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Registration and Compliance Issues Facing Foreign Broker-Dealers

by Michael Wise and Lisa M. Zulanas

Introduction

In today's global economy, compliance officers may encounter questions concerning foreign broker-dealers directing investment opportunities to United States residents. These foreign broker-dealers may seek to enlist a United States firm or resident in their activities. Compliance issues arise whether sales activities are conducted in person, by telephone or e-mail, or through a website. For example, a foreign broker-dealer may approach a United States firm seeking to establish a correspondent relationship, or links through the firms' respective websites. Proactive compliance personnel should be familiar with some of the regulatory issues relevant to foreign brokerage activity.

Registration Requirement

United States securities laws receive a broad, "extraterritorial" interpretation. The SEC views the definition of "broker" or "dealer" expansively, generally requiring any broker or dealer involved in United States activities to register, whether the broker-dealer is located in the United States or abroad. Solicitation of persons resident in the United States will trigger broker-dealer registration issues.

Registration applies not only to broker-dealers physically present in the United States, but also to any entity, wherever located, that attempts to induce transactions with investors in the United States. Many foreign broker-dealers have United States affiliates registered as broker-dealers.[1] These foreign broker-dealers often solicit United States institutional investors through their United States affiliates, and the United States affiliates generally assume responsibility for the transactions.

Rule 15a-6

In recognition of the growing internationalization of the securities markets, the SEC adopted Exchange Act Rule 15a-6 ("the Rule")[2], which may best be viewed as an "exception" to the general registration requirement. While the Rule affords some relief to foreign broker-dealers, it has a number of specific conditions that must be adhered to, or registration violations will result. Of course, even if a foreign broker-dealer is exempt from registration, its sales activities still are subject to anti-fraud liability.

The Rule provides that a foreign broker-dealer is exempt from SEC registration to the extent that the foreign broker-dealer effects transactions that have *not been solicited* by the foreign broker-dealer. "Solicitation" is broadly interpreted, and essentially means an affirmative effort to induce transactional business for the broker-dealer. It encompasses any form of communication, whether written or oral, with respect to the purchase or sale of securities. For example, solicitation might be evidenced by a telephone call or e-mail, an introductory visit to a United States resident, advertising, use of websites or conducting seminars.

Internet Activity

Of particular importance in today's business world, a foreign broker-dealer's website directed to United States residents may be viewed as solicitation, raising questions of registration under the

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federal securities laws. The SEC has attempted to define which solicitation materials posted on internet websites would not be considered securities activity taking place "in the United States," and would remain beyond SEC purview.[3]

Application of the registration provisions often depends on whether internet communications are "targeted" to United States residents. To avoid being considered targeted materials, a foreign broker-dealer should implement restrictive measures. These measures must be reasonably designed to restrict access to the website only to certain types of authorized persons, and to guard against sales or the provision of services to unauthorized U.S. persons. An off-shore website generally is not targeted to United States residents if:

1) The website includes a *prominent disclaimer* making it clear that the offer is directed *only* to residents of countries *other than* the United States.

• For example, the website could state that the described securities or services are not being offered *in* the United States or *to* United States persons. Alternatively, the website could specify those foreign jurisdictions (other than the United States) in which such offers of services are being made, and;

2) The sponsor of the website (the "offeror") implements procedures reasonably designed to guard against sales to unauthorized United States persons.

• For example, the offeror could ascertain the website viewer's residence by obtaining information such as the viewer's mailing address or other identifying information.

As a practical matter, a foreign broker-dealer (not registered in the United States) will refuse to provide brokerage services to any potential customer that the broker-dealer has reason to believe, or that indicates, is a U.S. person, based on residence, mailing address, payment method or similar information.

In practice, some foreign broker-dealers' websites post the above warnings, and may restrict access based on a viewer's stated residence. A viewer who discloses a United States address is informed by a pop-up or similar screen that the website is not available to such customer, and that the foreign broker-dealer will not conduct any business with such customer, unless properly registered. Some entities use a password-protected website, which ensures that a viewer may not access site contents (beyond the home page) unless pre-approved by the foreign broker-dealer. The above safeguards are non-exclusive and a foreign broker-dealer may consider adopting other precautions as long as it can demonstrate that it does not effect securities transactions with U.S. persons as a result of its internet activities.

In the event that a foreign broker-dealer's website does not contain such disclaimers or restrictions on access, and United States residents have accessed the website, then the foreign broker-dealer should be advised to amend the website in question to include the restrictive measures outlined above.

Direct Customer Contact and "Chaperones"

The Rule provides an exemption where a foreign broker-dealer effects transaction with or for U.S.-registered broker-dealers, whether the registrant is acting on a principal or agency business.[4] However, this exemption does not allow direct contact by the foreign broker-dealer with a *customer* of the U.S. registrant.[5]

The Rule provides an exemption from registration for transactions by institutional investors with a non-registered foreign broker-dealer, so long as any resulting trades are effected though a United States registered broker-dealer who essentially "chaperones" the foreign broker-dealer's employees during their U.S.-directed activities. This exemption requires that business be limited to large institutional investors, and is subject to a number of detailed conditions.[6]

Temporary Residents

The Rule offers another important exemption with respect to foreign persons temporarily present in the United States. This foreign person exemption allows both effecting transactions, and solicitation of transactions.[7] The exemption applies to foreign persons temporarily present in the United States, with whom the foreign broker-dealer had a bona fide, pre-existing relationship before the foreign person entered the United States.

This category of persons likely would be foreign persons vacationing in the United States for extended purposes. The typical example would be a Canadian citizen who vacations in the southern United States over the winter, and wishes to maintain contact with his Canadian (non-U.S. registered) broker-dealer. Where foreign broker-dealers deal with United States-resident customers and such customers do not have a bona fide pre-existing relationship with the foreign broker-dealer prior to their taking up residence in the United States, registration and antifraud concerns may arise.

American Expatriates

A foreign broker-dealer is not required to register when it offers services to U.S. citizens resident outside the United States, provided that the transactions occur outside

the United States, and the foreign broker-dealer has not directed selling efforts toward identifiable groups of United States citizens resident abroad.[8] However, the foreign broker-dealer may not "target" selling efforts to a particular group. Examples of such prohibited targeting would be efforts directed to specific groups, such as United States military or embassy personnel stationed abroad.

Possible Reforms

In the Rule Proposal[9], the SEC suggested amendments which would relax several of the Rule's provisions outlined above. The Rule Proposal's current status is uncertain, particularly in light of the financial crisis and the proposed comprehensive new regulatory framework.

The Rule Proposal would have lowered the asset threshold for institutional investors recognized under the Rule. Previous institutional investor categories would be replaced with a single category of "qualified investor," consistent with Exchange Act Section 3(a)(54). "Qualified investors" would include institutional investors or natural persons who own or invest on a discretionary basis no less than $25 million, generally a decrease from the Rule's current $100 million level. The Rule Proposal recognizes that many sophisticated investors now are capable of assessing the potential risks and rewards of investing directly in foreign markets, and should have direct access to foreign broker-dealers.

Conclusion

The Rule was adopted twenty years ago in 1989. Since that time, trading in foreign stocks by U.S. investors has risen from $232 billion to $7.5 trillion and the introduction of computer and internet technology has revolutionized communication processes. Regulation of cross-border products and services by securities firms has not kept pace with these developments. Current regulations are complex and not flexible enough to meet today's market needs. The effect is to impose unnecessary burdens on U.S. investors.

Rule 15a-6 has worked to allow foreign financial entities increased access to U.S. markets. While benefiting markets, to an extent it has restricted business activities for both foreign and U.S. companies. Amendments to Rule 15a-6 would provide immediate benefits by improving the competitiveness of the U.S. financial services industry through increasing investment opportunities and eliminating unnecessary inefficiencies.

1. For purposes of this article, we adopt terminology consistent with United States authority. Thus, any reference to a "foreign" person or entity would mean a person or entity outside the United States.
2. 17 CFR 240.15a-6.
3. See Exch. Act Rel. 34-39779 (3/23/98).
4. See Rule 15a-6(a)(4)(i).
5. See Exch. Act Rel. 34-58047 (7/8/08) (the "Rule Proposal") at n. 41.
6. See Rule 15a-6(a)(3).
7. Rule 15a-6(a)(4)(iii).
8. Rule 15a-6(a)(4)(v).
9. See footnote 6 above.

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