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FINRA PROPOSES LIGHTER REGULATORY REGIME FOR LIMITED CORPORATE FINANCING BROKERS

I. Introduction.

The Financial Industry Regulatory Authority ("FINRA") recently issued a Regulatory Notice[1] (the "Notice") requesting comment on a Proposed Rule Set for "Limited Corporate Financing Brokers" ("LCFBs"). (The comment period expires on April 28, 2014.) This Alert provides an overview of the Rule Set and its merits.

The Rule Set would provide a somewhat lighter regulatory regime for LCFBs, defined as a broker that solely engages in one or more of the following activities (collectively, "LCFB Activities"):

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

2. 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;

3. advising a company regarding its selection of an investment banker;

4. assisting in the preparation of offering materials on behalf of an issuer;

5. providing fairness opinions; and

6. qualifying, identifying or soliciting potential institutional investors.

Of equal importance to the scope of LCFB Activities is the scope of the activities that would not be permitted (collectively, "Prohibited LCFB Activities"). The term LCFB would *not* include any broker or dealer that:

1. carries or maintains customer accounts;

2. holds or handles customers' funds or securities;

3. accepts orders from customers to purchase or sell securities either as principal or as agent for the customer;

4. possesses investment discretion on behalf of any customer; or

5. engages in proprietary trading of securities or market-making activities.

There are two primary aspects of the Rule Set that must be considered in assessing whether registering as a LCFB might be sufficiently beneficial to justify the regulatory burdens.

First, as regards the potential benefits, one must consider whether the scope of LCFB Activities is sufficiently broad to capture the financing activities of brokers that do not engage in Prohibited LCFB Activities, and whether the scope of Prohibited LCFB Activities is overly broad. Second, as regards the regulatory burdens, one must consider both the regulatory and commercial risks of engaging in LCFB Activities without being registered and whether the Rule Set provides appropriate relief from the regulatory scheme that otherwise would be applicable to a registered corporate financing broker.

Based upon this analysis, as discussed below, we conclude that the Rule Set represents a significant step forward in providing regulatory relief to limited corporate financing brokers, particularly those who source financing for their clients from institutional investors, but the scope of the proposed relief is limited and falls far short of that long sought by limited purpose and private placement brokers.

II. The Scope of LCFB Activities.

FINRA requests comment, among other issues, on the following: "Does the proposed rule set appropriately accommodate the scope of LCFB business models? If not, what other accommodations are necessary and how would customers be protected?" Another issue is:

> Is the definition of "limited corporate financing broker" appropriate? Are there any activities in which broker-dealers with limited corporate financing functions typically engage that are not included in the definition? Are there activities that should be added to the list of activities in which an LCFB may not engage?

If the scope of LCFB Activities is clarified, as suggested below, then the scope of Prohibited LCFB Activities would not appear to be overly broad.

A. Advisory Activities *vs*. Active Engagement in Transactions.

We note that the enumerated LCFB Activities, generally, focus on advice or assistance to a client directly, but do not explicitly address the active involvement of a broker with others, such as arranging a transaction, facilitating the negotiation of the terms of a transaction, and assistance in the consummation of a transaction. For the avoidance of doubt, we suggest that these activities be explicitly included in the definition of LCFB Activities because they often raise concerns that an entity is acting as a broker.[2]

B. Investment Banking Activities of the Manager, or an Affiliate, of Private Equity Funds.

The managing member or general partner of a private equity fund, organized as a limited liability company or limited partnership, or an affiliate, often provides services to the fund in connection with the acquisition or disposition (including an initial public

offering) of a portfolio company or a recapitalization of the portfolio company. The Staff of the Securities and Exchange Commission ("SEC") has raised concerns that such activities could require the entity providing such services to be registered as a broker-dealer if it is separately compensated therefor, particularly if "the fees are described as compensating the private fund adviser or its affiliates or personnel for 'investment banking activities,' including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions."[3]

It would be helpful, for the avoidance of doubt, for such investment banking activities to be explicitly included in the definition of LCFB Activities.

C. Acting as a "Finder;" the Definition of "Institutional Investor."

Also, of particular concern is the scope of relief proposed for a "finder" of potential "institutional investors" (although the word "finder" is not used in the rule proposal), *i.e.*, "qualifying, identifying or soliciting potential institutional investors." The benefit of this proposed relief is tempered by the narrow definition of "institutional investor" and accompanying commentary of FINRA:

> An LCFB would not be permitted to qualify, identify or solicit potential purchasers of securities unless the purchaser meets the definition of "institutional investor." However, an LCFB would be allowed to serve clients (such as individuals or entities seeking advice on securities offerings or sales of businesses) who do not meet the "institutional investor" definition.
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> The term [institutional investor] would include any:
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> - 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;

- other person (whether a natural person, corporation, partnership, trust, family office or otherwise) with total assets of at least $50 million; and
- any person acting solely on behalf of any such institutional investor.[4]

FINRA discouraged proposals to expand the definition of "institutional investor" by stating that it "purposely does not propose to define 'institutional investor' based on a more inclusive standard, such as the definition of 'accredited investor' in Regulation D under the Securities Act of 1933."[5]

In this context FINRA also emphasized its ongoing concern with the sale of private placements to accredited investors by stating:

> FINRA's regulatory programs have uncovered serious concerns with the manner in which firms market and sell private placements to accredited investors. Application of the LCFB Rules to firms that market and sell private placements to accredited investors would require FINRA to expand the applicable conduct rules and other provisions. Therefore, lowering the threshold of "institutional investor" would eviscerate the benefits of a streamlined rule set.[6]

These proposed limitations on the regulatory relief provided LCFBs significantly detract from the benefits of the Rule Set. The fact that FINRA has "uncovered serious concerns with the manner in which firms market and sell private placements to accredited investors," of course, must be addressed. We suggest, however, that these concerns could be reconciled with expanding the scope of "institutional investor" by employing one or both of the following mechanisms. First, the scope of the definition of "institutional investor" might be expanded to include a person (whether a natural person, corporation, partnership, trust, family office or otherwise) who must satisfy a higher financial standard than that of an "accredited investor," as defined in Rule 501 under the Securities Act of 1933, such as a "qualified purchaser," as defined in the Investment Company Act of 1940.[7] Second, an entity might be prohibited from soliciting transactions with "accredited investors," unless it satisfies higher regulatory standards than otherwise would be applicable, for example, that it has no recent disciplinary history

III. The Regulation of LCFB Activities.

A. The Existing Regulatory Framework.

1. Securities Exchange Act of 1934.

Historically, the SEC has regarded transaction-based compensation as a "red flag" indicia of broker-dealer status. As stated in the Notice, brokers that

perform financing activities often receive such compensation for their services and for that reason often are registered as broker-dealers with the SEC.[8] The Rule Set would not relieve a LCFB from the obligation to register, but would only provide regulatory relief from some of the requirements that otherwise would be imposed.

In this regard, the regulatory relief provided by the Rule Set would be dramatically less than that provided to "M&A Brokers" pursuant to the recent no-action letter (the "M&A Broker Letter") issued by the Staff of the SEC,[9] *i.e.*, a M&A Broker is not required to register with the SEC. However, the scope of the M&A Broker Letter is much narrower than the Rule Set because a M&A Broker is defined as a broker that satisfies ten requirements, including that: "[t]he buyer, or group of buyers, in any M&A Transaction will, upon completion of the M&A Transaction, control and actively operate the company or the business conducted with the assets of the business." For these purposes, a "M&A Transaction" is a merger, acquisition, business sale or business combination between a seller and buyer of a privately-held company. Accordingly, although a M&A Transaction might encompass a broad range of LCFB Activities, the control requirement significantly limits the reach of the M&A Broker Letter to limited corporate financing brokers.

The Notice appropriately poses the question whether it is "likely that some limited corporate financing firms will not register as a broker consistent with the fact pattern set forth in the [M&A Broker Letter], or will they register as an LCFB?" Based upon our analysis of the Rule Set and the M&A Broker Letter, at the federal level, the answer clearly is that an entity that can come within the scope of the M&A Broker Letter would elect to do so. However, the relief provided by the M&A Broker Letter would not apply to states, districts or territories and the impact of their regulatory requirements on a broker not registered with the SEC must be carefully considered.

2. State Laws.

Although the Exchange Act does not categorically preempt state, district or territory regulation of broker-dealers that are registered with the SEC, Section 15(i)(1) of the Exchange Act provides that no "law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish [requirements with respect to a broad range of matters] for brokers [or] dealers] that differ from, or are in addition to, the requirements in those areas established under the Exchange Act."[10] Consequently, each state has its own requirements for the registration of broker-dealers that conduct a securities business there and, absent an exemption from registration, a broker-dealer must register in each state in which it intends to conduct business. The result of this patchwork regulatory scheme is that the registration process in most states for a

SEC registered broker involves only the submission of Form BD to the state and the payment of a fee.

Accordingly, an entity that is not registered as a broker with the SEC (such as one relying on the M&A Broker Letter) must carefully consider the extent to which its activities in any state in which it has a place of business or in which it has clients are regulated across the entire regulatory spectrum.

3. Regulatory and Commercial Risks of Non-Registration.

If a person is required to register as a broker-dealer, and fails to do so while having active participation in a transaction coupled with transaction-based compensation, the transaction may be void.

Section 29(b) of the Exchange Act provides that:

> Every contract made in violation of any provision of this title or any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of [the Exchange Act] or any rule or regulation thereunder, shall be void: . . . as regards the rights of any persons who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract.[11]

State laws also may provide relief to persons who have engaged in transactions with an unregistered broker-dealer. For example, Section 25501.5(a)(1) of the California Corporation Code provides that a person who purchases a security from or sells a security to a broker-dealer that is required to be licensed, but is not in violation of California law, may bring an action for rescission of the sale or purchase or, if the plaintiff or the defendant no longer owns the security, for damages.

These provisions illustrate that aside from the regulatory risk that the SEC or a state regulator might bring an action against an unregistered entity acting as a broker-dealer in violation of federal or state law, a client of, or a counterparty in a transaction with, such entity might have a claim for rescission or damages.

B. The Rule Set's Regulatory Requirements.

A detailed analysis of the comprehensive regulatory regime that would be applicable to a LCFB is beyond the scope of this Alert, but the following general observations are noteworthy. The relief provided by the Rule Set is quite limited in that, among other things, it would not eliminate: (i) most exam and continuing education requirements for principals and

representatives that are associated with a LCFB; (ii) the net capital requirements for registered broker-dealers; (iii) most books and records requirements; and (iv) the application of a broad range of conduct rules, as summarized below.

1. Registration and Training of Principals and Representatives.

Under the Rule Set, the registration and examination requirements for LCFBs would be the same as for other registered broker-dealers, except that LCFB associated persons would be eligible for fewer categories of permissible activities, regarded as most directly relevant to LCFB Activities.[12]

As regards education and training requirements, the only requirements that would be eliminated are the Regulatory Element of the Continuing Education requirement and the annual compliance meeting.[13] The Regulatory Element requires all registered individuals to visit a FINRA vendor's testing center and complete a computer-based training program within 120 days of the second anniversary of their registration approval dates and every three years thereafter. However, LCFBs would remain subject to the Firm Element Continuing Education requirement (the "Firm Element"). The Firm Element requires broker-dealers to establish a formal training program to keep covered registered persons up-to-date on job and product related subjects. In planning, developing and implementing the Firm Element, each broker-dealer must consider its size, structure, scope of business and regulatory concerns.[14]

2. Net Capital Requirements.

The Notice is not specific, but states that LCFBs would be subject to some, but not all, of the SEC net capital rules and some, but not all, of the Financial & Operational Requirements.[15]

3. Books and Records.

LCFBs would be subject to the same SEC and FINRA books and records rules, including the email retention requirement, as other registered broker-dealers.[16]

4. Anti-Money Laundering.

The Anti-Money Laundering ("AML") requirements for LCFBs would be the same as for other registered broker-dealers, except that independent testing of the AML program could be conducted every other year instead of annually.[17]

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5. Supervision, Know-Your-Customer, Suitability and Communications with the Public.

The Notice simply states that the Rule Set would establish a "streamlined" set of conduct rules regarding these subjects.[18]

6. Other Requirements.

The Rule Set would not provide regulatory relief from many other requirements applicable to a registered broker-dealer, such as: (i) the requirement to file FOCUS reports and satisfy other financial reporting requirements;[19] and (ii) compliance with conduct rules, *e.g.*, regarding (a) gifts and entertainment[20] and (b) outside business activities of associated persons.[21]

IV. Concluding Observations.

The Rule Set is a significant step forward in that it could lessen the regulatory risks of, and burdens on, brokers providing corporate financing services and would facilitate capital raising by a broad range of issuers, including private funds. The benefits of the Rule Set could be significantly enhanced, however, by: (i) clarifying that its scope encompasses the full range of corporate financing activities engaged in by corporate financing and private placement brokers; (ii) expanding the types of investors that could be solicited; and (iii) lessening the regulatory burdens on qualified brokers, without sacrificing customer protections.

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Please do not hesitate to contact the author or your Orrick relationship partner with any questions that may arise.

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[1] FINRA Regulatory Notice 14-09, http://www.finra.org/Industry/Regulation/Notices/2014/P449587

[2] *See* SEC Guide to Broker-Dealer Registration http://www.sec.gov/divisions/marketreg/bdguide.htm

[3] "A Few Observations in the Private Fund Space," David W. Blass Chief Counsel, Division of Trading and Markets U.S. Securities and Exchange Commission, American Bar Association, Trading and Markets Subcommittee, Washington, D.C., April 5, 2013
http://www.sec.gov/News/Speech/Detail/Speech/1365171515178

[4] Notice at Endnote 3.

[5] The Notice at Endnote 3 further states that:

> LCFB Rules are intended to govern the activities of firms that engage in a limited range of activities, such as advising companies and private equity funds on capital raising and corporate restructuring. As part of these activities, an LCFB would be permitted to qualify, identify and solicit potential institutional investors, as defined by the LCFB Rules.

"Accredited investor," as most relevant to this discussion, is defined in Rule 501(a) under the Securities Act of 1933 as follows:

> Accredited investor shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:
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> . . .
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> (3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;
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> . . .
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> (5) Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000.
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> (i) Except as provided in paragraph (a)(5)(ii) of this section, for purposes of calculating net worth under this paragraph (a)(5):
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> (A) The person's primary residence shall not be included as an asset;
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> (B) Indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and
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> (C) Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability;
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> . . .
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> (6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
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> (7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in §230.506(b)(2)(ii); and
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> (8) Any entity in which all of the equity owners are accredited investors.

[6] Endnote 4, *supra*.

[7] "Qualified purchaser," as most relevant to this discussion, is defined in Section 2(a)(51) of the Investment Company Act of 1940 as follows:

> (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;
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> (ii)any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;
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> (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or
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> (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

[8] *See* SEC Guide to Broker-Dealer Registration http://www.sec.gov/divisions/marketreg/bdguide.htm

[9] Staff no-action letter issued to Faith Colish, *et al*., dated January 31, 2014. http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf

The conditions of the relief granted are that:

1. The M&A Broker will not have the ability to bind a party to an M&A Transaction.
2. An M&A Broker will not directly, or indirectly through any of its affiliates, provide financing for an M&A Transaction. An M&A Broker that assists purchasers to obtain financing from unaffiliated third parties must comply with all applicable legal requirements, and must disclose any compensation in writing to the client.
3. Under no circumstances will an M&A Broker have custody, control, or possession of or otherwise handle funds or securities issued or exchanged in connection with an M&A Transaction or other securities transaction for the account of others.
4. No M&A Transaction will involve a public offering. Any offering or sale of securities will be conducted in compliance with an applicable exemption from registration under the Securities Act of 1933. No party to any M&A Transaction will be a shell company, other than a business combination related shell company.
5. To the extent an M&A Broker represents both buyers and sellers, it will provide clear written disclosure as to the parties it represents and obtain written consent from both parties to the joint representation.
6. An M&A Broker will facilitate an M&A Transaction with a group of buyers only if the group is formed without the assistance of the M&A Broker.
7. The buyer, or group of buyers, in any M&A Transaction will, upon completion of the M&A Transaction, control and actively operate the company or the business conducted with the assets of the business. A buyer, or group of buyers collectively, would have the necessary control if it has the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. The necessary control will be presumed to exist if, upon completion of the transaction, the buyer or group of buyers has the right to vote 25% or more of a class of voting securities; has the power to sell or direct the sale of 25% or more of a class of voting securities; or in the case of a

partnership or limited liability company, has the right to receive upon dissolution or has contributed 25% or more of the capital. In addition, the buyer, or group of buyers, must actively operate the company or the business conducted with the assets of the company.

8. No M&A Transaction will result in the transfer of interests to a passive buyer or group of passive buyers.

9. Any securities received by the buyer or M&A Broker in an M&A Transaction will be restricted securities within the meaning of Rule 144(a)(3) under the Securities Act of 1933 because the securities would have been issued in a transaction not involving a public offering.

10. The M&A Broker (and, if the M&A Broker is an entity, each officer, director or employee of the M&A Broker): (i) has not been barred from association with a broker dealer by the Commission, any state or any self-regulatory organization; and (ii) is not suspended from association with a broker-dealer.

[10] Section 15(i)(1) of the Securities Exchange Act of 1934 provides that:

> No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, governmental securities brokers, or governmental securities dealers that differ from, or are in addition to, the requirements in those areas established under this title. The [SEC] shall consult periodically the securities commission (or any agency or office performing like functions) of the States concerning the adequacy of such requirements as established under [Exchange Act].

[11] As stated in the "Report and Recommendations of the Task Force on Private Placement Broker-Dealers," The Business Lawyer; Vol 60, 2005, at 959, Section 29(b) of the Securities Exchange Act of 1934:

> suggests that in any civil litigation an unregistered agent acting on behalf of the issuer will be compelled to return their commissions, fees and expenses; and that the issuer may justifiably refuse to pay commissions, fees and expenses at closing or recoup them at a later time.
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> It also raises the question of whether the issuer can be compelled to repay these funds to an investor, since the unregistered broker-dealer is acting on behalf of the issuer.
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> The investor may also be entitled to return of his or her investment, since the purchase contract between the issuer and the investor is a contract which is part of an illegal arrangement with the unregistered financial intermediary, and that intermediary is engaged in the offer and sale of the security to the investor. The language to Section 29(b) is broad enough to permit such an interpretation.

[12] Notice at 4.

[13] FINRA Rule 3010.

[14] Each broker-dealer also must administer its Firm Element Continuing Education Program in accordance with its annual Needs Analysis and Written Training Plan, and must maintain records documenting the content of the program and completion of the program. *See* Notice at 6 and FINRA Rule 1250.

[15] Notice at 7.

[16] Notice at 7.

[17] Notice at 6.

[18] Notice at 6.

[19] FINRA Rule 4530, Securities Exchange Act of 1934 Rule 17a-5.

[20] FINRA Rule 3220.

[21] FINRA Rule 3270.