

FINRA's Proposed Limited Broker Regime Falls Short of Private Fund Needs

FINRA proposes a new "lite" registration regime for private placements and M&A activity.

The Financial Industry Regulatory Authority's (FINRA) recently issued Regulatory Notice regarding proposed rules¹ (Proposed Rules) would apply to firms that fall within the definition of "broker" under the Securities Exchange Act of 1934 (Exchange Act), but that engage in only a limited range of activities — namely, advising companies and private equity funds on capital raising, mergers and acquisitions, and related activities. Under the Proposed Rules, these firms, called limited corporate finance brokers (LCFBs), would be subject to a reduced set of FINRA rules. This more limited rule set would presumably decrease the overall cost of maintaining a broker-dealer. Interested parties can comment on the Proposed Rules until April 28, 2014.

Background

The Proposed Rules, published on February 26, 2014, come almost one year after a speech by David Blass, Chief Counsel of the Securities and Exchange Commission's (SEC) Division of Trading and Markets, in which Blass indicated that in connection with the SEC's examinations of newly registered private fund advisers, the SEC staff observed that (i) certain private fund advisers are paying transaction-based compensation to their personnel for selling interests in a fund and (ii) private fund advisers, their personnel and/or their affiliates are receiving transaction-based compensation for purported investment banking or other broker activities relating to one or more of the fund's portfolio companies.² Blass cautioned that these types of activities may trigger the requirement to register with the SEC as a broker-dealer under the Exchange Act. Blass noted, however, that the SEC staff has been considering a wide spectrum of options for addressing these issues, including working collaboratively with FINRA on a more customized approach for regulation of market participants who perform only limited broker functions. The Proposed Rules appear to be the product, at least in part, of these efforts.

Key Changes

The Proposed Rules represent a promising framework, though they include at least two significant drawbacks for private funds. First, LCFBs may only deal with institutional investors (defined under FINRA rules to include any individual or entity with assets of \$50 million or more, and certain other specified entities³). Such a limitation could severely constrain the utility of this new registration category for marketing private funds. FINRA clarified it would not consider reducing this threshold to the accredited investor standard; however, whether FINRA may be convinced to lower the threshold to the qualified purchaser standard under the Investment Company Act of 1940⁴ remains to be seen. Such a change would dramatically alter the utility of the Proposed Rules in addressing the private fund marketing issue Blass raised. Second, LCFBs would be subject to the same registration process as ordinary broker-

dealers. Thus, the new membership application process for LCFBs is likely to remain as long and arduous as it is for other would-be FINRA members.⁵ In fact, the expense and length of the membership process remains a significant barrier for many aspiring broker-dealers, regardless of the proposed business model.

FINRA is requesting comment on the Proposed Rules, and we urge interested parties to avail themselves of the comment process. The comment period closes on April 28, 2014.

Scope of Proposed Rules

The Proposed Rules define an LCFB as any broker that solely engages in any one or more of the following types of 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
- Qualifying, identifying, or soliciting potential institutional investors⁶

LCFBs may not carry or maintain customer accounts, hold or handle customers' funds or securities, accept orders from customers to purchase or sell securities either as principal or as agent for the customer, possess investment discretion on behalf of any customer, or engage in proprietary trading of securities or market-making activities.⁷

Registration Requirements

An entity seeking to qualify as an LCFB would follow the same procedures for membership as any other FINRA applicant. However, a FINRA member seeking to change its status to an LCFB — subject to certain conditions — could file a request to amend its membership agreement rather than filing a continuing membership application.⁸

Principals and representatives of an LCFB would also be subject to the same registration and qualification examination requirements as principals and representatives of other FINRA member firms, but would be eligible for fewer registration categories.⁹

Limited Rule Set

As mentioned above, the Proposed Rules would establish a modestly more streamlined set of rules for LCFBs with respect to duties and conflicts, supervision of and responsibilities related to associated persons, financial and operational rules, and investigations and sanctions. With respect to duties and conflicts, the Proposed Rules would establish a streamlined set of conduct rules, which would cover, among other things; transactions involving FINRA employees; and transactions between members and non-members.¹⁰ The Proposed Rules would also impose more streamlined know-your-customer and

suitability obligations and an abbreviated version of the rule on communications with the public, which would essentially prohibit false and misleading statements.¹¹

As to supervision of and responsibilities related to associated persons, an LFCB would be subject to many of the rules concerning the supervision of offices, personnel, customer complaints, correspondence and internal communications.¹² However, an LFCB would not be subject to the rules requiring annual compliance meetings or review and investigations of transactions.

For financial and operational rules, an LFCB would be subject to FINRA's rules regarding, among other things, annual audits, fidelity bonds, books and records requirements, records of customer complaints and reporting requirements.¹³ Because an LFCB would not carry or maintain customer accounts, it would have more limited customer information requirements. An LFCB would be subject to SEC Rules under the Exchange Act and the FINRA rules on arbitration and mediation.¹⁴

Practical Implications for Private Funds

As described above, the Proposed Rules contain promising elements, but fall far short of the needs of private funds. If, however, FINRA were to amend the Proposed Rules to permit solicitation of qualified purchasers and provide a more streamlined process such that the time necessary to complete the registration of these broker-dealers would be substantially reduced — reflecting their more limited activities — the Proposed Rules would be a very welcome addition to the FINRA regime.

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Endnotes

- ¹ See Financial Industry Regulatory Authority Regulatory Notice 14-09, Rules for Limited Corporate Finance Brokers (February 2014), available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p448158.pdf>
- ² See David W. Blass, A Few Observations in the Private Fund Space (April 5, 2013), available at: <http://www.sec.gov/news/speech/2013/spch040513dwg.htm>.
- ³ See Proposed Rule 016(g).
- ⁴ See 15 U.S.C. 80a-3(c)(7).
- ⁵ See W. Hardy Comment Letter regarding Regulatory Notice 13-29 (November 4, 2013).
- ⁶ See Proposed Rule 016(h).
- ⁷ See *id.*
- ⁸ See Proposed Rule 116(b). If an existing firm is already approved to engage in the activities of an LCFB, 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 or a Change in Membership Application. 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 an LCFB under LCFB Rule 016(g), and (ii) the firm agrees to comply with the LCFB Rules.
- ⁹ See Proposed Rule 121-124.
- ¹⁰ See Proposed Rule 200, 202, 204, 207.
- ¹¹ See Proposed Rule 209, 211, 221.
- ¹² See Proposed Rule 311.
- ¹³ See Proposed Rule 414, 415, 416, 436, 451.
- ¹⁴ See Proposed Rule 1000.