New York State Bar Association
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Comments on FINRA Regulatory Notice 20-04 -- Proposed Amendments to the Capital Acquisition Broker (CAB) Rules

BUSINESS LAW SECTION
SECURITIES REGULATION COMMITTEE

BLS #6 June 30, 2020

The Committee on Securities Regulation (the "Committee") of the Business Law Section of the New York State Bar Association appreciates the opportunity to comment on the above-referenced FINRA Regulatory Notice 20-04 ("Regulatory Notice 20-04") which proposes amendments to FINRA's Capital Acquisition Broker Rules (the "CAB Rules").

The Committee is composed of members of the New York bar, including lawyers in private practice and in corporation law departments, a principal part of whose practice is securities regulation. Members of the Committee have reviewed a draft of this letter and the views expressed herein are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

The Committee commends the efforts of FINRA to improve the regulations governing capital acquisition brokers ("CABs") and to broaden the permissible activities of CABs. This letter covers the proposed areas for revision, in the order discussed in Regulatory Notice 20-04.

Investment Adviser Activities

The Committee strongly supports FINRA's proposal to allow CABs to register as investment advisers. This change will benefit CABs whose advisory services to companies contemplating a purchase or sale of securities or issuers who may request advice concerning the investment of offering proceeds may require registration as an investment adviser. It will also benefit CABs that wish to offer expanded services to existing institutional clients.

Additionally, this permission to become a dual registrant allows for enhanced oversight from another regulator. As a registered investment adviser, a CAB would also be subject to a compliance protocol that is appropriate for regulated entities that advise institutional investors. We support, as well, the proposal that a CAB's advisory activities be limited to those performed for institutional investors, which aligns with the CAB's securities-related activities.

The proposed revisions do not fully address one issue specifically mentioned in the Notice, however:

> Moreover, associated persons of CABs may not participate in private securities transactions (PSTs), which include the forwarding of orders from investment adviser clients to a third-party broker-dealer for execution.

Associated persons of CABs may be dual registered with an investment adviser affiliated with the CAB, i.e., an entity other than the CAB itself. Rule 328, the prohibition on all private securities transactions, would still prohibit those employees from forwarding orders from clients of the affiliated investment adviser to third-party broker-dealers for execution. As we stated in our January 22, 2016 comment letter to the SEC addressing the original CAB rule proposal (SR-FINRA-2015-054)("2016 Comment Letter"):

> Rule 328 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) or Regulation R.

While we would urge FINRA to permit that activity with respect to all clients of the investment adviser, including a bank or trust company, at a minimum the activity should be permitted with respect to institutional clients as defined in the CAB rules.

Institutional Investor Definition

The Committee supports the expansion of the Institutional Investor Definition to include knowledgeable employees to align with "knowledgeable employees" within Rule 3c-5 under the Investment Company Act of 1940 ("Investment Company Act") in respect of investments in funds sponsored by their employers. Many CABs permit the investment personnel involved in offerings to invest their personal money in the same private investments offered to clients. It is a common industry practice also for hedge fund and private equity senior officers and directors to invest in the private placements in which they are involved. Those persons would generally be deemed knowledgeable employees with reasonable measures of financial sophistication, possess financial industry training and education, and typically hold securities licenses and other professional accreditation.

Secondary Transactions

The Committee supports the expansion of the ability of a CAB to act as a placement agent for secondary trades of unregistered securities if (i) the CAB had previously acted as placement agent for such securities; (ii) the purchaser of such securities is an institutional investor; and (iii) the new sale falls within a Securities Act of 1933 ("Securities Act") exemption from registration. As we noted in the 2016 Comment Letter:

> In the recently adopted FAST Act, Congress recognized the importance of the accessibility of the secondary market in the securities of startup companies. In Title LXXVI, "Reforming Access for Investments in Startup Enterprises," Congress added a new exemption, Section 4(a)(7), for secondary sales to accredited investors. This exemption, together with Rules 144 and 144A, makes it easier for holders of unregistered companies, including current and former employees and investors in early rounds, to find buyers for their securities at reasonable prices.

The SEC spoke to this theme in the recent Concept Release on Harmonization of Securities Offering Exemptions (Release No. 33-10649, Jun. 18, 2019):

> Section II of this release has focused on the framework of exemptions available for primary offerings by an issuer. Secondary market liquidity for investors in these issuers is integral to capital formation in the primary offering market. While restricted and otherwise illiquid securities can yield a more stable shareholder base with less investor turnover, small businesses report struggling to attract capital in their primary offerings because potential investors are reluctant to invest unless they are confident there will be an exit opportunity. Those issuers that are able to attract investors may incur a higher cost of capital or bear an illiquidity discount if the securities lack secondary market liquidity. In addition, limited secondary market liquidity and a lack of an active trading market may impair investors' ability to diversify their portfolios over time because their capital may be locked up longer than they would like. In turn, an investor's inability to divest prior investments due to illiquidity may prevent the investor from reallocating capital to the next investment opportunity, thereby limiting the capital available to the next business. (Text at footnotes 591-595; footnotes omitted.)

While we appreciate that the revisions with respect to secondary transactions represent a major improvement, we believe that CABs should not be restricted to secondary transactions in securities of an issuer for which the CAB has previously acted as placement agent with respect to those securities. It is possible that institutional clients of the CAB will own unregistered securities of issuers for which the CAB has not acted as placement agent, and that the CAB may have another institutional client willing to buy those securities. So long as the CAB is only acting in secondary transactions in unregistered securities for institutional clients, regardless of whether the CAB has previously acted as placement agent for the issuer, the benefits described in the SEC Concept Release can be achieved without increased regulatory risks.

Compensation

The Committee supports FINRA's proposed Rule 511, which codifies FINRA's recently issued staff interpretation allowing receipt by a CAB of securities as compensation. That interpretation stated that CABs may be compensated in the form of securities issued by a privately held CAB client, rather than in cash, provided the receipt, exercise or subsequent sale of such securities will not cause the CAB to engage in activities prohibited under CAB Rule 016(c)(2) (Definitions). *See* Interpretive Letter to Jonathan

D. Wiley, The Forbes Securities Group (May 30, 2019). This position reflects industry practice of financial institutions receiving client securities as part of offerings.

Since FINRA adopted the CAB rules in 2017, CABs have evolved notwithstanding their limited business activities on behalf of privately held companies and we are grateful to FINRA for acknowledging such evolution. Part of that process has included the consideration of various forms of compensation for their deal making, beyond merely transaction-based compensation. The Committee is mindful that CAB Rule 201 (Standards of Commercial Honor and Principles of Trade) already applies in situations in which a CAB receives an equity stake or otherwise charges a commission or fee for a private placement that clearly is unreasonable under the circumstances. FINRA's focus on the potential conflict seems reasonable to the Committee.

Personal Investments

The Committee also supports FINRA's proposal to adopt a new CAB Rule 321 (Supervision of Associated Persons' Investments) and to extend applicability of FINRA Rule 3280 (Private Securities Transactions of an Associated Person) to CABs, requiring that any CAB whose business model creates potential insider trading risks institute personal trading oversight, supervisory procedures and compliance reporting, requiring CABs to establish, maintain and enforce written policies and procedures that are reasonably designed to mitigate and prevent those risks in compliance with the Securities Exchange Act of 1934, and SEC and FINRA rules prohibiting insider trading.

Under the revision to Rule 3210, persons associated with CABs would be required to obtain the prior written consent of the CAB to open or otherwise establish securities trading accounts for which they are a beneficial owner. The CAB also could request that the financial institution holding the associated person's securities account transmit duplicate copies of account confirmations and statements. Such enhanced compliance moves CABs closer to their investment banking and corporate finance brokerage peers in terms of supervision of associated persons, subject to FINRA Rule 3110(d) (Supervision) and oversight of their securities trading to prevent conflicts and the potential for insider trading. Similar personal trading compliance rules exist under the Investment Advisers Act of 1940 (Rules 17j-1 and Rule 402A-1) for associated persons of registered investment advisers.

The Committee does not view as unduly burdensome the additional risk controls and compliance procedures that CABs must undertake when balanced with enhanced investor protection and securities regulation.

Conclusion

The Committee views FINRA's proposed CAB rules to expand the scope of CAB activities, while enhancing compliance and supervision. The Committee appreciates the opportunity to comment on the Concept Release and respectfully requests that the Commission consider the recommendations set forth above. We are available to meet and discuss these matters and to respond to any questions.

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