Bloomberg BNA

Securities Regulation & Law Report™

BROKER-DEALERS

FINRA's New Capital Acquisition Broker Rules May Provide New Business Opportunities

BY VICTOR L. ZIMMERMANN AND MARK CONRAD

The Financial Industry Regulatory Authority's recent implementation of the "capital acquisition broker" ("CAB") rules and the resultant lightened regulatory burden creates increased business opportunities for brokers that have relationships with institutional investors and that raise capital for private investment funds. Subject to certain considerations, the CAB rules allow the inclusion of targeted and projected return information in institutional marketing materials that was previously disallowed—or at least questionable—by FINRA's unclear enforcement of its advertising rules and its lack of an exemption allowing for different content standards to apply to marketing materials distributed to institutional investors.

The CAB rules create an alternate form of registration and regulation for firms that otherwise would be subject to the full requirements of FINRA's standard broker-dealer registration and regulations. Broker-dealer registration and regulations were designed to ensure that broker-dealers are adequately trained and capitalized, treat customers fairly, and sufficiently disclose information to investors—essentially investor protection rules. Firms that raise capital for private funds, however, do not hold customer accounts, raise capital mainly from institutional investors, and generally do not engage in the types of activities for which the regulations were designed. In light of the limited business activities of capital acquisition brokers, FINRA believes that a more limited set of rules and regulations is appropriate for capital acquisition brokers that (1) fit within the CAB rules' definition and (2) elect to register as such.

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To define capital acquisition broker, CAB Rule 016(c)(1)(F) enumerates a list of activities, which includes "acting as a placement agent or finder . . . on behalf of an issuer in connection with a sale of newly-issued, unregistered securities to institutional investors . . . ." CAB Rule 016(i) defines institutional investor similarly to FINRA Rule 2210, but adds "qualified purchasers" as defined in Section 2(a)(51) of the Investment Company Act of 1940 to the listed entities considered to be institutional investors. Since the majority of broker-dealers that act as placement agents for private investment funds limit their solicitation activities to institutional investors under the new CAB rule definition, they will now have the option to register and be regulated under the new CAB rules.

Brokers registered under the CAB rules remain subject to FINRA bylaws and several rules that FINRA believes should apply to all members, but the CAB rules contain an abbreviated set of rules adapted to the lim-

 ISSN 0037-0665

ited roles of capital acquisition brokers. For example, they remain subject to several of the FINRA Rules regarding supervision including FINRA Rule 3220 (Influencing or Rewarding Employees of Others) and 3270 (Outside Business Activities of Registered Persons). The CAB Rules, however, provide fewer restrictions so that capital acquisition brokers can more effectively adapt their supervisory systems to their business model by eliminating certain rules such as the requirement to conduct annual compliance meetings. Similarly, FINRA requires broker-dealers registered under the CAB rules to conduct anti-money laundering compliance tests every two years as opposed to the annual test required by FINRA's full rule set.

Challenges

The real advantage in choosing to be regulated under the CAB rules, however, is that it may make private investment funds more desirous of using capital acquisition brokers since such brokers will be able to market private investment funds using targeted and/or projected returns, a practice that the content standards of FINRA Rule 2210(d) previously prohibited or severely discouraged. Many private fund sponsors use targeted returns in their marketing materials because institutional investors find that it enables them to better assess the risks of a particular investment fund. Institutional investors use targeted returns both as a means by which to determine the riskiness of the particular fund's investments and to allocate all of their investments to achieve the institutions' desired return.

Prior to the adoption of the CAB rule, however, registered brokers were prohibited or severely restrained from including such information in marketing materials for the fund since FINRA guidance has stated that FINRA Rule 2210(d) applies to communications with institutional investors. FINRA Rule 2210(d)(1)(F) does not specifically prohibit the inclusion of targeted returns in marketing materials but states that registered broker-dealers ''may not predict or project performance . . . or make any exaggerated or unwarranted claim, opinion or forecast'' in their communications with investors. Accordingly, whether targeted returns are prohibited by the rule may depend on if the communications cast the targets as predictions or projections of performance or rather as a statement of underlying risk with adequate disclosures.

Targeted and Projected Returns

A March 2014 New York Law Journal article pointed out that unclear FINRA enforcement has added to the confusion as to whether the inclusion of a stated targeted return in marketing materials, as opposed to projections of performance, are per se prohibited by the rule. Past FINRA Enforcement actions have concluded that marketing materials containing targeted returns violated FINRA Rule 2210. The language in those actions, however, suggests that the problem rested with the materials' inadequate discussion of the risk involved with the investment, a violation of FINRA Rule 2210(d)(1)(A)'s requirement that communications ''provide a sound basis for evaluating the facts in regard to any particular security.'' The actions did not state that the use of targeted returns specifically violated FINRA Rule 2210(d)(1)(F), which does not explicitly prohibit the inclusion of a ''targeted'' return in firm marketing materials. Some later FINRA disciplinary proceedings, though, have lumped marketing materials that contained targeted returns in with other violative projected returns and specified that these statements were unwarranted performance projections specifically prohibited by FINRA Rule 2210(d)(1)(F). Even if FINRA's main issue in these disciplinary proceedings was the materials' inadequate risk disclosure, the difference between a projected and a targeted return is nuanced and lack of clear guidance has severely restricted marketing private investment funds through broker-dealers.

In the face of current restrictions regarding the use of targeted and projected returns, many private fund sponsors and managers have used internal marketing personnel rather than non-affiliated broker-dealers to raise capital for their funds, thereby allowing them to include information regarding targeted and projected returns. The Investment Advisers Act of 1940 (the ''Advisers Act'')—and not FINRA regulations—governs the communications of managers and advisers to private funds, and consequently, the use of performance data in their marketing materials. Although the U.S. Securities and Exchange Commission (''SEC'') rules and regulations promulgated under the Advisers Act address and set guidelines for the use of past performance information, the Advisers Act has no specific limitation on the use of targeted or projected returns. SEC guidance requires, among other things, that advisers display performance data net of fees the client would have or actually paid. The SEC has also allowed the use of gross returns when used in ''one-on-one presentations to certain prospective clients, e.g., wealthy individuals, pension funds, diversities and other institutions, who have sufficient assets to justify the cost of the presentation.'' However, the SEC has not specifically addressed the use of targeted and projected returns leaving their use governed by the antifraud provisions of Advisers Act Section 206, and Advisers Act Rules 206(4)-1 and 206(4)-8.

Institutional investors' preference for receiving targeted returns has thus created a tension for private investment funds wanting to use non-affiliated broker-dealers to raise capital—which may be more effective than their in-house marketing staffs—but may nonetheless be less effective in practice because they must comply with FINRA's current rules prohibiting or restricting the use of targeted and projected returns. The new CAB rules should now eliminate such tension as they obviate previous FINRA guidance applying Rule 2210(d)'s content standards to communications with institutional investors, thereby allowing for the use of targeted or projected returns.

While preserving the fair dealing and good faith principles and the requirement that communications be fair and balanced while providing a sound basis for evaluating a security, the CAB rules otherwise relax the rules previously governing communications with investors. Communications from brokers that register under the CAB rules generally must not contain false and misleading statements, half-truths, implications that past performance will recur, or unwarranted claims and forecasts. Thus, communications to investors from capital acquisition brokers still must display material disclosures prominently, legibly, and in the main text, and must do so truthfully, but are otherwise generally unrestricted in their marketing materials. Capital acquisition brokers registered under the CAB rules may therefore

   ISSN 0037-0665

now provide potential investors with marketing materials that contain targeted and/or projected returns. To remain in compliance with the new rule, marketing materials with targeted returns should contain adequate disclosures regarding risks of the fund not achieving its intended return range.

Capital acquisition brokers interested in operating under the CAB rules can apply for FINRA membership and state in their application that they intend to operate solely as a capital acquisition broker. Existing firms registered under FINRA's full broker-dealer rule set can file a request to amend their membership agreement providing that their activities will be limited to those permitted under the CAB rules and that the firm agrees to comply with all applicable FINRA rules. Principals and representatives associated with capital acquisition brokers remain subject to the same registration, qualification, and continuing education requirements as principals and representatives of other FINRA firms, but after qualifying as a capital acquisition broker, the firm will be subject to the CAB rules. Capital acquisition brokers registered under the CAB rules may then operate under the CAB rules' streamlined communications rule without concern of the issues created by FINRA's enforcement of its communications standards discussed above. The CAB rules become effective on April 14, 2017 and FINRA will accept applications beginning on January 3, 2017.