SEC Proposes Expanding Rule 15a-6 Exemption for Foreign Broker-Dealers Doing Business in the United States

The Securities and Exchange Commission ("SEC") recently proposed expanding the Rule 15a-6 exemption which permits foreign broker-dealers to do business in the United States without having to register with the SEC as broker-dealers provided certain limitations are observed and specified conditions are met. [1] Citing the continually accelerating pace of internationalization in securities markets around the world since the adoption of Rule 15a-6 in 1989, the SEC is seeking to provide U.S. investors better access to global securities markets. The amendments would ease the conditions under which a foreign broker-dealer must operate if it wishes to do business in the United States without triggering the registration requirements of Sections 15(a)(1) or 15B(a)(1) of the Exchange Act, while maintaining a regulatory structure that the SEC believes protects investors and the public interest. Comments on the proposed amendments are due September 8, 2008.

1. Background

Section 15(a) of the Exchange Act generally provides that, absent an exception or exemption, a broker or dealer, whether domestic or foreign, that uses the mails or any means of interstate commerce to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security must register with the SEC. SEC registration triggers the imposition of a wide range of operational and recordkeeping requirements on broker-dealers and subjects them to SEC oversight — a regulatory scheme intended to protect investors. In 1989, in response to a growing trend of internationalization in the securities business, the SEC adopted Rule 15a-6 which permitted foreign broker-dealers to do business in the United States without registering under the Exchange Act provided they limited the scope of their U.S. business to certain classes of investors and conducted such business within the parameters established by the Rule. The SEC has re-examined the limitations of the Rule 15a-6 exemption in light of the further internationalization of the securities markets and as a result has proposed amendments to the Rule which would give foreign broker-dealers some measure of increased flexibility to do business in the United States without being required to register.[2]

Among the most significant changes proposed by the SEC are:

- extending the category of investors to which foreign broker-dealers may provide research reports from "major U. S. institutional investors" — a term that among other things requires an

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1 *Exemption of Certain Foreign Brokers or* Dealers, Exchange Act Release No. 34-58047 (June 27, 2008), at 1 ((the "Proposing Release") available at http://www.sec.gov/rules/proposed/2008//34-58047.pdf. Rule 15a-6 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), defines a "foreign broker or dealer" as "any non-U.S. resident person . . . that is not an office or branch of, or a natural person associated with, a registered broker-dealer, whose securities activities, if conducted in the United States, would be described by the definition of 'broker' or 'dealer' in Section 3(a)(4) or 3(a)(5) of the [Exchange] Act." Rule15a-6(b)(3)

2 *Proposing Release* at 4-13; 18-19.

institutional investor to have or manage at least $100 million in investment, to "qualified investors" — a term which includes companies and natural persons having at least $25 million in investments;

- revising the conditions under which, a foreign broker-dealer could induce or attempt to induce the purchase or sale of a security by U.S. investors — again by expanding the category of investors from "U. S. institutional investors" and "major U.S. institutional investors" to "qualified investors";

- adding U.S. resident fiduciaries of accounts for "foreign resident clients" as a class of investors with which foreign broker-dealers may do business in the U.S.;

- adding an exemption for foreign broker-dealers who are members of a foreign options exchange to effect transactions in options on foreign securities listed on that exchange on behalf of certain U.S. investors who have not otherwise been solicited by the foreign broker-dealer subject to complying with specified conditions.

The SEC would continue to permit a foreign broker-dealer to engage in securities transactions on behalf of U. S. investors that were not solicited as clients by the foreign-broker dealer although the SEC makes clear that it believes there are "relatively few" transactions which qualify for this particular exemption.

2. Extending the category of potential U.S. clients of foreign broker-dealer to include "qualified investors"

The most significant change the SEC is proposing would extend the category of investors with which foreign broker-dealers could interact, without having to register with the SEC. Under Proposed Rules 15a-6(a)(2) and 15a-6(a)(3), foreign broker-dealers would be able to deal with "qualified investors," as defined in Section 3(a)(54) of the Exchange Act[3], instead of being limited to dealing with "major U.S. institutional investors." This proposed change would have three principal effects:

[3] Section 3(a)(54)(A) of the Exchange Act defines a "qualified investor" as: (i) any investment company registered with the Commission under Section 8 of the Investment Company Act of 1940 ("Investment Company Act"); (ii) any issuer eligible for an exclusion from the definition of investment company pursuant to Section 3(c)(7) of the Investment Company Act; (iii) any bank (as defined in Section 3(a)(6) of the Exchange Act), savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act), broker, dealer, insurance company (as defined in Section 2(a)(13) of the Securities Act of 1933, as amended (the "Securities Act")), or business development company (as defined in Section 2(a)(48) of the Investment Company Act); (iv) any small business investment company licensed by the United States Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958; (v) any State sponsored employee benefit plan, or any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in Section 3(21) of that Act, which is either a bank, savings and loan association, insurance company, or registered investment adviser; (vi) any trust whose purchases of securities are directed by a person described in clauses (i) through (v) above; (vii) any market intermediary exempt under Section 3(c)(2) of the Investment Company Act; (viii) any associated person of a broker or dealer other than a natural person; (ix) any foreign bank (as defined in Section 1(b)(7) of the International Banking Act of 1978); (x) the government of any foreign country; (xi) any corporation, company, or partnership that owns and invests on a discretionary basis not less than $25,000,000 in

- it would for the first time permit foreign broker-dealers to solicit business from natural persons provided such persons owned or invested on a discretionary basis not less than $25 million in investments;

- it would lower the dollar threshold of discretionary investment for companies with which a foreign broker-dealer could do business from $100 million to $25 million; and

- it would lower the dollar threshold for governmental agencies and other similar entities with which a foreign broker-dealer could do business from $100 million to $50 million.[4]

3. Provision of Research Reports to "Qualified Investors"

The proposal also expands from major U.S. institutional investors to qualified investors the category of investors to which foreign broker-dealers would be permitted to provide research reports. Foreign broker-dealers would be allowed to furnish research reports directly to qualified investors and effect transactions in the securities discussed in those research reports with or for those qualified investors, without having to register with the SEC provided the following conditions were met:[5]

- The research reports may not recommend the use of the foreign broker-dealer to effect trades in any security.

- The foreign broker-dealer may not initiate contact with the qualified investors to follow up on the research reports and may not otherwise induce or attempt to induce the purchase or sale of any security by the qualified investors.

- If the foreign broker-dealer has a relationship with a registered broker-dealer that satisfied the requirements of paragraph (a)(3) of proposed Rule 15a-6, any transactions with the foreign broker-dealer discussed in the research reports must be effected pursuant to the provisions of that provision.

- The foreign broker-dealer may not provide research to U.S. persons pursuant to any express or implied understanding that those U.S. persons will direct commission income to the foreign broker-dealer.

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investments; (xii) any natural person who owns and invests on a discretionary basis not less than $25,000,000 in investments; (xiii) any government or political subdivision, agency, or instrumentality of a government that owns and invests on a discretionary basis not less than $50,000,000 in investments; or (xiv) any multinational or supranational entity or any agency or instrumentality thereof.

4 *Proposing Release* at 14, 15

5 *Id.* at 25.

4. Solicited Trades

The SEC proposes two changes to the exemption for how foreign broker-dealers may solicit trades with investors in the United States (referred to herein as "Exemption (A)(1)" and "Exemption (A)(2)," corresponding to proposed Rules 15a-6(a)(3)(iii)(A)(1) and 15a-6(a)(3)(iii)(A)(2)). Under both proposed exemptions U.S. registered broker-dealers would have fewer obligations to monitor the activities of foreign broker-dealers in the U.S. than under the current rule. Qualified investors would be allowed more direct contact with foreign broker-dealers, without certain barriers such as the chaperoning requirements that exist in the current exemption. Under both proposed exemptions, "foreign associated persons"[6] making visits to qualified investors would no longer have to be chaperoned by an associated person of a U.S. registered broker-dealer.[7]

Exemption (A)(1) would only be available to foreign broker dealers that conduct a "foreign business,"[8] while Exemption (A)(2) would be available to all foreign broker-dealers. The only significant difference between the two exemptions is that under Exemption (A)(1), only foreign broker-dealers who conduct a foreign business could receive, deliver, and safeguard the funds and securities of the U.S. investors on whose behalf they effect transactions in securities.

If, however,

> a foreign broker-dealer effects a transaction pursuant to [Exemption (A)(1) or Exemption (A)(2)] on a U.S. national securities exchange, through a U.S. alternative trading system, or with a market maker or an over-the-counter dealer in the United States, as is common with respect to U.S. securities, a U.S. registered broker-dealer would be involved in effecting the transaction and would be required to comply with the provisions of the

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6 The SEC proposes to define "foreign associated person" as being "any natural person domiciled outside the United States who is an associated person, as defined in section 3(a)(18) of the [Exchange] Act, of the foreign broker or dealer and who participates in the solicitation of a qualified investor under paragraph (a)(3) of [Proposed Rule 15a-6.]" Proposed Rule 15a-6(b)(1).

7 *Proposing Release* at 28.

8 "Foreign business" is defined in the proposed rule as "the business of a foreign broker or dealer with qualified investors and foreign resident clients where at least 85% of the aggregate value of the securities purchased or sold in transactions conducted pursuant to both paragraphs (a)(3) and (a)(4)(vi) of this section by the foreign broker or dealer calculated on a rolling two-year basis is derived from transactions in foreign securities, except that the foreign broker or dealer may rely on the calculation made for the prior year for the first 60 days of a new year." *2008 Release* at 118. The proposed rule would define "foreign securities" to mean: (i) an equity security (as defined in Securities Act Rule 405) of a foreign private issuer (as defined in Securities Act Rule 405); (ii) a debt security (as defined in Securities Act Rule 902) of a foreign private issuer (as defined in Securities A Rule 405); (iii) a debt security (as defined in Securities Act Rule 902) issued by an issuer organized or incorporated in the United States in connection with a distribution conducted solely outside the United States pursuant to Regulation S (Securities Act Rule 903 et seq.); (iv) a security that is a note, bond, debenture or evidence of indebtedness issued or guaranteed by a foreign government (as defined in Securities Act Rule 405) that is eligible to be registered with the Commission under Schedule B of the Securities Act; and (v) a derivative instrument on a security described in subparagraph (i), (ii), (iii), or (iv) of "Proposed Rule 15a-6(b)(3). *Proposing Release* at 37-38, 118-19.

federal securities laws, the rules thereunder and self-regulatory organization ("SRO") rules applicable to such activity.[9]

The SEC proposes to impose a number of duties on foreign broker-dealers, foreign associated persons representing foreign broker-dealers, and intermediary U.S. registered broker dealers that intend to rely on these exemptions. Under both proposed exemptions, a foreign broker-dealer would, among other things, be required to:

- Provide the SEC with any information or documents in its possession, custody, or control, any testimony of foreign associated persons, and any assistance in taking the evidence of other persons, wherever located, that the SEC requests and that relates to transactions under paragraph (a)(3) of proposed Rule 15a-6, except that if, after the foreign broker or dealer exercises its best efforts to provide the information, documents, testimony, or assistance, including requesting the appropriate governmental body and, if legally necessary, its customers (with respect to customer information) to permit the foreign broker or dealer to provide the information, documents, testimony, or assistance to the Commission, the foreign broker or dealer is prohibited from providing this information, documents, testimony, or assistance by applicable foreign law or regulations this provision will not apply. However, if that is the case, the SEC could, by order after notice and opportunity for hearing, withdraw the exemption provided by Proposed Rule 15a-6(a)(3) with respect to subsequent activities of the foreign broker-dealer in the U.S.[10]

- Determine that the foreign associated person of the foreign broker or dealer effecting transactions with the qualified investor is not subject to a statutory disqualification specified in section 3(a)(39) of the Exchange Act.[11]

- Have in its files, and make available upon request by a registered broker or dealer satisfying the requirements described in Rule 15a-6(a)(3)(iii) or the SEC, the types of information specified in Rule 17a-3(a)(12).[12]

Under both exemptions, the foreign associated person of a foreign broker-dealer would have to abide by the following conditions:[13]

- All securities activities would have to be conducted from outside the United States.

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9 *Proposing Release* at 31, 45.

10 Proposed Rule 15a-6(a)(3)(i)(A) and 15a-6(c).

11 Proposed Rule 15a-6(a)(3)(i)(B).

12 Proposed Rule 15a-6(a)(3)(i)(C). Rule 17a-3(a)(12) requires registered broker-dealers to collect and maintain information concerning the background and regulatory history of their associated persons and the Proposed Rule would also require such information include any sanctions of associated persons of the foreign broker-dealer by foreign securities regulators.

13 Proposed Rule 15a-6(a)(3)(ii).

- Visits[14] to qualified investors could occur within the United States, but transactions in any securities discussed during those visits would have to be effected pursuant to Proposed Rule 15a-6(a)(3).

Under both exemptions, a U.S. registered broker-dealer would have to do the following with respect to a foreign broker-dealer intending to rely on these exemptions:[15]

- Obtain from the foreign broker-dealer and each foreign associated person, written consent to service of process for any civil action brought by or proceeding before the SEC or a SRO, providing that process may be served on them by service on the registered broker or dealer in the manner set forth on the registered broker-dealer's current Form BD.

- Obtain from the foreign broker-dealer a representation that the foreign broker or dealer has complied with the requirements of paragraphs (a)(3)(i)(B) and (C) of Proposed Rule 15a-6.

- Maintain records of the written consents required by the above, and that it make these records available to the SEC upon request.

Each Exemption, discussed below, also has its own further unique requirements that it imposes on the various parties.

5. Exemption (A)(1)

Proposed Exemption (A)(1), available only to foreign broker-dealers that conduct a "foreign business" and are regulated for conducting securities activities by a foreign securities authority, [16,17] significantly reduces the role U.S. registered broker-dealers must play when a foreign broker-dealer wishes to effect a securities transaction on behalf of a U.S. qualified investor that has been solicited by that foreign broker-dealer. It would, for the first time, allow a foreign broker-dealer to provide full-service brokerage service to U.S. qualified investors by receiving, delivering and safeguarding the funds and securities of the U.S. investors on whose behalf they effect transactions in securities.[18] The U.S. registered broker-dealer assisting a foreign broker-dealer under this provision would be responsible for maintaining

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14 The SEC proposes that a "visit" for purposes of the proposed rule "be a facts and circumstances determination based on factors including, but not limited to, the purpose, length and frequency of any stays." The SEC provides further detail about what would constitute a visit in the *Proposing Release* at 50.

15 Proposed Rule 15a-6(a)(3)(iii)(B), (C), (D).

16 The proposed rule would give the same definition of "foreign securities authority" as is found in Section 3(a)(50) of the Exchange Act, defined there to mean "any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters."

17 The SEC has added this requirement to Proposed Exemption (A)(1) "to ensure that only foreign entities that are legitimately in the business of conducting securities activities, and that are regulated in the conduct of those activities, could rely on Exemption (A)(1). *Proposing Release* at 34.

18 *Proposing Release* at 40.

- copies of all books and records, including confirmations and statements issued by the foreign broker-dealer to the qualified investor, relating to any resulting transactions, except that such books and records may be maintained:

  (i) in the form, manner and for the periods prescribed by the foreign securities authority regulating the foreign broker or dealer; and

  (ii) with the foreign broker-dealer, provided that the registered broker-dealer makes a reasonable determination that copies of any or all of such books and records can be furnished promptly to the SEC, and promptly provides to the SEC any such books and records, upon request.[19]

Proposed Exemption (A)(1) relieves U.S. registered broker-dealers of several obligations under current Rule 15a-6(a)(3). Specifically, they 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 they were otherwise involved in effecting the transaction;

- extend or arrange for the extension of credit, issue confirmations and account statements, comply with the Net Capital Rule[20] with respect to the transactions, or receive, deliver and safeguard funds and securities in connection with the transactions in compliance with the Customer Protection Rule; or

- maintain accounts for the customers of foreign broker-dealers relying on Exemption (A)(1),or comply with the requirements applicable to broker-dealers that maintain such accounts.[21]

Because foreign broker-dealers operating pursuant to Exemption (A)(1) of the proposed rule would not be subject to the same regulatory requirements as U.S. registered broker-dealers, they would have to disclose to U.S. qualified investors that they are regulated by a foreign securities authority and not by the SEC. They would also be required to disclose that U.S. segregation requirements,[22] U.S. bankruptcy protections[23] and protections under the Securities Investor Protection Act ("SIPA") would not apply to any funds and securities held by the foreign broker-dealer for the qualified investor.[24]

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19 *Id.* at 113-14; *See* Proposed Rule 15a-6(a)(3)(iii)(A)(1).

20 Exchange Act Rule 15c3-1.

21 *Proposing Release* at 31-32.

22 E.g., the requirement that customer funds and assets be segregated from the broker-dealer's own proprietary funds and assets. *Proposing Release* at 35.

23 E.g., preference to creditors in bankruptcy. *Proposing Release* at 35.

24 *Proposing Release* at 35.

6. Exemption (A)(2)

Proposed Exemption (A)(2) is designed to be used by foreign broker-dealers that intend to solicit transactions from qualified investors that have accounts, and custody their funds and securities, with U.S. registered broker-dealers.[25] It would be available to all foreign broker-dealers. Under Proposed Exemption (A)(2), a U.S. registered broker-dealer would be responsible for:

- Maintaining books and records, including copies of all confirmations issued by the foreign broker or dealer to the qualified investor, relating to any resulting transactions; and
- Receiving, delivering and safeguarding funds and securities in connection with the transactions on behalf of the qualified investor in compliance with the Customer Protection Rule.[26]

Proposed Exemption (A)(2) would also reduce the role of intermediating U.S. registered broker-dealers. They would no longer be required to "effect" a transaction. They would only need to maintain relevant books and records, and receive, deliver, and custody the funds and securities in connection with the transaction.[27]

Because the foreign-broker dealer would not be responsible for receiving, delivering, or safeguarding qualified investors' funds and securities, foreign broker-dealers operating under Proposed Exemption (A)(2) would not need to make disclosures to qualified investors regarding segregation requirements, bankruptcy protections and protections under SIPA.[28]

7. Counterparties and Specific Customers

The SEC also proposes to expand the parties to which the exemptions provided by Rule 15a-6(a)(4) apply. Presently, this provision permits a foreign broker-dealer to effect transactions in securities with or for, or induce or attempt to induce the purchase or sale of any security by, registered brokers or dealers, certain international banks and bank organizations, certain foreign persons temporarily in the United States, and certain U.S. persons or groups of U.S. persons abroad. The SEC proposes to add to that list U.S. resident fiduciaries of accounts for "foreign resident clients."[29,30]

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25 *Id.* at 43.

26 Proposed Rule 15a-6(a)(3)(iii)(A)(2).

27 *Proposing Release* at 45.

28 *Proposing Release* at 46; Proposed Rule 15a-6(a)(3)(i)(D).

29 Proposed Rule 15a-6(a)(4)(vi).

30 The SEC proposes to define a "foreign resident client" as:

(i) Any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for federal income tax purposes;

(ii) Any natural person not a U.S. resident for federal income tax purposes; and

(iii) Any entity not organized or incorporated under the laws of the United States 85 percent or more of whose outstanding voting securities are beneficially owned by persons in paragraphs (b)(4)(i) and (b)(4)(ii) of Proposed Rule 15a-6(b)(4).

The SEC states that it was prompted to make this proposal because it "recognize[s] that foreign resident clients would not expect that the broker-dealer through which a U.S. resident fiduciary is effecting transactions is regulated by the [SEC]."[31]

8. Familiarization with Foreign Options Exchanges

The final proposed exemption would allow a foreign broker-dealer that is a member of a foreign options exchange to effect transactions in options on foreign securities listed on that exchange for a qualified investor that has not otherwise been solicited by the foreign broker-dealer. The proposed exemption would allow a representative of a foreign options exchange located in a foreign office or a representative office in the United States to communicate or otherwise furnish to persons that the representative reasonably believes are qualified investors:[32]

- through participation in programs and seminars in the United States, among other things, information regarding the foreign options exchange, the options on foreign securities traded on the foreign options exchange and, if applicable, the foreign options exchange's OTC options processing service;[33]
- a disclosure document that provides an overview of the foreign options exchange and the options on foreign securities traded on that exchange, including the differences from standardized options in the U.S. options market and special factors relevant to transactions by U.S. persons in options on the foreign options exchange; and
- solely upon request of a qualified investor, a list of participants on the foreign options exchange permitted to take orders from the public and any registered broker or dealer affiliates of such participants.

A foreign broker or dealer would be permitted to:[34]

- make available to qualified investors the foreign options exchange's OTC options processing service; and
- provide qualified investors, in response to an unsolicited inquiry concerning options on foreign securities traded on the foreign options exchange, with a disclosure document that provides an overview of the foreign options exchange and the options on foreign securities traded on that

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31 *Proposing Release* at 58.

32 Proposed Rule 15a-6(a)(5)(i)(A), (B), (C).

33 The SEC proposes to define an "OTC options processing service" as "a mechanism for submitting an options contract on a foreign security that has been negotiated and completed in an over-the-counter transaction to a foreign options exchange so that the foreign options exchange may replace that contract with an equivalent standardized options contract that is listed on the foreign options exchange and that has the same terms and conditions as the over-the-counter options." Proposed Rule 15a-6(b)(6).

34 Proposed Rule 15a-6(a)(5)(ii)(A), (B).

exchange, including the differences from standardized options in the U.S. domestic options market and special factors relevant to transactions by U.S. persons in options on that exchange.

A foreign exchange would also be permitted to make available to qualified investors through a foreign broker-dealer the foreign option exchange's OTC options processing service.

9. Unsolicited Trades

The SEC does not propose changing the exception in Rule 15a-6(a)(1), which allows foreign brokers-dealers to effect transactions in securities with or for persons that have not been solicited by the foreign broker-dealer. However, the SEC emphasizes that it will continue to construe what constitutes "solicitation" broadly, and that "relatively few transactions qualify for the unsolicited exemption."[35]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

[35] *Proposing Release* at 22.