

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-77391; File No. SR-FINRA-2015-054)

March 17, 2016

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change to Adopt FINRA Capital Acquisition Broker Rules

I. Introduction

On October 9, 2015, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt rules for capital acquisition brokers (collectively, the “CAB Rules”). The proposed rule change was published for comment in the Federal Register on December 23, 2015.³ The Commission received seventeen comment letters on the proposed rule change.⁴ On December 9, 2015, FINRA extended the time period for Commission action on this proposed rule change until March 22, 2016.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Exchange Act Release No. 76675 (Dec. 23, 2015), 80 FR 79969 (“Notice”).

⁴ See letters from Peter W. LaVigne, Esq., Chair, Securities Regulation Committee, Business Law Section, New York State Bar Association dated January 22, 2016 (“New York State Bar Association Letter”); Judith M. Shaw, President, North American Securities Administrators Association (“NASAA”), and Maine Securities Administrator, Washington, District of Columbia dated January 15, 2016 (“NASAA Letter”); Michael S. Quinn, Member and CCO, Q Advisors dated January 13, 2016 (“Q Advisors Letter”); Howard Spindel, Senior Managing Director, and Cassandra E. Joseph, Managing Director, Integrated Management Solutions USA LLC dated January 13, 2016 (“IMS Letter”); Lisa Roth, President, Monahan & Roth, LLC dated January 13, 2016 (“Roth Letter”); Mark Fairbanks, President, Foreside Distributors dated January 13, 2016 (“Foreside Letter”); Arne Rovell, Coronado Investments, LLC dated January 6, 2016 (“Coronado Letter”); Daniel H. Kolber, President/CEO, Intellivest Securities, Inc. dated December 30, 2015 (“Intellivest Letter”); Roger W. Mehle, Washington, District of Columbia dated December 29, 2015 (“Mehle Letter”); Donna B. DiMaria, Chairman of the Board of Directors, and Lisa Roth, Board of Directors, Third Party Marketers Association dated January 12, 2016 (“3PM Letter”) (letters supporting the 3PM letter: Sajjan K. Thomas, President, and Stephen J. Myott, Chief Compliance Officer, Thomas Capital Group, Inc. dated January 13, 2016; Richard A. Murphy, North Bridge Capital LLC, Boston, Massachusetts dated January 13, 2016; Steven Jafarzadeh, CAIA, CCO, Stonehaven, New York dated January 13, 2016;

The Commission is publishing this order to solicit comments on the proposed rule change and to institute proceedings pursuant to Exchange Act Section 19(b)(2)(B)⁵ to determine whether to approve or disapprove the proposed rule change.

Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to the proposed rule change, nor does it mean that the Commission will ultimately disapprove the proposed rule change. Rather, as discussed below, the Commission seeks additional input on the proposed rule change and issues presented by the proposal.

II. Description of the Proposed Rule Change⁶

FINRA is proposing to create a separate rule set that would apply to firms that meet the definition of “capital acquisition broker” (“CAB”) and elect to be governed under this rule set. FINRA states that there are firms that are solely corporate financing firms that advise companies on mergers and acquisitions, advise issuers on raising debt and equity capital in private placements with institutional investors, or provide advisory services on a consulting basis to companies that need assistance analyzing their strategic and financial alternatives. These firms often are registered as broker-dealers because of their activities and because they may receive transaction-based compensation as part of their services.

Nevertheless, FINRA believes that these firms do not engage in many of the types of activities typically associated with traditional broker-dealers. For example, these firms typically do not carry or act as an introducing broker with respect to customer accounts, handle customer

Dan Glusker, Perkins Fund Marketing LLC dated January 13, 2016; Ron Oldenkamp, President, Genesis Marketing Group dated January 13, 2016; Timothy Cahill, President, Compass Securities Corporation dated January 13, 2016; Frank P. L. Minard, Managing Partner, XT Capital Partners, LLC dated January 12, 2016).

⁵ 15 U.S.C. 78s(b)(2)(B).

⁶ The proposed rule change, as described in this Item II, is excerpted, in part, from the Notice, which was substantially prepared by FINRA. See supra note 3.

funds or securities, accept orders to purchase or sell securities either as principal or agent for the customer, exercise investment discretion on behalf of any customer, or engage in proprietary trading of securities or market-making activities.

FINRA is proposing to establish a separate rule set that would apply exclusively to firms that meet the definition of “capital acquisition broker” and that elect to be governed under this rule set. CABs would be subject to the FINRA By-Laws, as well as core FINRA rules that FINRA believes should apply to all firms. The rule set would also include other FINRA rules that are tailored to address CABs’ business activities. A brief description of the proposed rule set for CABs is contained below.

A. General Standards

Proposed CAB Rule 014 provides that all persons that have been approved for membership in FINRA as a CAB and persons associated with CABs shall be subject to the Capital Acquisition Broker rules and the FINRA By-Laws (including the schedules thereto), unless the context requires otherwise. Proposed CAB Rule 015 provides that FINRA Rule 0150(b) shall apply to the CAB rules. FINRA Rule 0150(b) provides that the FINRA rules do not apply to transactions in, and business activities relating to, municipal securities as that term is defined in the Exchange Act.

CAB Rule 016 sets forth basic definitions modified as appropriate to apply to CABs. The proposed definitions of “capital acquisition broker” and “institutional investor” are particularly important to the application of the rule set. The term “capital acquisition broker” would mean any broker that solely engages in any one or more of the following activities:

- advising an issuer, including a private fund, concerning its securities offerings or other capital raising activities;

- 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;
- advising a company regarding its selection of an investment banker;
- assisting in the preparation of offering materials on behalf of an issuer;
- providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;
- qualifying, identifying, soliciting, or acting as a placement agent or finder with respect to institutional investors in connection with purchases or sales of unregistered securities; and
- 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 dealer pursuant to Section 15(b) of the Exchange Act.⁷

A firm would be permitted to register as, or change its status to, a CAB only if the firm solely engages in one or more of these activities.

The term “capital acquisition broker” would not include any broker or dealer that:

- carries or acts as an introducing broker with respect to customer accounts;

⁷ See proposed CAB Rule 016(c)(1).

- holds or handles customers' funds or securities;
- accepts orders from customers to purchase or sell securities either as principal or as agent for the customer (except as permitted by paragraphs (c)(1)(F) and (G) of CAB Rule 016);
- has investment discretion on behalf of any customer;
- engages in proprietary trading of securities or market-making activities; or
- participates in or maintains an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding or Regulation A under the Securities Act of 1933.⁸

The term “institutional investor” would have the same meaning as that term has under FINRA Rule 2210 (Communications with the Public), with one exception. The term would include any:

- bank, savings and loan association, insurance company or registered investment company;
- governmental entity or subdivision thereof;
- 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 does not include any participant of such plans;
- 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 does not include any participant of such plans;

⁸ See proposed CAB Rule 016(c)(2).

- other person (whether a natural person, corporation, partnership, trust, family office or otherwise) with total assets of at least \$50 million; and
- person acting solely on behalf of any such institutional investor.

The definition also would include any person meeting the definition of “qualified purchaser” as that term is defined in Section 2(a)(51) of the Investment Company Act of 1940.⁹

B. FINRA Membership

The proposed CAB Rule 100 Series sets forth the requirements for firms that wish to register as a CAB. The proposed CAB Rule 100 Series generally incorporates by reference FINRA Rules 1010 (Electronic Filing Requirements for Uniform Forms), and 1122 (Filing of Misleading Information as to Membership or Registration), and NASD Rules 1011 (Definitions), 1012 (General Provisions), 1013 (New Member Application and Interview), 1014 (Department Decision), 1015 (Review by National Adjudicatory Council), 1016 (Discretionary Review by FINRA Board), 1017 (Application for Approval of Change in Ownership, Control, or Business Operations), 1019 (Application to Commission for Review), 1090 (Foreign Members), 1100 (Foreign Associates) and IM-1011-1 (Safe Harbor for Business Expansions). Accordingly, a CAB applicant would follow the same procedures for membership as any other FINRA applicant, with four modifications.

- First, an applicant for membership that seeks to qualify as a CAB would have to state in its application that it intends to operate solely as such.
- Second, in reviewing an application for membership as a CAB, the FINRA Member Regulation Department would consider, in addition to the standards for admission set forth in NASD Rule 1014, whether the applicant’s proposed activities are consistent

⁹ See proposed CAB Rule 016(i). FINRA Rule 2210 does not include “qualified purchaser” within its definition of “institutional investor.”

with the limitations imposed on CABs under CAB Rule 016(c).

- Third, proposed CAB Rule 116(b) sets forth the procedures for an existing FINRA firm to change its status to a CAB. If an existing firm is already approved to engage in the activities of a CAB, and the firm does not intend to change its existing ownership, control or business operations, it would not be required to file either a New Member Application (“NMA”) or a Change in Membership Application (“CMA”). Instead, such a firm would be required to file a request to amend its membership agreement or obtain a membership agreement (if none exists currently) to provide that: (i) the firm’s activities will be limited to those permitted for CABs under CAB Rule 016(c), and (ii) the firm agrees to comply with the CAB rules.¹⁰
- Fourth, proposed CAB Rules 116(c) and (d) set forth the procedures for an existing CAB to terminate its status as such and continue as a FINRA firm. Under Rule 116(c), such a firm would be required to file a CMA with the FINRA Member Regulation Department, and to amend its membership agreement to provide that the firm agrees to comply with all FINRA rules.¹¹

Under Rule 116(d), however, if during the first year following an existing FINRA member firm’s amendment to its membership agreement to convert a full-service broker-dealer to a CAB pursuant to Rule 116(b) a CAB seeks to terminate its status as such and continue as a FINRA member firm, the CAB may notify the FINRA Membership Application Program group of this change without having to file an application for approval of a material change in business operations pursuant to NASD Rule 1017. The CAB would instead file a request to amend its

¹⁰ There would not be an application fee associated with this request.

¹¹ Absent a waiver, such a firm would have to pay an application fee associated with the CMA. See FINRA By-Laws, Schedule A, Section 4(i).

membership agreement to provide that the member firm agrees to comply with all FINRA rules, and execute an amended membership agreement that imposes the same limitations on the member firm's activities that existed prior to the member firm's change of status to a CAB.¹²

The proposed CAB Rule 100 Series also would govern the registration and qualification examinations of principals and representatives that are associated with CABs. These Rules incorporate by reference NASD Rules 1021 (Registration Requirements – Principals), 1022 (Categories of Principal Registration), 1031 (Registration Requirements – Representatives), 1032 (Categories of Representative Registration), 1060 (Persons Exempt from Registration), 1070 (Qualification Examinations and Waiver of Requirements), 1080 (Confidentiality of Examinations), IM-1000-2 (Status of Persons Serving in the Armed Forces of the United States), IM-1000-3 (Failure to Register Personnel) and FINRA Rule 1250 (Continuing Education Requirements). Accordingly, CAB firm principals and representatives would be subject to the same registration, qualification examination, and continuing education requirements as principals and representatives of other FINRA firms. CABs also would be subject to FINRA Rule 1230(b)(6) regarding Operations Professional registration.

C. Duties and Conflicts (CAB Rule 200 Series)

The proposed CAB Rule 200 Series would establish a streamlined set of conduct rules. CABs would be subject to FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices), 2040 (Payments to Unregistered Persons),¹³ 2070 (Transactions Involving FINRA Employees), 2080 (Obtaining

¹² To the extent that the rules applicable to the member firm had been amended since it had changed its status to a CAB, FINRA would have the discretion to modify any limitations to reflect any new rule requirements.

¹³ The SEC has approved FINRA's rule change to adopt rules relating to payments to unregistered persons for the consolidated FINRA rulebook. See Regulatory Notice 15-07 (March 2015). FINRA Rule 2040 became effective on August 24, 2015.

an Order of Expungement of Customer Dispute Information from the CRD System), 2081 (Prohibited Conditions Relating to Expungement of Customer Dispute Information), 2263 (Arbitration Disclosure to Associated Persons Signing or Acknowledging Form U4), and 2268 (Requirements When Using Predispute Arbitration Agreements for Customer Accounts).

CAB Rules 209 and 211 would impose know-your-customer and suitability obligations similar to those imposed under FINRA Rules 2090 and 2111. CAB Rule 211(b) includes an exception to the customer-specific suitability obligations for institutional investors similar to the exception found in FINRA Rule 2111(b).

Proposed CAB Rule 221 is an abbreviated version of FINRA Rule 2210 (Communications with the Public), essentially prohibiting false and misleading statements.

Under proposed CAB Rule 240, if a CAB or associated person of a CAB had engaged in activities that would require the CAB to register as a broker or dealer under the Exchange Act, and that are inconsistent with the limitations imposed on CABs under CAB Rule 016(c), FINRA could examine for and enforce all FINRA rules against such a broker or associated person, including any rule that applies to a FINRA broker-dealer that is not a CAB or to an associated person who is not a person associated with a CAB.

FINRA has determined not to subject CABs to FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed), and 2124 (Net Transactions with Customers), since CABs' business model does not raise the same concerns that Rules 2121, 2122 and 2124 are intended to address.

Rule 2121 provides that, for securities in both listed and unlisted securities, a member that buys for its own account from its customer, or sells for its own account to its customer, shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including

market conditions with respect to the security at the time of the transaction, the expense involved, and the fact that the member is entitled to a profit. Further, if the member acts as agent for its customer in any such transaction, the member shall not charge its customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to the security at the time of the transaction, the expense of executing the order and the value of any service the member may have rendered by reason of its experience in and knowledge of such security and the market therefor.

CABs would not be permitted to act as a principal in a securities transaction.

Accordingly, the provisions of Rule 2121 that govern principal transactions would not apply to a CAB's permitted activities.

CABs would be permitted act as agent in a securities transaction only in very narrow circumstances. CABs would be allowed to act as an agent with respect to institutional investors in connection with purchases or sales of unregistered securities. CABs also would be permitted to effect securities transactions solely in connection with the transfer of ownership and control of a privately-held 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.

In both instances, FINRA believes that these circumstances either involve institutional parties that negotiate the terms of permitted securities transactions without the need for the conditions set forth in Rule 2121, or involve the sale of a business as a going concern, which differs in nature from the types of transactions that typically raise issues under Rule 2121.

Rule 2122 provides that charges, if any, for services performed, including, but not limited to, miscellaneous services such as collections due for principal, dividends, or interest; exchange

or transfer of securities; appraisals, safekeeping or custody of securities, and other services shall be reasonable and not unfairly discriminatory among customers. As discussed above, CABs typically provide services to institutional customers that generally do not need the protections that Rule 2122 offers, since these customers are capable of negotiating fair prices for the services that CABs provide. Moreover, CABs are not permitted to provide many of the services listed in Rule 2122, such as collecting principal, dividends or interest, or providing safekeeping or custody services.

Rule 2124 sets forth specific requirements for executing transactions with customers on a “net” basis. “Net” transactions are defined as a type of principal transaction, and CABs may not trade securities on a principal basis. For these reasons, FINRA does not believe it is necessary to include FINRA Rules 2121, 2122 and 2124 as part of the CAB rule set.

CAB Rule 201 would subject CABs to FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), which requires a member, in the conduct of its business, to observe high standards of commercial honor and just and equitable principles of trade. Depending on the facts, other rules, such as Rule 2010, may apply in situations in which a CAB charged a commission or fee that clearly is unreasonable under the circumstances.

D. Supervision and Responsibilities Related to Associated Persons (CAB Rule 300 Series)

The proposed CAB Rule 300 Series would establish a limited set of supervisory rules for CABs. CABs would be subject to FINRA Rules 3220 (Influencing or Rewarding Employees of Others), 3240 (Borrowing from or Lending to Customers), and 3270 (Outside Business Activities of Registered Persons).

Proposed CAB Rule 311 would subject CABs to some, but not all, of the requirements of FINRA Rule 3110 (Supervision) and, consistent with Rule 3110, is designed to provide CABs with the flexibility to tailor their supervisory systems to their business models. CABs would be subject to many of the provisions of Rule 3110 concerning the supervision of offices, personnel, customer complaints, correspondence and internal communications. However, CABs would not be subject to the provisions of Rule 3110 that require annual compliance meetings (paragraph (a)(7)), review and investigation of transactions (paragraphs (b)(2) and (d)), specific documentation and supervisory procedures for supervisory personnel (paragraph (b)(6)), and internal inspections (paragraph (c)).

FINRA does not believe that the annual compliance meeting requirement in FINRA Rule 3110(a)(7) should apply to CABs given the nature of CABs' business model and structure. FINRA has observed that most current FINRA member firms that would qualify as CABs tend to be small and often operate out of a single office. In addition, the range of rules that CABs would be subject to is narrower than the rules that apply to other broker-dealers. Moreover, as noted above, CABs would be subject to both the Regulatory and Firm Element continuing education requirements. Accordingly, FINRA does not believe that CABs need to conduct an annual compliance meeting as required under FINRA Rule 3110(a)(7).¹⁴ The fact that the annual compliance meeting requirement would not apply to CABs or their associated persons in no way would reduce their responsibility to have knowledge of and comply with applicable securities laws and regulations and the CAB rule set.

FINRA does not believe that FINRA Rule 3110(b)(2), which requires members to adopt and implement procedures for the review by a registered principal of all transactions relating to

¹⁴ For the same reasons, FINRA does not believe that FINRA Rule 3110.04 should apply to CABs.

the member's investment banking or securities business, or FINRA Rule 3110(d), which imposes requirements related to the investigation of securities transactions and heightened reporting requirements for members engaged in investment banking services, should apply to CABs. CABs would not be permitted to carry or act as an introducing broker with respect to customer accounts, hold or handle customers' funds or securities, accept orders from customers to purchase or sell securities except under the narrow circumstances discussed above, have investment discretion on behalf of any customer, engage in proprietary trading or market-making activities, or participate in Crowdfunding or Regulation A securities offerings. Accordingly, due to these restrictions, FINRA does not believe a CAB's business model necessitates the application of these provisions, which primarily address trading and investment banking functions that are beyond the permissible scope of a CAB's activities.¹⁵

FINRA does not believe that the requirements of FINRA Rule 3110(b)(6) should apply to CABs. Paragraph (b)(6) generally requires a member to have procedures to prohibit its supervisory personnel from (1) supervising their own activities; and (2) reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising.¹⁶ FINRA also does not believe that FINRA Rule 3110(c), which requires members to conduct internal inspections of their businesses, should apply to CABs.

¹⁵ For the same reasons, FINRA does not believe that FINRA Rule 3110.05 should apply to CABs.

¹⁶ FINRA Rule 3110(b)(6)(C)(i) and (ii). FINRA Rule 3110(b)(6) also requires that a member's supervisory procedures include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and FINRA rules, as well as a record of the names of its designated supervisory personnel and the dates for which such designation is or was effective. FINRA Rule 3110(b)(6)(A) and (B). In addition, paragraph (b)(6) requires a member to have procedures reasonably designed to prevent the standards of supervision required pursuant to FINRA Rule 3110(a) from being compromised due to the conflicts of interest that may be present with respect to an associated person being supervised. FINRA Rule 3110(b)(6)(D).

FINRA believes that a CAB's business model, which is geared toward acting as a consultant in capital acquisition transactions, or acting as an agent solely in connection with purchases or sales of unregistered securities to institutional investors, or with the transfer of ownership and control of a privately-held company, does not give rise to the same conflicts of interest and supervisory concerns that paragraph (b)(6) is intended to address. As discussed above, many CABs operate out of a single office with a small staff, which reduces the need for internal inspections of numerous or remote offices. In addition, part of the purpose of creating a separate CAB rule set is to streamline and reduce existing FINRA rule requirements where it does not hinder investor protection. FINRA believes that the remaining provisions of FINRA Rule 3110, coupled with the CAB Rule 200 Series addressing duties and conflicts, will sufficiently protect CABs' customers from potential harm due to insufficient supervision.¹⁷

Proposed CAB Rule 313 would require CABs to designate and identify one or more principals to serve as a firm's chief compliance officer, similar to the requirements of FINRA Rule 3130(a). CAB Rule 313 would not require a CAB to have its chief executive officer ("CEO") certify that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable federal securities laws and regulations, and FINRA and MSRB rules, which are required under FINRA Rules 3130(b) and (c). FINRA does not believe the CEO certification is necessary given a CAB's narrow business model and smaller rule set.

¹⁷ For the same reasons, FINRA does not believe that FINRA Rules 3110.10, .12, .13, or .14 should apply to CABs. FINRA also believes that it is unnecessary to apply FINRA Rule 3110.15 to CABs, since the temporary program authorized by the rule expired on December 1, 2015.

Proposed Rule 328 would prohibit any person associated with a CAB from participating in any manner in a private securities transaction as defined in FINRA Rule 3280(e).¹⁸ FINRA does not believe that an associated person of a CAB should be engaged in selling securities away from the CAB, nor should a CAB have to oversee and review such transactions, given its limited business model. This restriction would not prohibit associated persons from investing in securities on their own behalf, or engaging in securities transactions with immediate family members, provided that the associated person does not receive selling compensation.

Proposed CAB Rule 331 would require each CAB to implement a written anti-money laundering (“AML”) program. This is consistent with the SEC’s requirements and Chapter X of Title 31 of the Code of Federal Regulations. Accordingly, the proposed rule is similar to FINRA Rule 3310 (Anti-Money Laundering Compliance Program); however, the proposed rule contemplates that all CABs would be eligible to conduct the required independent testing for compliance every two years.

E. Financial and Operational Rules (CAB Rule 400 Series)

The proposed CAB Rule 400 Series would establish a streamlined set of rules concerning firms’ financial and operational obligations. CABs would be subject to FINRA Rules 4140 (Audit), 4150 (Guarantees by, or Flow through Benefits for, Members), 4160 (Verification of Assets), 4511 (Books and Records – General Requirements), 4513 (Records of Written Customer Complaints), 4517 (Member Filing and Contact Information Requirements), 4524 (Supplemental

¹⁸ FINRA Rule 3280(e) defines “private securities transaction” 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.”

FOCUS Information), 4530 (Reporting Requirements), and 4570 (Custodian of Books and Records).

Proposed CAB Rule 411 includes some, but not all, of the capital compliance requirements of FINRA Rule 4110. CABs would be required to suspend business operations during any period a firm is not in compliance with the applicable net capital requirements set forth in Exchange Act Rule 15c3-1, and the rule also would authorize FINRA to direct a CAB to suspend its operation under those circumstances. Proposed CAB Rule 411 also sets forth requirements concerning withdrawal of capital, subordinated loans, notes collateralized by securities, and capital borrowings.

CABs would not be subject to FINRA Rules 4370 (Business Continuity Plans and Emergency Contact Information) or 4380 (Mandatory Participation in FINRA BC/DR Testing Under Regulation SCI). FINRA does not believe it would be necessary for a CAB to maintain a business continuity plan (BCP), given a CAB's limited activities, particularly since a CAB would not engage in retail customer account transactions or clearance, settlement, trading, underwriting or similar investment banking activities. Moreover, FINRA Rule 4380 relates to Rule SCI under the Exchange Act, which is not applicable to a member that limits its activities to those permitted under the CAB rule set.

Because CABs would not carry or act as an introducing broker with respect to customer accounts, they would have more limited customer information requirements than is imposed under FINRA Rule 4512.¹⁹ CABs would have to maintain each customer's name and residence, whether the customer is of legal age (if applicable), and the names of any persons authorized to

¹⁹ See proposed CAB Rule 451(b).

transact business on behalf of the customer. CABs would still have to make and preserve all books and records required under Exchange Act Rules 17a-3 and 17a-4.

CAB Rule 452(a) establishes a limited set of requirements for the supervision and review of a firm's general ledger accounts.

F. Securities Offerings (CAB Rule 500 Series)

The proposed CAB Rule 500 Series would subject CABs to certain rules concerning securities offerings. CABs would be subject to FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5150 (Fairness Opinions).

G. Investigations and Sanctions, Code of Procedure, and Arbitration and Mediation (CAB Rules 800, 900 and 1000)

CABs would be subject to the FINRA Rule 8000 Series governing investigations and sanctions of firms, other than FINRA Rules 8110 (Availability of Manual to Customers), 8211 (Automated Submission of Trading Data Requested by FINRA), and 8213 (Automated Submission of Trading Data for Non-Exchange-Listed Securities Requested by FINRA).

CABs would not be subject to FINRA Rule 8110 (Availability of Manual to Customers), which requires members to make available a current copy of the FINRA manual for examination by customers upon request. If the Commission approves this proposed rule change, the CAB rule set would be available through the FINRA website. Accordingly, FINRA does not believe this rule is necessary for CABs.

CABs also would not be subject to FINRA Rules 8211 (Automated Submission of Trading Data Requested by FINRA) or 8213 (Automated Submission of Trading Data for Non-Exchange-Listed Securities Requested by FINRA). Given that these rules are intended to assist

FINRA in requesting trade data from firms engaged in securities trading, and that CABs would not engage in securities trading, FINRA does not believe that these rules should apply to CABs.

CABs would be subject to the FINRA Rule 9000 Series governing disciplinary and other proceedings involving firms, other than the FINRA Rule 9700 Series (Procedures on Grievances Concerning the Automated Systems). Proposed CAB Rule 900(c) would provide that any CAB may be subject to a fine under FINRA Rule 9216(b) with respect to an enumerated list of FINRA By-Laws, CAB rules and SEC rules under the Exchange Act. Proposed CAB Rule 900(d) would authorize FINRA staff to require a CAB to file communications with the FINRA Advertising Regulation Department at least ten days prior to use if the staff determined that the CAB had departed from CAB Rule 221's standards.

CABs would be subject to the FINRA Rule 12000 Series (Code of Arbitration Procedure for Customer Disputes), 13000 Series (Code of Arbitration Procedure for Industry Disputes) and 14000 Series (Code of Mediation Procedure).

III. Summary of Comments

Commenters generally supported FINRA's proposal to develop a new rule set for CABs. As discussed below, some commenters recommended that the proposal include additional requirements or explanations in certain aspects.

A. Review of Membership Application

One commenter suggested that FINRA should approve the membership applications of new CABs within 60 days of the filing of the application, provided that certain conditions are met, including: a completed application; the required supervisory principals, who have each

taken and passed the applicable examinations; and no significant disciplinary history or other red flag indications of potential compliance problems.²⁰

B. Registration and Licensing

Two commenters requested that FINRA confirm that CABs may hold all licenses previously sought and attained by their associated persons, including Series 53, 4 and other licenses.²¹ One of these commenters also suggested that CABs should not be subject to FINRA Rule 1230(b)(6)²² regarding Operations Professional registration because of the scope and nature of the examination.²³ The other commenter suggested that FINRA should exempt CAB Chief Compliance Officers (“CCOs”) from the proposed requirement to obtain and maintain the Series 14 CCO license because of the broad and comprehensive scope of the proposed license.²⁴ This commenter also sought clarification as to whether a CAB’s responsibility under Rule 209²⁵ is limited to learning the essential facts of the agent.²⁶

²⁰ See New York State Bar Association Letter. NASD Rule 1014 permits up to a 180 day review period absent an extension.

²¹ See 3PM and M&R Letters.

²² Rule 1230 requires that each of the following persons be registered with FINRA as an Operations Professional: (i) senior management with direct responsibility over the covered functions under the Rule; (ii) any person designated by senior management under the Rule as a supervisor, manager or other person responsible for approving or authorizing work, including work of other persons, in direct furtherance of each of the covered functions in the Rule, as applicable, provided that there is sufficient designation of such persons by senior management to address each of the applicable covered functions; and (iii) persons with the authority or discretion materially to commit a member’s capital in direct furtherance of the covered functions in the Rule or to commit a member to any material contract or agreement (written or oral) in direct furtherance of the covered functions in the Rule.

²³ See 3PM Letter.

²⁴ See M&R Letter.

²⁵ Proposed Rule 209 states that every capital acquisition broker shall use reasonable diligence to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer. For purposes of this Rule, facts “essential” to “knowing the customer” are those required to (a) effectively service the customer, (b) understand the authority of each person acting on behalf of the customer, and (c) comply with applicable laws, regulations and rules.

²⁶ See M&R Letter.

C. Registered Representative Exams

One commenter suggested that FINRA (outside of the rulemaking context) establish new examinations specifically for the registered representatives and supervisory principals of CABs that will test only that subject matter relevant to the business of CABs.²⁷

D. Prohibition on Private Securities Transactions

One commenter suggested that proposed Rule 328 (Prohibition on Private Securities Transactions)²⁸ should be revised to exclude: (1) the investment advisory activities of associated persons who are also employees or supervised persons of an investment adviser registered with the SEC or a state, and (2) employees of a bank or trust company engaged in securities or advisory activities that a bank may engage in pursuant to the exceptions from the definition of broker or dealer in Exchange Act Sections 3(a)(4) or (5) of Regulation R.²⁹

Another commenter believes that FINRA's proposed CAB rule set unduly prohibits sales of private placements to accredited investors and therefore vitiates any usefulness or appeal of the CAB rules to certain firms.³⁰

E. Secondary Transactions

As discussed above, the definition of CAB in proposed Rule 016(c) includes, among the permissible activities of a CAB, "qualifying, identifying, soliciting, or acting as a placement agent or finder with respect to institutional investors in connection with purchases or sales of unregistered securities." One commenter interpreted that description as including both primary

²⁷ See New York State Bar Association Letter.

²⁸ Proposed Rule 328 would prohibit persons associated with a CAB from participating in any manner in a private securities transaction as defined in FINRA Rule 3280(e).

²⁹ See New York State Bar Association Letter.

³⁰ See Mehle Letter.

issuances and secondary transaction in unregistered securities and requested that FINRA confirm the intent to include secondary transactions among the permitted activities of a CAB.³¹

F. Grace Period for Reverses CAB Registration

One commenter states although a CAB firm has a year to decide if it wants to become a registered broker-dealer, it is not convinced that this one-year grace period is a sufficient amount of time for a firm to determine if CAB status is appropriate for its business model.³² The commenter states that a converted firm may not have sufficient data within the first year to evaluate its decision fully and recommends that this grace period be extended to at least 24 months or that there be no grace time restrictions at all.³³ This commenter suggested that FINRA allow interim continued operations as a CAB (provided the firm is in regulatory compliance) while an active CMA is being reviewed by FINRA, with the firm remaining subject to all the CAB strictures pending a final decision by FINRA on the CMA.³⁴

G. Impermissible Activities

One commenter recommended that FINRA consider a grace period for firms that unintentionally conduct activities beyond the scope of a CAB's permissible activities.³⁵

H. CAB Rule Suggested Changes

Several commenters suggested various changes to FINRA's proposed CAB rules. The significant suggested changes are described below.

³¹ See New York State Bar Association Letter.

³² Id.

³³ Id.

³⁴ Id.

³⁵ See 3PM Letter.

1. Institutional Investor Definition

One comment suggested that FINRA consider lowering the threshold for institutional investor preferably to \$5 million or even less.³⁶ This commenter also suggested that many broker-dealers would otherwise qualify as a CAB except that sometimes investors investing in clients' offerings may have less than \$50 million in assets but are otherwise sophisticated, knowledgeable and advised by competent attorneys.³⁷

In addition to institutional investors, one commenter suggested that FINRA permit CAB transactions with certain other categories of persons, specifically: (1) a "knowledgeable employee" as defined in Investment Company Act Rule 3C-5, except that for purposes of the institutional investor definition, "covered company" would mean either the CAB or the issuer of the securities sold in the transaction; and (2) a person designated by the issuer of the securities sold in the transaction, provided that the CAB did not solicit the person or make a recommendation to the person with respect to purchase of the securities.³⁸

This commenter also stated that there may be circumstances where the issuer wishes to sell securities to persons who would not otherwise qualify as institutional investors, but wants the transaction to be effected by the CAB.³⁹ In addition, the commenter believes that CAB rules should not prohibit sales to those categories of persons, since the usual concerns about suitability

³⁶ See Intellivest Letter.

³⁷ Id.

³⁸ New York State Bar Association Letter. See also Coronado Letter (requesting a de minimis and/or knowledgeable employee exemption to allow for one-off capital-raises (under various scenarios where accredited individuals working at alternative investment firms and the funds they manage or other closely affiliated individuals desire to invest) without violating the proposed CAB rules).

³⁹ New York State Bar Association Letter.

determinations and content of communications by member firms to retail investors would not apply.⁴⁰

2. Know Your Customer

One commenter requested clarification of FINRA’s statement that “[i]t also recognizes that a CAB or its associated person may look to an institutional investor’s agent if the investor is represented by an agent.”⁴¹ Specifically, clarification as to what “look to” requires and whether this can be interpreted to mean that a CAB’s responsibility under Rule 209 is limited to learning the essential facts of the agent.⁴²

3. Suitability

One commenter generally agreed with Rule 211 (Suitability), but believes that the rule as proposed fails by requiring the suitability analyses to be performed before any recommendation is made.⁴³ The commenter believes that the rule does not recognize that the process of diligence is ongoing, in many cases can take several months to several years before an investment decision is made, and often does not, and should not conclude until the deal is closed. The commenter also believes that Rule 211 should emphasize this point and encourage registered representatives to periodically review their suitability analysis throughout the offering process, but no less

⁴⁰ Id.

⁴¹ See 3PM Letter.

⁴² Id.

⁴³ Id. Rule 211 states that a capital acquisition broker or an associated person of a capital acquisition broker must have a reasonable basis to believe that a recommended transaction or investment strategy (as defined in FINRA Rule 2111) involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the broker or associated person to ascertain the customer’s investment profile.

frequently than once before the subscription agreement or relevant contract is signed and due diligence is as complete as it can be at that particular time.⁴⁴

One commenter stated that CABs are not making recommendations in the traditional definition of the term, and therefore, as an example, will not have insight into the overall composition of the institutional investor's portfolio – as a retail broker would have over one of their accounts.⁴⁵ Accordingly, this commenter suggested that the rules should address some type of minimum compliance that would be appropriate in these situations. Further, the commenter suggested that a demonstrable best efforts basis may be a satisfactory alternative in such instances.⁴⁶

4. Commissions/Fees

One commenter stated that applying Rule 2010 (Standards of Commercial Honor and Principles of Trade) in situations in which a CAB charged a commission or fee that clearly is unreasonable under the circumstances may create an interpretive issue between the two sets of rules.⁴⁷

5. Supervisory Procedures

One commenter stated that requirements related to supervisory procedures for supervisors should not be required for CABs.⁴⁸ This commenter also recommended that FINRA clarify its

⁴⁴ 3PM Letter.

⁴⁵ Id.

⁴⁶ Id.

⁴⁷ IMS Letter.

⁴⁸ Foreside Letter.

expectations with respect to email review.⁴⁹ Specifically, the commenter suggested that the rules should note that expectations for email review should be tailored according to the CAB's business and that such expectations would not be as stringent as those for broker-dealers engaged in non-CAB activities.⁵⁰

6. Cybersecurity

One commenter recommended that FINRA clarify the expectations with respect to cybersecurity.⁵¹ Specifically, while the proposal suggests that a CAB not be required to have a business continuity plan, the commenter suggested that the final rules include a requirement to have appropriate cybersecurity/information security programs in place, tailored to the CAB's business.⁵²

I. Rules Beyond FINRA's CAB Rules

1. SIPC

One commenter stated that the CAB designation should be added to the list of exempt entities contained in the SIPC rules (although the commenter understands that FINRA is not in a position to alter the current SIPC requirement).⁵³

2. Net Capital

One commenter expressed concern that FINRA will force existing FINRA members and new applicants who now or will operate as so-called "nickel BDs" to become CABs, if for no

⁴⁹ Id.

⁵⁰ Id.

⁵¹ Id.

⁵² Id.

⁵³ Q Advisors Letter.

other reason than to vindicate FINRA's questionable statistics of eligible firms.⁵⁴ This commenter also disagreed with the fact that although CABs may nominally advise an issuer of private funds on its capital raising efforts, FINRA's customer limitations for CABs only allow them to contact institutional investors.

One commenter objected to what it believes is FINRA's failure to change or in any way modify the net capital, recordkeeping and reporting requirements applicable to CABs.⁵⁵ This commenter stated that compliance with the Financial Responsibility and Net Capital rules remains the same for both CABs and FINRA-registered BDs, and that there is no relief from the annual audit requirement, which, in light of auditors having to comply with onerous PCAOB and SEC rules, has become a significant expense to all FINRA member firms regardless of size.⁵⁶

Similarly, one commenter stated that the FINRA proposal should address the capital requirements, which appear to be unnecessary based on the business model of CABs and also address the requirement for a PCAOB audit in light of the streamlined rule set seems wholly out of line, excessive and meaningless to investor protections.⁵⁷

One commenter suggested that proposed CAB Rule 411⁵⁸ should remove the minimum net capital requirement of \$5,000 currently applied to CAB members.⁵⁹ While the commenter understood that this is outside of FINRA's authority, the commenter urged the SEC to review the

⁵⁴ IMS Letter.

⁵⁵ Id.

⁵⁶ Id.

⁵⁷ See M&R Letter.

⁵⁸ Rule 411 states that unless otherwise permitted by FINRA, a capital acquisition broker must suspend all business operations during any period in which it is not in compliance with applicable net capital requirements set forth in Exchange Act Rule 15c3-1.

⁵⁹ See 3PM Letter.

calculation of net capital for CABs and modify the rule so that the nature of a CAB's business does not cause it to have to improperly report its financial condition to FINRA.⁶⁰

3. Audit

One commenter believed FINRA should eliminate the audit requirement altogether for broker-dealers that never hold securities or cash belonging to others.⁶¹ Another commenter also suggested that FINRA has not made any effort to have the SEC change Rule 17a-5 to exclude CABs from the annual audit requirement, or to require a review instead of an audit.⁶²

Another commenter suggested that annual compliance meetings and annual inspections should not be required for CABs.⁶³

4. Anti-Money Laundering

One commenter requests that the SEC work with the appropriate authorities to revisit the AML responsibilities of CABs and consider requiring U.S. registered entities, such as registered investment advisers, to share certain data with FINRA member firms so that all registered participants may satisfy their respective compliance obligations in the most complete and accurate manner possible.⁶⁴ In addition, this commenter sought the SEC's confirmation that the terms and conditions of the no-action letters initially dated 2004 and extended by subsequent no-

⁶⁰ Id.

⁶¹ See IMS Letter.

⁶² See Mehle Letter.

⁶³ See Foreside Letter.

⁶⁴ See 3PM Letter.

action letter in January 2015 apply to CABs to the extent that customer identification is reasonable performed by a federally regulated entity under a contractual obligation.⁶⁵

5. Form Custody

One commenter urged FINRA to make efforts to have the SEC eliminate the quarterly “Form Custody” FOCUS report for CABs.⁶⁶

J. State Regulation

One commenter suggested that the Commission, FINRA, and NASAA should cooperate to more fully analyze the interaction between the CAB proposal and state registration requirements to better harmonize the application of these provisions.⁶⁷ This commenter suggested that the most relevant provisions to it are the proposal’s inclusion of firms that effect 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 dealer pursuant to Section 15(b) of the Exchange Act.⁶⁸

The commenter indicated that it would welcome the opportunity to work with FINRA and the Commission on the issues presented by the proposal, and encouraged the Commission to

⁶⁵ Id.

⁶⁶ Mehle Letter.

⁶⁷ NASAA Letter.

⁶⁸ Id.

delay approval of the proposal until there has been an opportunity to more fully explore these issues.⁶⁹

IV. Proceedings to Determine Whether to Approve or Disapprove SR-FINRA-2015-054 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Exchange Act Section 19(b)(2)(B) to determine whether the proposed rule change should be approved or disapproved.⁷⁰ Institution of proceedings appears appropriate at this time in view of the legal and policy issues raised by the proposal. As noted above, institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, the Commission seeks and encourages interested persons to comment on the issues presented by the proposed rule change and provide the Commission with arguments to support the Commission's analysis as to whether to approve or disapprove the proposal.

Pursuant to Exchange Act Section 19(b)(2)(B),⁷¹ the Commission is providing notice of the grounds for disapproval under consideration. In particular, Exchange Act Section 15A(b)(6)⁷² requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. In addition, Exchange Act Section

⁶⁹ Id.

⁷⁰ 15 U.S.C. 78s(b)(2). Exchange Act Section 19(b)(2)(B) provides that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. The time for conclusion of the proceedings may be extended for up to an additional 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding or if the self-regulatory organization consents to the extension.

⁷¹ 15 U.S.C. 78s(b)(2)(B).

⁷² 15 U.S.C. 78q-3(b)(6).

15A(b)(9)⁷³ requires that FINRA rules not impose any unnecessary or inappropriate burden on competition.

The Commission believes FINRA's proposed rule change raises questions as to whether it is consistent with the requirements of Exchange Act Sections 15A(b)(6) and 15A(b)(9).

V. Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues raised by the proposed rule change. In particular, the Commission invites the written views of interested persons on whether the proposed rule change is inconsistent with Sections 15A(b)(6) and 15A(b)(9), or any other provision, of the Exchange Act, or the rules and regulations thereunder.

Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.⁷⁴

Interested persons are invited to submit written data, views, and arguments by [insert date 21 days from publication in the Federal Register] concerning whether the proposed rule change should be approved or disapproved. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 45 days from publication in the Federal Register]. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

⁷³ 15 U.S.C. 78o-3(b)(9).

⁷⁴ Exchange Act Section 19(b)(2), as amended by the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2015-02 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2015-054. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principle office of FINRA. All comments received will be posted without change. The Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

All submissions should refer to File Number SR-FINRA-2015-054 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. If comments are received, any rebuttal comments should be submitted by [insert date 45 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁷⁵

Robert W. Errett
Deputy Secretary

⁷⁵ 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(57).