Recent SEC Broker-Dealer Cross-Border Initiatives – Time to Reassess Your Rule 15a-6 Arrangements and Procedures?

I. Introduction

A recent rule proposal,1 if adopted, may give certain securities market participants improved and potentially more cost-effective access to foreign securities markets and foreign securities experts. In recognition of the increasing globalization of securities markets, the Securities and Exchange Commission (“SEC” or “Commission”) has proposed long-awaited amendments (“Proposed Amendments”) to Rule 15a-6 (the “Rule”) under the Securities Exchange Act of 1934, as amended (“Exchange Act”). In summary, the Proposed Amendments (i) expand the categories of U.S investors that a foreign broker-dealer (a “FBD”) may solicit, send research to, and execute trades for, (ii) streamline the conditions under which a FBD may engage in these activities with certain U.S. investors, and (iii) significantly reduce the role that a U.S. broker-dealer (“U.S. BD”) must play in intermediating transactions effected by a FBD.

The proposed revisions to the Rule would exempt FBDs from the broker-dealer registration requirements of, and all reporting and other requirements under, the Exchange Act, except for those related to the Commission’s disciplinary authority under Sections 15(b)(4) and 15(b)(6). FBDs and their associated persons, however, will continue to be subject to Exchange Act provisions and rules unrelated to the FBD’s status as a broker-dealer, such as the general antifraud provisions of Section 10(b) and Rule 10b-5.

Under the Proposed Amendments, certain U.S. investors, FBDs and U.S. BDs, which currently act as intermediaries for FBDs, would be expected to benefit from cost efficiencies. Any cost savings for broker-dealers, however, may vary depending on whether the U.S. BD, which often is an affiliate of a FBD, continues to play a significant role in the overall client relationship with U.S. investors.

Comments to the Proposed Amendments are due September 8, 2008.

II. The Proposed Amendments

A. Qualified Investors

A key proposal expands the types of U.S. investors that a FBD may contact for the purpose of soliciting securities transactions and providing research reports. Under the current version of the Rule (with limited exceptions, as discussed in II.B.4., below), FBDs now are limited to contacting “U.S. institutional investors” and “major U.S. institutional investors.” These investor categories, particularly the $100 million asset requirement to achieve “major U.S. institutional investor” status, have the effect, for example, of omitting from the Rule’s exemption transactions with private investment funds to the extent their assets are below the

The SEC staff extended the definition of “major U.S. institutional investor” by no-action letter relief to include any entity, including any investment adviser (whether or not registered under the Investment Advisers Act of 1940), that owns or controls (or, in the case of an investment adviser, has under management) in excess of $100 million in aggregate financial assets. The SEC has stated that the Proposed Amendments are intended to supersede all existing no-action letter guidance and that such guidance will be withdrawn.

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(a) General Requirements for FBDs and Intermediating U.S. BDs

(i) FBD Requirements

To be eligible to solicit trades with qualified investors under the amended safe harbor, a FBD must be regulated in a “foreign country by a foreign securities authority” and disclose to the qualified investor that it is regulated by the foreign securities authority, not by the Commission. As with the current Rule, FBDs are still required to produce information, documents and testimony to the SEC and assist with obtaining evidence from other persons, unless prohibited by local law. FBDs and their associated persons soliciting transactions with qualified investors would continue to be required to consent to service of process of any civil action brought against them by the SEC or a self-regulatory organization (“SRO”).

In furtherance of the reallocation of roles and responsibilities under the Proposed Amendments, the FBD, rather than the U.S. BD, would be responsible for (i) determining that the foreign associated person of the FBD effecting transactions with the qualified investor is not subject to a statutory disqualification, and (ii) holding in its files and making available upon request by a U.S. BD or the SEC information similar to that required by Form U-4 for associated persons of the FBD who participate in the solicitation of qualified investors.

(ii) Intermediating U.S. BD Requirements

The Proposed Amendments retain the basic condition of the Rule that a U.S. BD obtain from the FBD and its associated persons written consents to service of process for any civil action brought by or before the SEC or a SRO. It must also obtain a representation from the FBD that it has obtained Form U-4 type information from its associated persons and determined that they are not statutorily disqualified. The U.S. BD must maintain copies of these consents and representations and make them available to the SEC upon request.

(b) FBDs Conducting a “Foreign Business”

If a FBD conducts a “foreign business,” it is permitted to effect all aspects of a solicited securities transaction.
with qualified investors and “U.S. Fiduciaries” (as defined in II.4. below), including executing, clearing, and settling the transaction and maintaining custody of client assets. It is also allowed to maintain all books and records, including confirmations and any statements issued to the qualified investor, and may maintain them “in the form, manner and for the periods prescribed by the foreign securities authority regulating the [FBD],” rather than as required by the Commission’s rules. Such firms are referred to here as “Category 1 FBDs.”

A FBD conducts a “foreign business” if, generally, 85% of its securities business, on a rolling two-year basis, with qualified investors, and U.S. Fiduciaries effecting transactions for the account of “foreign resident clients,” is in transactions in “foreign securities.” As indicated above, the Category 1 FBD would still have to have a relationship with an intermediating U.S. BD, but this U.S. BD need not be involved in any part of the trade. In this context, the role of the U.S. BD would (besides obtaining the previously mentioned consents and disclosures), in effect, be limited to assuring that the Commission could promptly obtain, upon request, copies of all books and records relating to transactions between FBDs and qualified investors (“FDB Books and Records”).

In addition, Category 1 FBDs must disclose to qualified investors that “the U.S. segregation requirements, U.S. bankruptcy protections and protections under the Securities Investor Protection Act will not apply to any funds or securities held by the foreign broker or dealer.”

Most significantly, in the case of trades solicited by a Category 1 FBD, the U.S. BD, which does not otherwise participate in the trade, has no responsibility for the transaction including no net capital, customer protection rule and anti-money laundering responsibilities, or responsibility to review trades for compliance with SEC or SRO requirements. Thus, under the Proposed Amendments, the U.S. regulatory burdens on both the Category 1 FBD and U.S. BD are significantly reduced.

(c) FBDs Not Conducting a “Foreign Business”

A FBD that does not meet the “foreign business” requirement may trade directly with qualified investors on less restrictive terms than currently permitted, but on more limited terms than a FBD who does meet the “foreign business” requirement. Such FBDs, which are referred to here as Category 2 FBDs, may solicit and “effect” trades directly with qualified investors and, thus, presumably clear and settle such trades. They may not, however, custody the qualified investor’s account.

There are also more burdens on the intermediating U.S. BD. In the Category 2 FBD context, the SEC views the U.S. BD as “carrying the account” and being responsible for maintaining required books and records and receiving, delivering and safeguarding funds and securities on behalf of qualified investors in compliance with the SEC’s customer protection rule.

(d) Elimination of Chaperoning Requirements

One of the most significant changes made by the Proposed Amendments is the elimination of the current burdensome “chaperoning” provisions for both categories of FBDs. Thus, associated persons of the FBD that meet requirements similar to those currently in place (e.g., no statutory disqualification) could have unlimited telephone calls and e-mail communications with qualified investors from outside the United States without a U.S. BD chaperone. Although not explicitly stated in the Proposed Amendments, the SEC stated that it would interpret the amended Rule to permit visits to qualified investors in the United States by associated persons of a FBD of up to 180 days in the aggregate in a calendar year, rather than 30 days as is now the case under SEC staff interpretation.

4 Conversely, if the FBD (whether a Category 1 FBD or Category 2 FBD) effects a securities transaction on a national securities exchange, an alternative trading system, or with a market maker in a U.S. over-the-counter (“OTC”) market, a U.S. BD would participate in the securities transaction and be responsible for complying with relevant U.S. laws and SEC and SRO rules and regulations.
2. Provision of Research

The Proposed Amendments modify the current exemption in subsection (a)(2) of the Rule for the delivery of research only insofar as the Commission has expanded the recipients eligible to receive research, and engage in securities transactions based on the research, from “major U.S. institutional investors” to qualified investors. The same strict conditions of the current Rule would continue to apply in order to prevent a FBD from soliciting transactions in the securities covered in a research report absent an arrangement with a U.S. BD under subsection (a)(3) of the Rule. The SEC recognized, however, that few FBDs rely on subsection (a)(2) of the Rule because of these restrictions.\(^5\)

3. Execution of Unsolicited Trades

The Proposed Amendments made no substantive change to the Rule’s exemption for unsolicited trades. That is, a FBD does not become subject to the Commission’s broker-dealer registration and regulatory regime simply because a U.S. person initiates contact for purposes of effecting a securities transaction. Thus, any U.S. person could initiate unsolicited contact with a FBD under this exemption. The SEC’s views on the scope of solicitation were set forth in detail in the original proposing release and adopting release to the Rule.\(^6\) The SEC considers the unsolicited trade exemption to be narrow and not generally available if a FBD conducts an “ongoing business” with a U.S. investor which, in the Commission’s view, “would likely involve some form of solicitation in the United States.”

Notably, however, the Commission slightly revised its earlier position (and adopted a position taken by its staff in a previous no-action letter) regarding the U.S. dissemination of foreign quotes through a third-party system (e.g., systems operated by foreign marketplaces or private vendors). In adopting the Rule in 1989, the Commission previously took the position that the U.S. dissemination of foreign quotes of a third-party system would not be a solicitation if (i) the system did not allow the execution of securities transactions between the FBD and U.S. persons through the system, and (ii) the quotations were “primarily” distributed in foreign countries. The Commission no longer requires that the quotes be “primarily” distributed in a foreign country because, according to the SEC, third-party quotation systems no longer serve a primary location; therefore, such distinctions between a U.S. primary location and foreign primary location would not be meaningful. The Commission would still view the U.S. dissemination of foreign quotes through a third-party quotation system as solicitation if the system permitted executions through the system. In addition, the Commission retained restrictions on order-entry systems that would give U.S. investors direct access to foreign markets.

4. Transactions with Specific Counterparties

Under the current Rule, there are certain categories of U.S. persons that a FBD may trade with directly without the intermediation of a U.S. BD and the related record-keeper obligations imposed for transactions made in reliance on subsection (a)(3) of the Rule. These include SEC registered broker-dealers, banks acting under an exemption from the definition of broker or dealer, U.S. persons living outside the United States who are not targeted as identifiable groups, such as military personnel, an agency or branch of a U.S. person permanently located outside the United States, a non-U.S. preexisting client who is temporarily resident in the United States who are not targeted as identifiable groups, and certain international organizations. The Proposed Amendments add to these categories any U.S. person, other than a registered broker or dealer or bank (exempt from the definition of broker-dealer), that acts in a fiduciary capacity for an account of a foreign resident client, subject to certain conditions (a “U.S. Fiduciary”). This new counterparty is unique in that the expanded exemption is only available to Category 1 FBDs. This provision is proposed in order to address the perception that although a U.S. resident fiduciary for a foreign resident client is deemed to be a “U.S. person” for purposes of the broker-dealer registration provisions of the Exchange Act, foreign resident clients do not have the expectation that a Category 1 FBD through which transactions are effected would be subject to regulation by the SEC. Presumably, a foreign resident client also would not expect that the FBD Books and Records would be subject to SEC access as would be the case with transactions with qualified investors under subsection (a)(3) of the Rule. The FBD would be required to obtain and maintain a representation from

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\(^5\) See discussion at Section III. E., infra.
the U.S. Fiduciary that it manages the account of the foreign resident client as a fiduciary.

5. Familiarization with Foreign Options Exchanges

As a separate regulatory initiative, the SEC proposed a new exemption to allow a Foreign Options Exchange (a “FOE”) and a FBD which is a member of a FOE to engage in certain activities to familiarize qualified investors with the FOE and to allow such foreign exchanges to make available to qualified investors the FOE’s OTC options processing service.

The Proposed Amendments include a new exemption that is intended to allow both FOEs and FBDs who are members of FOEs to familiarize qualified investors with the FOE, the options traded on the FOE, the differences from the U.S. domestic options market, and any OTC options processing service offered by the FOE. The FOE may also make available to qualified investors, through member FBDs, the FOE’s options processing trading service.

The types of activities permitted by this exemption are very limited and could be considered “solicitations” absent the exemption. The SEC recognized that, “given the broad interpretation of solicitation, it would be difficult, if not impractical,” for a FBD to conduct “repeated transactions with the same qualified investor without the foreign broker-dealer engaging” in some additional activity that would be deemed to be solicitation. Accordingly, the SEC anticipates that most of these transactions must be completed pursuant to the exemption available for solicited transactions.

III. Impact on Market Participants and Observations on The Proposed Amendments

A. U.S. Investors and New Dollar Thresholds

If adopted, the Proposed Amendments are expected to provide greater, more efficient access to foreign securities, foreign securities markets and FBDs for a broader group of U.S. investors. This group of investors will include certain private investment funds, such as smaller funds relying on Section 3(c)(7) of the Company Act that do not meet the Rule’s current $100 million asset requirement for “major U.S. institutional investor” status. It will also include, for the first time, individual investors who own or invest on a discretionary basis at least $25 million in investments. FBDs, however, will generally continue to be prohibited from soliciting trades with retail investors in the United States.

The shift from the more familiar $100 million asset threshold to, in certain cases, a threshold of $25 million in “investments” raises new interpretative questions under the Rule. In contrast to the Company Act, which defines by rule the term “investments” for purposes of “qualified purchaser” status necessary for reliance on Section 3(c)(7), no such similar rule exists under the Exchange Act, and the Commission offered no guidance in the Proposed Amendments whether the Company Act could be used to determine “investments” and, therefore, “qualified investor” status. Additionally, the Commission offered no guidance on the evidence, if any, that is necessary for a FBD to demonstrate that it is dealing with a qualified investor. Under the Company Act, for example, an issuer relying on Section 3(c)(7) must have a reasonable belief that each investor in the fund is a “qualified purchaser.”

Given the significant expansion of the scope of U.S. investors that a FBD may reach, guidance from the Commission or its staff may be necessary to ensure the practical implementation of the Rule.

B. FBDs with a Limited or No Current U.S. Presence

The Proposed Amendments’ greatest benefits may accrue to those FBDs that do not now have any business in the United States or that use a U.S. BD solely to comply with the existing requirements of the Rule, and not as an integral part of their relationships with U.S. investors. Category 1 FBDs will be able to solicit and trade directly with qualified investors with minimal U.S. regulatory burdens and limited involvement of a U.S. BD. Presumably, this will materially reduce their costs of doing business with qualified investors in the United States. Nonetheless, it is not clear what oversight a U.S. BD would be required to perform with regard to the FBD Books and Records and what it is required to do to determine that copies of the FBD Books and Records can be furnished promptly to the SEC. Consequently, it is not self-evident that the public policy benefits of retaining these roles for a U.S. BD would outweigh the costs and administrative burdens that the FBD would continue to incur.
C. FBDs with U.S. Subsidiaries or Affiliates

The impact of the Proposed Amendments on FBDs with a U.S. registered broker-dealer subsidiary or affiliate (a “U.S. affiliate” or “affiliate”) will depend on the role and importance of the affiliate in the relationship with the U.S. investors. Many FBDs service U.S. clients both from non-U.S. locations and their U.S. affiliate office. Some U.S. clients like the option of being able to contact a sales trader in the United States, a sales trader resident outside the United States, the analyst who wrote a research report who is resident outside the United States, or any combination thereof. For firms with these types of clients, the impact of the Proposed Amendments will be less significant because the U.S. BD will often be actively involved in the transaction. They will, however, benefit from the elimination of the chaperoning requirements and the expansion of the categories of eligible U.S. investors through the adoption of the “qualified investor” definition.

D. State Law

By their terms, the Proposed Amendments only deal with exemptions from the U.S. federal broker-dealer registration requirements. Individual states, however, have their own “blue sky” broker-dealer regulatory regimes that generally apply where a broker-dealer has a nexus with the state either by having a physical presence in the state or more than a de minimis number of clients that are residents of the state. Most, but not all, state “blue sky” laws provide exemptions for various categories of institutional investors. Accordingly, FBDs seeking to do business in the United States for the first time or FDBs who are considering altering their relationship with their current intermediating U.S. BD should consider state law requirements as they apply to the FBD’s U.S. activities, U.S. clients and potential U.S. clients.

E. Research

In the Release, the SEC acknowledged that FBDs rarely rely on the exemption for delivery of research under subsection (a)(2) of the Rule, which allows FBDs to send research reports directly to major U.S. institutional investors under strict conditions. These conditions include, among others, a prohibition on any follow-up communications with the recipient of the research initiated by the FBD outside of arrangements for solicited trades under subsection (a)(3) of the Rule. Thus, the “(a)(2)” exemption is usually not commercially viable and many FBDs distribute research and solicit trades with eligible U.S. investors in the context of a 15a-6(a)(3) relationship, often with an affiliated U.S. BD.

To the extent that a U.S. affiliate is distributing research of the FBD, FINRA Rule 2711(h)(13) requires that the research be approved by a principal or supervisory analyst who must review the research to determine if it contains false or misleading information that should be known from reading the report or that is known based upon information available to the U.S. affiliate. The U.S. BD distributing affiliate research must also ensure that it has required FINRA disclosures or includes a link to a website where those disclosures may be found. These requirements would not apply to the distribution of research if the FBD and U.S. BD in a Rule 15a-6(a)(3) arrangement were not affiliates to the extent additional conditions of Rule 2711(h)(13) (B) were satisfied.

The SEC stated that, because U.S. BDs are no longer required to effect transactions on behalf of either Category 1 or Category 2 FBDs, “the intermediating U.S. registered broker-dealer would no longer be required to comply with the provisions of the federal securities laws, the rules thereunder and SRO rules applicable to a broker-dealer effecting a transaction in securities, unless it were otherwise involved in effecting the transaction.” It is unclear how this language affects a U.S. BD’s obligations under the FINRA research rules. The SEC (and FINRA) could take the approach that the U.S. BD participated in soliciting the transaction by distributing the research on behalf of its affiliate. Guidance from the SEC may be necessary to clarify the reach of SRO research rules and related SEC Regulation AC disclosure issues in the order adopting the final version of the Proposed Amendments.

F. Net Capital

Under the proposal for solicited trades, the SEC made several sweeping statements about limited compliance with Exchange Act requirements by U.S. BDs dealing with Category 1 and Category 2 FBDs in the context of effecting foreign securities transactions. In the case of transactions by Category 1 FBDs, the SEC clearly stated that a U.S. BD would not be subject to, among other things, net capital obligations under Rule 15c3-1 under the Exchange Act ("net capital rule"). In the case of a Category 2 FBD transaction, though, the
SEC noted that a U.S. BD would “carry” the account of a qualified investor and have custody of assets when effecting a Category 2 FBD transaction. The obligations associated with “carrying” a client account and the related net capital and customer protection rules are not entirely consistent with the SEC’s more sweeping statements regarding a U.S. BD’s reduced compliance with Exchange Act rules, as noted above. The obligations when “carrying” a qualified investor’s account have practical repercussions for intermediating U.S. BDs, presumably implicating the net capital rule to require the U.S. BD to take a charge to its net capital for fails of trades executed by a Category 2 FBD.

Additional SEC guidance may be necessary for U.S. BDs to more precisely identify the extent to which various Exchange Act rules apply or do not apply to particular transaction scenarios.

G. Definition of “Foreign Broker or Dealer”

Under the streamlined approach of the Proposed Amendments, a FBD must merely be “regulated for conducting securities activities, including the specific activities in which the foreign broker or dealer engages with the qualified investor, in a foreign country by a foreign securities authority.” This is noteworthy because, at least in the case of the broker-dealer activities exempted by the Rule, the SEC has not conditioned relief on the requirement that such activities be subject to a regulatory regime comparable to the U.S. broker-dealer regulatory regime.

K&L Gates has counseled U.S. investors, U.S. broker-dealers, and foreign broker-dealers on compliance with Rule 15a-6 for many years. We are available to assist all market participants interested in the Proposed Amendments with comment letters, advice on possible amendments to Rule 15a-6 service agreements, compliance/supervisory procedures, and related issues.