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FINRA Requests Comment on a Proposed Rule Set for Limited Corporate Financing Brokers

The Financial Industry Regulatory Authority, Inc. ("FINRA") is soliciting comments on a proposed streamlined rule set for "limited corporate financing brokers" ("LCFBs").¹ An LCFB is a firm that engages in a limited range of brokerage activities, including advising companies and private equity funds on capital raising, mergers and acquisitions and corporate restructurings and soliciting potential institutional investors. These firms often are registered as broker-dealers because they receive transaction-based compensation for their role in securities transactions. Nevertheless, these firms do not engage in many of the types of activities typically associated with traditional broker-dealers (e.g., maintaining customer accounts, handling customer funds or securities, or accepting orders to purchase or sell securities either as principal or agent for a customer). FINRA is proposing to establish a more streamlined rule set that would apply exclusively to LCFB's limited activities (the "LCFB Rule Set").

As proposed, the LCFB Rule Set is likely to be of limited benefit to firms. As described below, a firm subject to the LCFB Rule Set would not be able to solicit investment by any persons (other than banks, S&Ls, insurance companies, governmental entities and certain employee benefit plans) with less than \$50 million of assets. Moreover, LCFBs would be subject to most FINRA requirements currently applicable to broker-dealers engaged in LCFB activities – the streamlining consists chiefly of the omission of rules that already do not apply to LCFBs because of the limited nature of their business activities.² Finally, LCFBs would still be subject to all SEC rules and regulations applicable to broker-dealers.³

¹ See FINRA, Limited Corporate Financing Brokers, Regulatory Notice 14-09 (Feb. 2014), available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p449586.pdf> ("RN 14-09").

² As described below, LCFBs would be subject to less extensive requirements in a few areas, e.g., continuing education, communications with the public and supervision.

³ Under a recent no-action letter, certain "M&A Brokers" are not required to register with the SEC or become members of FINRA and therefore are not subject to SEC rules applicable to registered broker-dealers or any FINRA rules. SEC Staff No-Action Letter re. M&A Brokers (pub. avail. Jan. 31, 2014 (revised Feb 4, 2014)), available at: <http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf> (effectively permitting "M&A Brokers," subject to certain conditions, to advise on, arrange, and receive transaction-based compensation relating to, certain securities transactions in connection with the purchase or sale of privately-held companies without registering as broker-dealers).

Activities of Limited Corporate Financing Brokers

Under the proposal, an LCFB would be any broker that *solely* engages in 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; and
- qualifying, identifying, or soliciting potential institutional investors.

A broker-dealer would not be an LCFB (and therefore would be subject to the rules generally applicable to FINRA members) if it:

- carries or maintains customer accounts;
- 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;
- possesses investment discretion on behalf of any customer; or
- engages in proprietary trading of securities or market-making activities.

Solicitation of Institutional Investors

An LCFB would be permitted to qualify, identify and solicit potential institutional investors (but not, as noted above, able to accept institutional customers' orders to purchase or sell securities). For this purpose, "institutional investors" include only

- banks, savings and loan associations, insurance companies or registered investment companies;
- governmental entities or subdivisions thereof;
- certain types of employee benefit plans with at least 100 participants;

- other persons (whether natural persons, corporations, partnerships, trusts, family offices or otherwise) with total assets of at least \$50 million; and
- any persons acting solely on behalf of any such institutional investors.⁴

LCFBs therefore would not be able to qualify, identify or solicit investments from retail investors, or even accredited investors or qualified purchasers that do not qualify as “institutional investors.” LCFBs would, however, be allowed to provide other services (e.g., advice on capital raising or M&A transactions) to individuals or entities that are not institutional investors.

LCFB Rule Set

The following is a brief overview of the rule set that FINRA is proposing to apply to LCFBs.⁵

General Standards (LCFB Rule 010 Series)

LCFBs would be subject to the FINRA By-Laws, unless the context demands otherwise.

Member Application and Associated Person Registration (LCFB Rule 100 Series)

LCFBs would generally be subject to the same membership procedures and approval standards as other broker-dealers. Principals and representatives of LCFBs would also be subject to the same registration and qualification examination requirements as principals and representatives of other FINRA members, but they would be eligible for fewer registration categories and their continuing education requirements would be more streamlined.

Duties and Conflicts (LCFB Rule 200 Series)

The proposed LCFB rules would establish a streamlined set of conduct rules. LCFBs would still be subject to certain core FINRA rules (e.g., requiring adherence to high standards of commercial honor and just and equitable principles of trade), but would be exempt from or subject to an abbreviated version of others. Among other differences from the rules applicable to other FINRA members:

⁴ Although RN 14-09 states that “institutional investor” has the same meaning as it does under FINRA Rule 2210 (Communications with the Public), the definition of “institutional investor” in Rule 2210 includes the following additional types of institutional investors:

- an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); and
- [FINRA] member or registered person of such a member.

⁵ The text of the proposed rules is available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p448158.pdf>,

- LCFBs would be expressly prohibited from disclaiming obligations to determine the suitability of investments they recommend, although they (like other FINRA members) would be eligible for an exemption from the customer-specific suitability obligation with respect to recommendations to institutional accounts⁶ that are able to independently evaluate investment risks, and indicate that they will exercise such independent judgment in evaluating recommendations.
- LCFBs would be subject to an abbreviated version of Rule 2210 (Communications With the Public) that generally applies the content restrictions of Rule 2210 (including the prohibition on predicting or projecting performance) but does not impose review, approval or recordkeeping requirements.
- LCFBs would not be subject to special requirements relating to direct participation programs.

Supervision and Responsibilities Related to Associated Persons (LCFB Rule 300 Series)

LCFBs would be subject to a limited set of supervisory rules that allow LCFBs flexibility to tailor their supervisory systems to their business models, but would nonetheless subject LCFBs to many of the rules generally applicable to FINRA members relating to supervision. Among other differences from the rules applicable to other FINRA members:

- LCFBs would not be subject to the requirement to conduct or provide annual internal inspections, annual compliance meetings or compliance certifications.

Financial and Operational Rules (LCFB Rule 400 Series)

Because an LCFB would not be permitted to carry or maintain customer accounts, the proposed LCFB rules would establish a streamlined set of rules for firms' financial and operational obligations.

Securities Offerings (LCFB Rule 500 Series)

Although LCFBs would be subject to FINRA Rule 5122 (Private Placements of Securities Issued by Members), they would not be subject to FINRA Rule 5123 (Private Placements of Securities). In addition, although LCFBs would be allowed to provide fairness opinions, the proposed LCFB rules would not appear to subject them to FINRA Rule 5150 (Fairness Opinions).

⁶ As proposed, this exemption uses a definition of "institutional account" that is different from the definition of "institutional investor" discussed above.

Investigations and Sanctions, Code of Procedure, and Arbitration and Mediation (LCFB Rules 800, 900, and 1000)

LCFB generally would be subject to FINRA rules relating to investigations and sanctions, codes of procedure, and arbitration and mediation.

Comment Period

The proposal calls for interested parties to comment on the proposed rule set by April 28, 2014. FINRA requests comment on all aspects of the proposal, including whether the proposed rule set appropriately accommodates the scope of LCFB business and whether other accommodations are necessary.

If you have any questions, please feel free to contact any of your regular contacts at the firm listed on our website at www.cgsh.com.

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