.

Question 5: Are CABs permitted to receive securities as compensation for their services?

Answer: Yes. New CAB Rule 511 codifies a FINRA staff interpretation permitting CABs to receive compensation in the form of equity securities of a privately held issuer on behalf of which the CAB provided services. However, the prohibition on engaging in proprietary trading will make it difficult for CABs that receive compensation in the form of issuer options or warrants to sell those restricted securities.

Question 6: Are associated persons of CABs subject to the same registration, qualification, and continuing examination requirements as representatives of non-CAB FINRA member firms?

Answer: Yes. While some commentators have suggested that FINRA create a separate representative or principal category solely for CABs or reduce (or eliminate) continuing education (CE) requirements for CAB personnel, FINRA has stated that as a matter of investor protection and regulatory consistency, its rules should impose substantially similar qualification, registration, and CE requirements on associated persons of both CABs and non-CAB member firms. In responding to comments on the proposed rule changes, FINRA noted that it is important for associated persons of CABs to maintain their CE to ensure that the individuals are current on applicable securities laws and to ease their transition should they choose to work for a non-CAB broker-dealer.

The latest amendments to the CAB rule book eliminate many of the limitations that previously deterred would-be CABs from selecting this registration option. Has your score on our quiz improved since the last go-round? If the answers are to your liking, maybe the time is right to explore CAB registration.

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[1] The amended rule defines “institutional investor” as any (1) bank, savings and loan association, insurance company or registered investment company; (2) governmental entity or subdivision thereof; (3) employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but not including any participant of such plans; (4) qualified plan, as defined in Section 3(a)(12)(C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but not including any participant of such plans; (5) other person (whether a natural person, corporation, partnership, trust, family office or otherwise) with total assets of at least $50 million; (6) person meeting the definition of “qualified purchaser” as that term is defined in Section 2(a)(51) of the Investment Company Act; (7) person acting solely on behalf of any such institutional investor; and (8) eligible employee.

[2] FINRA Rule 3280 imposes certain notice, approval, and supervision requirements where an associated person of a FINRA member firm seeks to participate in a private securities transaction.

[3] If FINRA's proposed Rule 3290 is approved as filed, FINRA members, including CABs, would no longer be required under FINRA rules to approve, supervise, or maintain records of associated persons' outside investment advisory activity conducted through unaffiliated investment advisers (and affiliated investment adviser activity would be excluded), although the firm would still receive notice and conduct an up-front assessment and could impose conditions.

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