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A legal update from Dechert's Financial Services Group

Opening the Door a Little Wider: SEC Proposes to Ease Requirements on Foreign Broker-Dealers Selling to U.S. Investors

The U.S. Securities and Exchange Commission (the "SEC") has recently proposed amendments (the "Proposed Amendments") to Rule 15a-6, its rule under the Securities Exchange Act of 1934 (the "Exchange Act") that exempts foreign broker-dealers who solicit certain U.S. investors, or who engage in certain other activities with U.S. contacts, from the broker-dealer registration requirements of the Exchange Act.[1] Comments on the Proposed Amendments are due by September 8, 2008.

Current Rule 15a-6 allows a foreign broker-dealer to engage in certain limited types of securities sales and solicitation activities in the U.S. and to communicate with certain persons in the U.S. without having to register with the SEC as a broker-dealer. With the increasing globalization of financial markets, a greater number of U.S. investors have been interested in investing in foreign securities. However, foreign broker-dealers have found the requirements of current Rule 15a-6 increasingly burdensome and outdated.

The Proposed Amendments seek to modernize the current Rule 15a-6 exemptions by, among other measures, allowing foreign broker-dealers to communicate with an expanded category of U.S. investors, changing the nature of the so-called "chaperone relationship" between a foreign broker-dealer and a registered U.S. broker-dealer, and permitting certain communications by and concerning foreign options exchanges.

Overview of Current Rule 15a-6 and the Proposed Amendments

Current Rule 15a-6's four main provisions allow a foreign broker-dealer to:[2]

- effect *unsolicited* transactions on behalf of U.S. investors;[3]
- furnish research reports to, but not initiate any subsequent contact with, certain U.S. institutional investors;[4]
- solicit and meet in the U.S. with certain U.S. institutional investors, provided that a U.S. broker-dealer acts

[1] Exemption of Certain Foreign Brokers or Dealers; Proposed Rule, Release No. 34-58047 (June 27, 2008) ("Proposing Release").

[2] Each of these provisions is subject to a number of additional conditions, which we have not summarized here.

[3] Rule 15a-6(a)(1). In other words, an unregistered foreign broker-dealer who is solicited by a U.S. investor may effect transactions for such investor without having to register as a broker-dealer in the U.S.

[4] Rule 15a-6(a)(2).

- as a "chaperone" and certain other conditions are satisfied;[5] and
- solicit certain financial institutions and other counterparties.[6]

The Proposed Amendments would:

- expand the category of U.S. investors with which a foreign broker-dealer could interact under the research report and chaperoning provisions;
- shift responsibility toward the foreign broker-dealer in the chaperoning relationship and eliminate the need for the U.S. broker-dealer to be present at meetings or on calls with U.S. investors;
- add an exemption for transactions between foreign broker-dealers that conduct a foreign business and U.S. resident fiduciaries of accounts for foreign resident clients; and
- add a provision allowing foreign options exchanges and/or foreign broker-dealer members of foreign options exchanges to effect certain transactions or conduct certain activities.

Research Reports and Follow-Up Contacts

Under current Rule 15a-6(a)(2), a foreign broker-dealer may send research reports to "major U.S. institutional investors," and under current Rule 15a-6(a)(3), a foreign broker-dealer may solicit (and meet in the U.S. with) "major U.S. institutional investors" and "U.S. institutional investors," in each case subject to various other conditions. Examples of the types of institutional investors with whom a foreign broker-dealer may interact under current Rule 15a-6(a)(2) or Rule 15a-6(a)(3) include U.S. registered investment companies, banks, insurance companies, and U.S. registered investment advisers that have assets, or have assets under management, greater than $100 million.

The Proposed Amendments eliminate the enumerated categories of institutional investors and substitute the term "qualified investors," as that term is defined in Section 3(a)(54) of the Exchange Act. Examples of "qualified investors" include U.S. registered investment companies, private funds relying on Section 3(c)(7) of the Investment Company Act of 1940, banks and foreign banks, broker-dealers and corporations, companies, partnerships, and natural persons that own and invest at least $25 million in investments on a discretionary basis. Thus, foreign broker-dealers could deliver research reports to, and otherwise solicit and meet in the U.S. with, qualified investors. This change would significantly expand the category of eligible U.S. investors by reducing the asset/assets under management levels required of institutional investors (from $100 million to $25 million) and by including high net worth natural persons with $25 million in assets among the list of those with whom foreign broker-dealers may interact.

Chaperoning by U.S. Broker-Dealers

Current Rule 15a-6(a)(3) allows a foreign broker-dealer to solicit, and meet in the U.S. with, certain U.S. institutional investors, provided that a U.S. broker-dealer acts as a "chaperone" and certain other conditions are met. As a chaperone, the U.S. broker-dealer is required to attend meetings and participate on calls between certain institutional investors and the foreign broker-dealer and to perform other oversight and transactional functions.

The Proposed Amendments would:

- permit foreign broker-dealers to solicit, and meet in the U.S. with, qualified investors (subject to the limits and conditions described below);
- introduce significant changes to the chaperoning relationship by shifting responsibility toward the foreign broker-dealer and eliminating the need for the U.S. broker-dealer to be present at meetings or on calls with U.S. qualified investors; and
- replace the existing exemption under current Rule 15a-6(a)(3) with two exemptions for foreign broker-dealers as further described below.

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5 Rule 15a-6(a)(3). The U.S. registered broker-dealer chaperone is required to attend meetings and participate in calls between certain institutional investors and the unregistered foreign broker-dealer and to perform certain oversight and transactional functions.

6 Rule 15a-6(a)(4). For example, U.S. registered broker-dealers, whether acting as principals or agents, and banks.

One exemption, referred to in the Proposing Release as "Exemption (A)(1),"[7] would only be available to foreign broker-dealers that conduct a "foreign business."[8] The other exemption, referred to in the Proposing Release as "Exemption (A)(2),"[9] would be available to all foreign broker-dealers. For a foreign broker-dealer to rely on either exemption, it must be regulated in a foreign country by a foreign securities authority (both in relation to securities activities generally and in relation to its dealings with U.S. qualified investors under Rule 15a-6).[10]

Foreign broker-dealers relying on Exemption A(1) may effect transactions in securities for U.S. qualified investors and may custody the securities and funds of such investors. In other words, the exemption permits a foreign broker-dealer to act as a full-service broker-dealer. The related effect of Exemption A(1) is that there is no longer a requirement that an intermediating U.S. broker-dealer extend credit, issue confirmations, receive, deliver or safeguard customer funds or securities, or otherwise comply with the net capital or customer protection rules with respect to such transactions.

Exemption A(2), in contrast, is designed for foreign broker-dealers who do not conduct a full-service foreign business and for U.S. qualified investors who maintain accounts at U.S. registered broker-dealers but desire to have access to foreign broker-dealers. While foreign broker-dealers that rely on Exemption A(2) would be permitted to effect transactions in securities for U.S. qualified investors, they would not be permitted to custody the securities and funds of such investors. The custody function would continue to be performed by a U.S. registered broker-dealer.

While the Proposed Amendments would not eliminate the need for a U.S. registered broker-dealer chaperone to oversee certain aspects of the foreign broker-dealer's interactions with qualified investors, they would certainly reduce the chaperone's role and responsibilities.

Notably, a U.S. registered broker-dealer chaperone would not be required to effect all aspects of a solicited transaction,[11] accompany associated persons of the foreign broker-dealer ("foreign associated persons") during in-person visits in the U.S. with qualified investors, or participate in communications (e-mail or telephone) between foreign associated persons and U.S. qualified investors. In-person visits to the U.S. by foreign associated persons would, however, be subject to limits to prevent foreign broker-dealers from maintaining a permanent sales force in the U.S. In the Proposing Release, the SEC proposes to interpret a "visit" as one or more trips to the U.S. by a foreign associated person over a calendar year that do not last more than 180 days in the aggregate.[12]

Similarly, Exemption A(1), while requiring the U.S. registered broker-dealer to maintain books and records relating to the transactions effected by the full-service foreign broker-dealer, would nevertheless allow for such books and records, including confirmations and statements issued by the foreign broker-dealer, to be maintained (in the form and manner, and for the periods prescribed by the foreign securities authority regulating the foreign broker-dealer) by the foreign

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7 *See* proposed new paragraph (iii)(A)(*1*) of Rule 15a-6(a)(3).

8 Proposed Rule 15a-6(b)(3) would define a "foreign business" as a business 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 Rules 15a-6(a)(3) and 15a-6(a)(4)(vi), calculated on a rolling two-year basis, is derived from transactions in "foreign securities." Proposed Rule 15a-6(b)(5) would define a "foreign security" as (i) an equity or debt security of a foreign private issuer, (ii) a debt security issued by a U.S. issuer in connection with a Regulation S distribution conducted solely outside the U.S., (iii) a note, bond, debenture or evidence of indebtedness issued or guaranteed by a foreign government eligible for registration under Schedule B of the Securities Act of 1933, or (iv) a derivative instrument on any of the above securities.

9 *See* proposed new paragraph (iii)(A)(*2*) of Rule 15a-6(a)(3).

10 The proposed rule would give the term "foreign securities authority" the same meaning as in Section 3(a)(50) of the Exchange Act, which defines "foreign securities authority" 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." *See* Proposing Release at § III.D.1.a.i.

11 However, where a transaction is effected 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 U.S., a U.S. registered broker-dealer would necessarily be involved in effecting the transactions. *See* Proposing Release at §§ III.D.1.a.i and III.D.1.b.i.

12 *See* Proposing Release at § II.D.1.b.ii.2.

broker-dealer itself, provided that the U.S. registered broker-dealer determines that copies could be furnished promptly to the SEC and promptly provides such copies to the SEC upon request.[13] Under Exemption A(2), however, the U.S. registered broker-dealer chaperone would continue to maintain such books and records (including confirmations and statements).

The duty of determining that the foreign broker-dealer's employees involved in interactions with U.S. qualified investors are not subject to a statutory disqualification under the Exchange Act would shift from the U.S. registered broker-dealer chaperone to the foreign broker-dealer, as would the duty to maintain a questionnaire or application of employment (of the type required by Exchange Act Rule 17a-3(a)(12)) containing the personal information and regulatory history of each foreign associated person.[14] As under the current rule, the foreign broker-dealer would, at the request of the SEC, be required to provide to the SEC documents and testimony in relation to transactions under Rule 15a-6(a)(3).[15]

In addition to the record-keeping and custody obligations (in relation to Exemption A(2)) referred to above, the U.S. registered broker-dealer chaperone would also be responsible (as under the current rule) for obtaining from the foreign broker-dealer and its foreign associated persons consents to service of process for civil proceedings brought by the SEC or self-regulatory organizations and for obtaining certain representations from the foreign broker-dealer (*e.g.*, that the foreign broker-dealer has determined that none of its foreign associated persons are subject to a statutory disqualification).[16]

New Disclosure Requirements

To counterbalance the increased communication afforded to foreign broker-dealers under the Proposed Amendments, proposed Rule 15a-6(a)(3)(i)(D) would also require a foreign broker-dealer to disclose to qualified investors that it is regulated by a foreign securities authority and not by the SEC and, for those full-service foreign broker-dealers relying on Exemption A(1), that U.S. segregation requirements, U.S. bankruptcy protections, and protections under the Securities Investor Protection Act would not apply to any funds and securities held by the foreign broker-dealer.

Additional Exempted Counterparties

In a new Rule 15a-6(a)(4)(vi), the Proposed Amendments would add an exemption for transactions between foreign broker-dealers that conduct a foreign business and U.S. resident fiduciaries of accounts for foreign resident clients.[17]

Proposed Amendments Regarding Foreign Options Exchanges

A new subsection (a)(5) of Rule 15a-6 would permit a foreign broker-dealer to effect transactions in options on foreign securities listed on a foreign options exchange of which the foreign broker-dealer is a member for a qualified investor that it has not solicited (although the proposed rule would also permit certain actions by the foreign broker-dealer, such as making the exchange's

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13 In making this determination, the U.S. registered broker-dealer would be required to consider any legal limitations in the relevant foreign jurisdiction that might limit the foreign broker-dealer's ability to provide information about transactions effected in reliance upon Exemption A(1). *See* Proposing Release at § III.D.1.a.i.

14 *See* proposed Rules 15a-6(a)(3)(i)(B) and (C). The foreign broker-dealer would also be required to provide the questionnaire or application for employment to the U.S. registered broker-dealer or SEC if requested.

15 If applicable foreign law would prohibit such co-operation, the SEC may, after a notice and opportunity for hearing, withdraw the foreign broker-dealer's ability to rely on Rule 15a-6(a)(3). *See* proposed Rule 15a-6(a)(3)(i)(A) and Rule 15a-6(c).

16 *See* proposed Rules 15a-6(a)(3)(iii)(B), (C) and (D).

17 Proposed Rule 15a-6(b)(4) would define "foreign resident client" as: (i) any entity not organized or incorporated under the laws of the U.S. and not engaged in a trade or business in the U.S. 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 U.S., 85% or more of whose outstanding voting securities are beneficially owned by persons described in (i) and (ii) above. *Cf. Cleary, Gottlieb, Steen & Hamilton*, SEC No-Action Letter (pub. avail. Nov. 22, 1995, revised Jan. 30, 1996).

OTC processing services available to the qualified investor or providing disclosure documents about the exchange in response to unsolicited inquiries, without such actions amounting to solicitation).[18] Proposed Rule 15a-6(a)(5) would also allow foreign options exchanges to conduct certain activities designed to educate qualified investors about the exchanges, including providing qualified investors with informational brochures providing an overview of the exchange, the options traded on it, how the options differ from standardized options in the U.S. options market and any special factors relevant to transactions by U.S. persons in options on the exchange and, upon request, providing qualified investors with a list of participants on the foreign options exchange permitted to take orders from the public. In addition, the foreign options exchange would be permitted to make available the exchange's OTC options processing service to qualified investors (through the foreign broker-dealer).

Other Securities Law Considerations

Foreign broker-dealers relying on Rule 15a-6's exemptions from registration will continue to remain subject to certain other provisions of U.S. securities laws, including Sections 15(b)(4) and 15(b)(6) of the Exchange Act, which allow the SEC to censure or restrict the activities of broker-dealers who commit certain unlawful or criminal acts or other bad acts; Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent and deceptive practices in connection with the purchase or sale of a security; and applicable requirements of the Securities Act of 1933.

In addition, certain foreign broker-dealers may also meet the definition of an investment adviser, and would therefore be subject to registration as such under the Investment Advisers Act of 1940 (the "Advisers Act"). Notably, foreign broker-dealers furnishing research reports to U.S. persons generally would be investment advisers if they are paid for providing those research reports.[19] These foreign broker-dealers cannot rely solely on compliance with Rule 15a-6 to avoid registration under the Advisers Act and would continue to be required to rely on an applicable exception from registration. Section 202(a)(11)(C) of the Advisers Act provides an exception from the definition of investment adviser to broker-dealers whose advisory services are "solely incidental" to their business as broker-dealers and who receive no "special compensation" for their investment advice. Although the SEC staff has stated that it considers that this exception is available to registered broker-dealers, the staff has also indicated that it "generally would expect to respond favorably to no-action requests regarding registration under the Advisers Act" by foreign broker-dealers relying on Rules 15a-6(a)(2), (3) or (4) if they meet the requirements of Section 202(a)(11)(C) of the Advisers Act.[20]

Related Developments

In a related development, the SEC staff recently released an interpretive letter (the "Interpretive Letter") clarifying that Rule 206(4)-3 under the Advisers Act does not apply to payments by registered advisers to persons who solicit investments in investment pools managed by the adviser.[21] Rule 206(4)-3 (the "Cash Solicitation Rule") stipulates that a registered investment adviser who pays a fee to a solicitor or "finder" in exchange for soliciting clients for the adviser must comply with certain conditions intended to address conflicts of interest inherent in such cash solicitation arrangements. In support of its position, the SEC staff expressed the view that the Cash Solicitation Rule was designed to apply to situations in which the solicited person might ultimately enter into an advisory contract with the manager and focused on the Cash Solicitation Rule's use of the terms "client" and "prospective client" rather than "investor" and "prospective investor" to describe the category of solicited persons that would trigger application of the rule.

The Interpretive Letter declines to address whether the receipt of cash compensation for soliciting or referring investors to an adviser's investment pool would result in the solicitor or finder being considered a "broker" under

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18 *See* proposed Rule 15a-6(a)(5)(ii).

19 *See* Registration Requirements for Foreign Broker-Dealers, Release No. 34-27017 (July 11, 1989) ("Current Rule 15a-6 Adopting Release") at § IV.B.2.c.

20 *See* Current Rule 15a-6 Adopting Release at § IV.B.2.c. The SEC staff have given no-action assurances in this regard. *See James Capel and Co. Ltd.*, SEC No-Action Letter (Dec. 6, 1989); *Dean Witter Reynolds (Canada) Inc.*, SEC No-Action Letter (March 1, 1990); *Barclays Plc*, SEC No-Action Letter (Feb. 14, 1991); *Charterhouse Tilney*, SEC No-Action Letter (July 15, 1993).

21 *Mayer Brown LLP*, Interpretive Letter (July 15, 2008).

Section 3(a)(4) of the Exchange Act. However, the letter marks a shift in the SEC's treatment of such solicitation arrangements away from the purview of the Advisers Act, and the SEC's emphasis on considering these solicited/referred persons as "investors" rather than "clients" relative to private fund advisers moves these types of cash solicitations closer toward the broker-dealer regulatory framework.

Conclusion

The Proposed Amendments to Rule 15a-6 aim to modernize the SEC's approach to providing U.S. investors with access to foreign securities markets through foreign broker-dealers and to relax the responsibilities of supervising registered U.S. broker-dealers. The SEC has solicited comments to the Proposed Amendments. Comments are due to the SEC no later than September 8, 2008, and we would be happy to assist clients in the preparation of comment letters.

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