Rule 15a-6: Safe Harbor for Unregistered Foreign Broker-Dealers

Presented at the ALI/ABA Course of Study:
Broker-Dealer Regulation
January 8-9, 2004
Washington, D.C.

January 8-2004

Written By:

Andrew M. Klein
t 202.778.6415
aklein@schiffhardin.com

SCHIFF HARDIN LLP
1101 Connecticut Avenue, N.W.
Suite 600
Washington, DC 20036
t 202.778.6400
f 202.778.6460

www.schiffhardin.com

A. — Section 15 of the Exchange Act

If an entity comes within the definitions of "broker" or "dealer" in Sections 3(a)(4) and (5) of the Securities Exchange Act of 1934 ("Exchange Act") — by virtue of being "engaged in the business of effecting transactions in securities for the accounts of others" (with exceptions for certain activities of banks, as defined in Section 3(a)(6) of the Exchange Act) or "engaged in the business of buying and selling securities for such person's own account through a broker or otherwise," but excluding a "person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as part of a regular business" — and uses the mails or any means or instrumentality of interstate commerce (commonly referred to as the "jurisdictional means") to induce or effect securities transactions, the entity is generally required by Section 15 of the Exchange Act to register with the Securities and Exchange Commission ("SEC") as a broker-dealer and to conduct its business as such in accordance with applicable provisions of the Exchange Act and rules thereunder.

B. — Early Treatment of Foreign Broker-Dealers

The international activities of foreign firms that involve securities transactions for or with U.S. persons, or inducements to such persons to engage in such transactions, regularly present the following questions: (i) do those firms meet the definition of "broker" or "dealer" under the Exchange Act; (ii) do their activities involve use of the jurisdictional means; and (iii) do those activities involve effecting or inducing transactions in securities? If affirmative answers are given to these three questions, the foreign firm must register here as a broker-dealer unless an exemption from such registration is available (or a written undertaking is obtained from the staff of the SEC to the effect that the staff will not recommend enforcement action against the foreign firm if it conducts itself, under specified circumstances, in accordance with stated facts).

The issues presented by the international securities activities of foreign firms were first addressed in a comprehensive fashion in Securities Act Release 4708, 29 FR 9828 (July 9, 1964). Release 4708 analyzed application of the Securities Act of 1933 to offerings of securities issued abroad by foreign issuers and the need for registration of foreign broker-dealers who participated in foreign offerings of securities of U.S. issuers. That release set out conditions under which broker-dealer registration in the United States by foreign broker-dealers participating in such offerings would not be required, emphasizing particularly that sales would only be made outside of the United States to non-U.S. persons.

The principles articulated in Release 4708 were extended by no-action letter to foreign sales by foreign broker-dealers to non-U.S. persons of securities of U.S. issuers obtained in U.S. secondary markets through U.S. broker-dealers. Securities transactions between foreign broker-dealers (regardless of whether the securities were issued by foreign or U.S. issuers) and U.S. investors, however, invariably were deemed to require registration of the foreign firm as a broker-dealer under the Exchange Act. No distinction was made in this regard between transactions that were solicited by the foreign broker-dealer and those that were not, although the facts presented usually implied that such solicitation had occurred or would occur.

No-action positions also were taken with respect to the need to register a foreign broker-dealer that prepared abroad and disseminated research concerning foreign issuers to U.S. investors through registered U.S. affiliates so long as the affiliated U.S. broker-dealer would be fully responsible for executing and confirming trades resulting from the research and all other aspects of maintaining the U.S. investors' accounts. Relief also was given in situations where a U.S. broker-dealer would participate in communications between U.S. institutional investors and a foreign broker-dealer that led to transactions on the condition that any resulting trades would be executed by the U.S. broker-dealer. Similar treatment was accorded to foreign broker-dealers whose quotations for foreign securities (including the names and addresses of the foreign originators of the quotes) were collected by a foreign securities exchange and relayed to U.S. institutional investors by a registered U.S. self-regulatory organization (*i.e.*, the NASD) pursuant to an arrangement with the foreign exchange.

The early history and evolution of the staff's no-action positions with respect to foreign broker-dealers noted above are summarized in Release No. 34-25801, 53 FR 23645 (June 23, 1988). That release also set out a comprehensive interpretive statement with respect to registration of foreign broker-dealers under the Exchange Act. Underlying the interpretive positions taken were the ideas that (i) foreign persons dealing with a foreign broker-dealer, even when buying or selling securities of U.S. issuers, should not and typically do not expect the protections of the U.S. securities laws to apply to their transactions; and (ii) U.S. persons residing abroad who deal with foreign broker-dealers should not have and do not have that expectation either (except where the foreign

broker-dealer specifically targets identifiable groups of U.S. persons residing abroad, such as embassy or armed services personnel for solicitation).

Solicitation of U.S. persons resident in the U.S. by foreign broker-dealers, including by means of providing quotations by an individual foreign broker-dealer (except as part of a general quotation stream disseminated by a foreign exchange) or research directed to them (otherwise than through a U.S. broker-dealer), was viewed as requiring the foreign broker-dealer to register here. Foreign broker-dealers who formed U.S. affiliates that registered as broker dealers here, however, were permitted to solicit U.S. institutional investors through those affiliates so long as the U.S. affiliate assumed full responsibility for those contacts and for executing any solicited trades, including confirming, clearing and settling them, safekeeping customers' funds and securities, making appropriate net capital computations regarding such trades, and arranging for the extension of any credit used to purchase securities.

C — Proposed Rule 15a-6

Release 25801 also proposed Rule 15a-6 under the Exchange Act. That rule, as proposed, would have exempted from registration foreign broker-dealers that induced or attempted to induce the purchase or sale of any security by a U.S. institutional investor upon satisfaction of certain conditions. Key among these conditions were requirements that:

i. the foreign broker-dealer would have had to conduct its activities from outside the United States through a U.S. broker-dealer affiliate;
ii. all transactions would have to be effected by the U.S. broker-dealer affiliate;
iii. the U.S. affiliate would have to maintain information (readily available to the SEC) with respect to the associated person of the foreign broker-dealer who would be in contact with U.S. institutional investors;
iv. the U.S. affiliate would have to obtain written consents to service of process in any civil action or proceeding conducted by the SEC or any self-regulatory organization from the foreign broker-dealer and each foreign associated person who would be in contact with U.S. institutional investors;
v. the U.S. affiliate would have to assume responsibility for all aspects of the U.S. institutional investors' accounts, including confirming trades, extending or arranging for credit, maintaining applicable books and records, and receiving and safeguarding customers' funds and securities; and
vi. the foreign broker-dealer would have to provide the SEC upon request with any information or documents within the foreign broker-dealer's possession or control that directly or indirectly related to transactions with U.S. institutional investors or with the registered broker-dealer that effected such transactions.

The term "U.S. institutional investor" was proposed to be defined to cover, among others, any registered broker-dealer, registered investment company, registered investment adviser with assets under management of at least $100 million, or accredited investor with total assets in excess of $100 million.

D — Rule 15a-6 As Adopted

The SEC adopted Rule 15a-6 in final form in Release No. 34-27017, 54 FR 30013 (July 18, 1989) ("Adopting Release"). As adopted, Rule 15a-6 incorporated most of the interpretive positions stated in Release 25801.

The Adopting Release repeats that, in addition to requiring broker-dealer operations physically located within the United States to register, the SEC also generally compels registration by foreign broker-dealers that induce or attempt to induce trades by any person in the United States (except foreign persons temporarily present here). The Adopting Release provides specific exemptions from registration in the U.S. by foreign broker-dealers for various categories of securities activities with or for U.S. persons. These are described below.

1. Unsolicited Trades: Paragraph (a)(1)

Paragraph (a)(1) of Rule 15a-6 exempts from broker-dealer registration any foreign broker-dealer to the extent that it effects transactions in securities with or for persons "that have not been solicited by the foreign broker-dealer."

"Solicitation," as indicated earlier in Release 25801, means any affirmative effort by a broker-dealer intended to induce transactional business for the broker-dealer or its affiliates, whether in a single transaction or an ongoing securities business relationship. Solicitation can take the form of a telephone call, introductory visits to make U.S. persons aware of the foreign broker-dealer's availability to effect securities transactions, advertising one's function as a broker-dealer, conducting investment seminars (even if hosted by a U.S. broker-dealer), recommending the purchase or sale of particular securities with the expectation that the broker-dealer will be used to effect the recommended transactions, and distribution in the United States of foreign markets' quotations.

Notwithstanding the foregoing, collective distributions of quotes by foreign exchanges or third-parties *(i.e.*, by someone other than the foreign broker-dealer whose quotations and related trade information are being disseminated), at least where these quotations are distributed primarily in foreign countries and absent other inducements to trade by the foreign market makers whose quotes are disseminated, is expressly permitted by the Adopting Release without triggering the need for broker-dealer registration by the foreign firms whose quotations are included in such systems. Such systems, however, must not allow securities transactions to be executed between foreign broker-dealers and persons in the United States. See Adopting Release at 30018. Nor is it permissible for a foreign market to disseminate its quotations directly to U.S. investors through a private quotation system controlled by a foreign broker-dealer because such private, direct dissemination is viewed as a direct inducement to trade with that foreign broker-dealer. Id. at 30019; see also Release No. 34-39779 (March 23, 1998), addressing foreign broker-dealer web sites offering a broad range of information about the foreign broker-dealer and its services and quite clearly constituting inducements to transact and taking the position that such sites would not be regarded as impermissible "inducements" if the foreign broker-dealer (i) posts a disclaimer stating that its services are not available in the U.S. and (ii) refuses to provide brokerage services to any potential customer that the broker-dealer has reason to believe is a U.S. person.

2. Research: Paragraph (a)(2)

Paragraph (a)(2) of Rule 15a-6 exempts from registration foreign broker-dealers that furnish research reports directly or indirectly to "major U.S. institutional investors" under certain conditions. "Major U.S. institutional investors" are defined in paragraph (b)(2) of the rule to include U.S. institutional investors with assets in excess of $100 million and registered investment advisers with more than $100 million under management (hereinafter "Major IIs"). "U.S. institutional investors" are defined in paragraph (b)(7) of the rule to mean, among others, any registered investment company, bank, savings and loan association, insurance company, business development company or employee benefit plan (as defined in Rule 501(a)(1) of Regulation D under the Securities Act of 1933) (hereinafter "IIs"). (The definition of Major IIs incorporates the definition of IIs. Neither refers to high net worth individuals. Thus, sophisticated wealthy individuals were neither Major IIs nor IIs. The Nine Firms Letter, discussed under the caption, **E. Subsequent Developments**, below, effectively changed these definitions to include any person owning or controlling in excess of $100 million in aggregate financial assets.) Such research, however, may not recommend use of the foreign broker-dealer that provides the research to effect transactions. Further, the research provider may not follow up the research by contacting recipients or otherwise attempting to induce them to purchase or sell any securities. If these conditions are satisfied, however, the provider nevertheless may effect trades with or for the research recipients at their request without becoming subject to registration here as a broker-dealer.

Research provided by a foreign broker-dealer may not be distributed to anyone other than Major IIs without triggering the registration requirement unless (i) the research is distributed by a U.S. registered broker-dealer and unless the research itself states prominently that (a) the U.S. broker-dealer has assumed responsibility for the research report's content, and (b) recipients of the research who wish to effect transactions in any security covered by the report should do so with or through the U.S. registered broker-dealer rather than with or through the foreign broker-dealer provider; and (ii) any transactions in the securities covered by the research by recipients must be effected only through the U.S. broker-dealer distributor.

So-called "soft dollar" research arrangements, contemplating that a certain amount of commission business will be directed to the foreign broker-dealer research provider, are not covered by the research exemption and are viewed instead as impermissible inducements to purchase — regardless of whether the securities traded are or are not covered by the research provided pursuant to the arrangement.

3. Direct Contacts and "Chaperones:" Paragraph (a)(3)

Paragraph (a)(3) of Rule 15a-6 provides an exemption from registration for foreign broker-dealers that induce or attempt to induce trades in securities by Major IIs and IIs so long as any resulting trades are effected through a U.S. registered broker-dealer and various conditions are met by both the foreign broker dealer, its associated persons, and the registered broker-dealer that effects the trades. Foreign associated persons of foreign broker-dealers that seek to rely on the paragraph cannot be subject to any statutory disqualification as defined in Section 3(a)(39) of the

Exchange Act or any substantially equivalent foreign sanction or bar.

Under paragraph (a)(3) of the rule, a foreign broker-dealer may contact IIs directly only if an associated person of a U.S. registered broker-dealer participates in each of those contacts in person or electronically (including oral conversations), thereby making the registered broker-dealer responsible for the content of those communications. Direct contacts with Major IIs, however, may occur without such participation. In both cases, any resulting transaction must be effected by a registered broker-dealer acting as intermediary. This means that the registered broker-dealer must handle all aspects of such transactions except negotiation of their terms.

In particular, the U.S. registered broker-dealer must (i) issue all required confirmations and account statements to investors, (ii) be responsible for extending or arranging for credit in connection with purchases, and for maintaining required books and records, and (iii) obtain and retain copies of all consents to service of process by the foreign broker-dealer and its foreign associated persons and all other required information pertaining to the foreign broker-dealer and such associated persons, including records pertaining to any transactions entered into by Major IIs or IIs involving the foreign broker-dealer. (Required records must be maintained physically by the registered broker-dealer, but processing such records mechanically can be performed by the foreign broker-dealer.) The registered broker-dealer may not delegate any of its functions to the foreign broker-dealer other than physically executing trades on foreign securities exchanges. The registered broke-dealer is also responsible for reviewing resulting trades for possible violations of the federal securities laws and cannot ignore indications of irregularity. See Adopting Release at 30025-26.

To utilize paragraph (a)(3) of Rule 15a-6, the foreign broker-dealer must provide to the SEC, upon request or pursuant to any agreement reached by the SEC with any foreign securities authority, any information or documents in the foreign broker-dealer's possession or control and testimony of its foreign associated persons (and assistance in taking evidence from anyone else) that relates to transactions effected in reliance on the paragraph. The Adopting Release and the rule take into account that foreign blocking statutes or secrecy laws might impede compliance with the contemplated process, and, if they do, the rule provides that the SEC, after notice and an opportunity for a hearing, may withdraw the foreign broker-dealer's ability to rely on paragraph (a)(3).

All of the foreign broker-dealer's activities under paragraph (a)(3) of Rule 15a-6 must be conducted from outside the United States, provided, however, that foreign associated persons may visit with Major IIs and IIs in the United States if accompanied by an associated person of a registered broker-dealer that accepts responsibility for the foreign broker-dealer's communications with such U.S. investors and any resulting transactions are effected thorough that registered broker-dealer.

By no-action letters issued after adoption of Rule 15a-6, discussed below under the caption, **E. Subsequent Developments**, certain of the conditions imposed by paragraph (a)(3) of Rule 15a-6 on contacts between foreign broker-dealers and Major IIs and IIs have been modified in important ways.

4. Transactions Involving Registered Broker-Dealers and Certain Others: Paragraph (a)(4)

Paragraph (a)(4) of Rule 15a-6 permits foreign broker-dealers to effect transactions with or for registered broker-dealers and banks acting in a broker-dealer capacity, and, thus, to deal indirectly with U.S. investors through any United States broker-dealer acting in an agency or dealer capacity. The SEC, however, has said explicitly that it does not intend by this to permit foreign broker-dealers to act as a dealer in the United States through an affiliated, registered broker-dealer. For example, if the affiliated, registered broker-dealer were to be acting as a market maker in the U.S., and that broker-dealer's day-to-day activities were to be controlled by the foreign broker-dealer (*e.g.*, by restricting the U.S. affiliate's ability to trade against the foreign broker-dealer's positions or to take independent positions), the foreign broker-dealer could be considered a dealer subject to registration here. See Adopting Release at 30030, citing Letter from Jonathan Katz, Secretary, SEC, to Marcia MacHarg, Debevoise & Plimpton, August 13, 1986 (Vickers da Costa/Citicorp order), granting an exemption to several foreign broker-dealers from registration here that enabled them to engage in trades effected on a riskless principal basis by a U.S. affiliate with U.S. persons (to fill standing orders submitted by the foreign broker-dealers to that affiliate).

Paragraph (a)(4) of the rule also permits foreign broker-dealers to transact with (i) certain named

international organizations (and their pension funds) regardless of their location or use of the jurisdictional means, (ii) foreign persons temporarily in the United States with whom the foreign broker-dealer had a pre-existing relationship before the foreign person entered the U.S., (iii) foreign agencies or branches of U.S. persons located outside of the United States, provided that the transactions are effected outside of the U.S., and (iv) non-resident U.S. citizens (provided that the foreign broker-dealer does not target selling efforts toward identifiable groups of such citizens resident abroad) so long as the transactions occur outside of the U.S.

E — Subsequent Developments

While Rule 15a-6 has not been amended since its adoption, certain no-action letters issued subsequently are of special interest and importance.

1. Seven Firms Letter

In a no-action letter to Giovanni P. Prezioso, Cleary Gottlieb, Steen & Hamilton, from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, dated January 30, 1996 (“Seven Firms Letter”), the staff permitted the foreign affiliates of a group of U.S. registered broker-dealers to effect transactions in “foreign securities” (as defined in the letter) with U.S. resident fiduciaries for the accounts of “offshore clients” (as defined in the letter) without registering as broker-dealers in the U.S. or effecting those transactions in accordance with Rule 15a-6. A U.S. resident fiduciary ordinarily would be viewed as a U.S. person for purposes of Rule 15a-6 and normal application of Section 15 of the Exchange Act to transactions with or efforts to induce transactions with U.S. person by foreign broker-dealers. Nevertheless, the staff appears to have been persuaded that such a construction would put U.S. fiduciaries at a severe competitive disadvantage in providing money management services to foreign persons, and, further, that such foreign persons ordinarily would not expect their transactions in “foreign securities” effected with a foreign broker-dealer to be subject to the protections of the federal securities laws notwithstanding that their accounts were managed by a U.S. fiduciary.

Of special interest is the manner in which the Seven Firms Letter deals with derivatives, including over-the-counter derivatives, determining whether they constitute “foreign securities” by reference to the underlying instrument (and its status as a “foreign security “ or U.S. security) rather than the nationality or residence of the writer of the derivative. Further, while debt securities issued by a U.S. issuer that are offered and sold in accordance with Regulation S under the Securities Act ordinarily would qualify as “foreign securities” (and would retain that status even if later introduced to the U.S. by sales exempt from registration under the Securities Act), that would not be the case if such securities are offered and sold as part of a “global offering” involving both a distribution in the U.S. under a Securities Act registration statement and a contemporaneous distribution outside of the U.S.

2. Nine Firms Letter

In a no-action letter to Giovanni Prezioso, Cleary Gottlieb Steen & Hamilton, from Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated April 9, 2003 (“Nine Firms Letter”), the staff gave further relief to foreign broker-dealer affiliates of registered U.S. broker-dealers to permit the following, notwithstanding anything to the contrary in Rule 15a-6(a)(3):

i. foreign broker-dealer interaction with any entity, including any investment adviser, whether or not registered under the Investment Advisers Act of 1940 (*e.g.*, hedge fund managers), that owns or controls, or, in the case of a registered adviser, has under management, in excess of $100 million in aggregate financial assets as if it were a Major II (although such entities are not included in the definition of Major II contained in the rule);

ii. clearance and settlement of transactions in “foreign securities” (as defined) or U.S. government securities intermediated by a U.S. broker-dealer to occur through direct transfers of funds and securities between the foreign broker-dealer and the U.S. investor so long as (a) the foreign broker-dealer does not act as custodian of the funds or securities of the U.S. investor, (b) the foreign broker-dealer agrees to make available to the intermediating U.S. broker-dealer clearance and settlement information as to such transfers, and (c) the foreign broker-dealer is not in default to any counterparty on any material financial market transaction;

iii. foreign associated persons, without being accompanied by an associated person of a U.S. registered broker-dealer, may (a) engage in oral communications from outside the U.S. with IIs outside the regular trading hours of the New York Stock Exchange so long as they do not accept

orders to effect transactions in securities other than foreign securities, and (b) have in-person contacts with Major IIs and others covered by the Nine firms Letter as if they were Major IIs (see clause (i) above), so long as the number of days on which such contacts occur does not exceed 30 per year, and, in both cases, so long as the foreign associated person does not accept orders to effect any securities transactions during such visits;

iv. distribution of third-party quotations originated by foreign broker-dealers (including prices and other trade reporting information input directly by the foreign broker-dealers) in the United States regardless of whether the services are or are not distributed "primarily" in foreign countries; and

v. foreign broker-dealers to provide U.S. investors with access to screen-based quotation systems that supply quotations, prices and other trade-reporting information input directly by the foreign broker-dealer so long as any transactions between the U.S. investor and the foreign broker-dealer are intermediated as required by Rule 15a-6(a)(3). In this regard, such trades could not be effected directly by the foreign broker-dealer under paragraph (a)(1) of the rule in the case of proprietary quotation system distributed by the foreign broker-dealer as opposed to a third-party quotation service because those trades would not be considered unsolicited.

SCHIFF HARDIN LLP

About the Author

Andrew M. Klein is a partner at Schiff Hardin LLP resident in the Washington, D.C. office. He is a former Director of the SEC's Division of Market Regulation. He may be reached at aklein@schiffhardin.com.

SCHIFF HARDIN LLP

For Further Information

If you have questions concerning this memorandum or Rule 15a-6, please contact any of the following members of our Securities and Futures Market Regulation Group in our Washington office:

Andrew M. Klein	aklein@schiffhardin.com	202.778.6415
Howard L. Kramer	hkramer@schiffhardin.com	202.778.6414
Laura S. Pruitt	lpruitt@schiffhardin.com	202.778.6447
James L. Eastman	jeastman@schiffhardin.com	202.778.6455

CH2\ 1069951.1