Regulation of Non-U.S. Broker-Dealers Doing Business in the United States

Published by the Broker-Dealer & Investment Management Regulation Group
December 2011[1]

This memorandum discusses U.S. registration requirements and compliance issues relevant to non-U.S. securities dealers considering doing business in the United States.

Jurisdiction Over Non-U.S. Broker-Dealers

Just like U.S. securities dealers, non-U.S. dealers doing business in the United States are subject to regulation by the U.S. Securities and Exchange Commission ("SEC") as well as the securities regulatory agencies in the states in which they do business.

The U.S. Securities Exchange Act of 1934 (the "Exchange Act") requires the registration of any broker-dealer effecting securities transactions by means of interstate commerce. Section 15(a) of the Exchange Act makes it unlawful for a "broker" or "dealer" to make use of the mails or any means or instrumentality of interstate commerce "to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security" unless the broker-dealer is registered with the SEC. The terms "broker" and "dealer" are not limited to U.S. persons under Sections 3(a)(4) and (5) of the Exchange Act, while "interstate commerce" is defined broadly

[1] This memorandum is based on a series of articles publiched in the April 2008 and May 2008 editions of *The Metropolitan Corporate Counsel* by Benjamin J. Catalano and Rachel S. Lerner.

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under Section 3(a)17 of the Exchange Act to include commerce by whatever means between any foreign country and any State or territory of the United States.

The various states' securities laws regulate broker-dealers within their jurisdictions, and, unless an appropriate exemption is available, require, among other things, the registration as a broker-dealer of any person effecting securities transactions for others, as well as the registration as an agent of any person selling securities on behalf of the broker-dealer.

The SEC has advised that persons or entities that regularly (i) participate in the solicitation, negotiation or execution of securities transactions, (ii) receive transaction-based compensation contingent on the value or success of securities transactions, or (iii) handle investor funds or securities, may be required to register as brokers. Persons or entities that (i) hold themselves out as being willing to buy and sell securities on a continuous basis, or (ii) originate securities that they buy and sell, may be required to register as dealers. Accordingly, underwriters and investment dealers doing business in the United States generally must register as broker-dealers in accordance with Section 15(b) of the Exchange Act. In addition, certain finders, investment advisers, financial consultants and persons or entities providing services to broker-dealers may be required to register as broker-dealers if they engage in one or more activities characteristic of broker or dealers described above.

These guidelines generally apply to state registration of broker-dealers as well.

Rule 15a-6 under the Exchange Act provides a limited exemption from registration for non-U.S. broker-dealers that have limited contacts with investors in the United States. Rule 15a-6, as supplemented by SEC no-action letters, can be used at the federal level to permit the following activities:

- Transactions with U.S. registered broker-dealers (acting as a principal or as an agent);
- Unsolicited transactions. Note, however, that "solicitation" is a very broad concept that includes any effort to induce transactional business, including the transmission of sales literature or research reports and soft-dollar arrangements;
- Transactions with non-U.S. persons temporarily present in the United States with whom the non-U.S. securities dealer had a bona fide, pre-existing relationship before the non-U.S. person entered the United States.

In addition to the foregoing exemptions, Rule 15a-6 can be used to facilitate contacts by representatives of a non-U.S. securities dealer with "U.S. institutional investors" and "major U.S. institutional investors," as those terms are defined in the rule, if the account is maintained by a U.S. registered broker-dealer (that may or may not be affiliated with the non-U.S. firm). Moreover, as a result of a previous interpretation reaffirmed in the SEC release adopting Rule 15a-6, the non-U.S. securities dealer may distribute research reports to persons in the United States through a U.S. registered broker-dealer provided that (i) the U.S. registered broker-dealer prominently states in the research report that it accepts responsibility for the report's contents, (ii) the research report prominently states that persons receiving the report should effect transactions in securities discussed in the report through the U.S. broker-dealer, and (iii) transactions by recipients of the research in such securities are effected by the U.S. broker-dealer.

The exemption from registration under Rule 15a-6 does not apply to broker-dealer registration requirements in the states. However, state securities laws (commonly referred to as "Blue Sky Laws") contain various exemptions from registration, including an exemption for transactions by broker-dealers located outside the state with one or more specified institutions, an exemption for broker-to-broker transactions, and an isolated trade exemption (generally, 15 or fewer offers within a 12 month period). (There are generally no exemptions under the Blue Sky Laws for unsolicited transactions or transactions in securities exempt from registration in the state.)

Broker-Dealer Registration and SRO Membership

A. Federal Registration

In order to register as a broker-dealer in the United States, an application for registration must be made to the SEC and a self-regulatory organization ("SRO"), in most instances the Financial Industry Regulatory Authority ("FINRA").[2] The broker-dealer does not have to be a U.S. entity; nor does it have to be located in the United States.

The broker-dealer may register by filing an application with the SEC pursuant to Section 15(b) of the Exchange Act, and the rules promulgated thereunder. Under Section 15(b)(1), the SEC must, within 45 days, either issue a order granting registration or institute proceedings to determine whether registration should be denied.[3] An order granting registration does not become "effective" until the broker-dealer becomes a member of an SRO.[4]

Under SEC Rule 15b1-1, an application must be filed on Form BD through FINRA's Central Registration Depository (CRD) system. The CRD system was developed by FINRA and the North American Securities Administrators Association — an organization of state securities regulators — to enable applicants to use a single form and combined payment to apply for registration and membership in multiple jurisdictions.

Form BD consists of 13 items, plus schedules. Among other things, Form BD requires disclosure of the following information about the registrant: (1) the chain of ownership, (2) any affiliations with other entities in the securities or investment advisory businesses, (3) the officers and directors, and (4) the types of business activities to be conducted. In addition, information must be disclosed regarding disciplinary history (including crimes, violations of securities or investment-related laws or rules of foreign financial regulatory authorities, and proceedings that might result in a finding of such violation) involving the registrant's owners, registered employees, affiliated entities and individuals holding senior management positions with affiliated entities. Form BD constitutes the entire application for registration with the SEC. There is no fee for filing Form BD.

B. SRO Membership

Application for membership in FINRA consists of two parts, which are filed simultaneously with the appropriate FINRA District Office. Part I consists of several administrative items including Form BD, Forms U-4 and U-5, fingerprint cards for employees subject to SEC Rule 17f-2, and payment of the appropriate application and related fees. Part II consists of business, financial and employee-related information including a business plan, copies of agreements with banks, clearing agents and service bureaus, financial information including all sources of capital, a description of the supervisory system and written supervisory procedures, an anti-money laundering ("AML") program and a description of the continuing education program. During the application process, the broker-dealer is also expected to become a member of the Securities Investor Protection Corporation (SIPC), obtain a fidelity bond, and complete a lost or stolen securities program registration.

As part of the application process, principal officers and other persons associated with the broker-dealer who would be engaged in the securities or investment banking businesses must register, take certain qualifying examinations and be fingerprinted. The broker-dealer must have at least two fully qualified principals and a financial and operations principal (FINOP). The chief executive officer and all other supervisory principals must pass the Series 7 and Series 24 examinations, the FINOP must pass the Series 27 examination, and specified

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[2] FINRA is the result of a merger of two SROs, the New York Stock Exchange and the National Association of Securities Dealers, Inc. (the "NASD").

[3] Grounds for denial of registration include the failure to disclose information required in the application or the previous sale of securities in violation of registration requirements.

[4] Unless the SEC issues an exemption, it is unlawful to effect securities transactions until the broker-dealer is an SRO member.

"back office" operations personnel and their supervisors must pass the Series 99 examination. Registered representatives must pass the Series 7 examination and there are various other qualification examinations for specific business functions.

Two of the most important parts of the FINRA application are the broker-dealer's written supervisory procedures and continuing education program.

The supervisory system should be designed to accomplish the following objectives: (1) prevent insider trading as required by Section 15(g) of the Exchange Act, (2) serve as the broker-dealer's system of supervision required by NASD Rule 3010,[5] and (3) provide a defense against liability for the failure to supervise by the firm and its employees under Section 15(b)(4) and Section 15(b)(6) of the Exchange Act, respectively. NASD Rule 3010 also provides that the broker-dealer must have written supervisory procedures reasonably designed to prevent and detect violations of the securities laws and NASD rules.

FINRA Rule 1250[6] requires the continuing education of certain registered persons associated with the broker-dealer. The rule provides for a "Regulatory Element" and a "Firm Element." The Regulatory Element is a computer-based training program administered by FINRA. It is required for all registered persons on the second anniversary of his or her securities registration and every three years thereafter. The Firm Element applies to all registered persons who have direct contact with customers and are engaged in sales, trading or investment banking activities, and to their immediate supervisors. The content of the Firm Element is largely left to the broker-dealer's determination; however, training programs must meet minimum standards, and must focus on the particular investment products and services that the broker-dealer offers to customers. The description of the broker-dealer's continuing education program should focus on the Firm Element and include an evaluation of the firm's training needs and a written training plan.

C. State Registration

In addition to registration with the SEC and membership in an SRO, a broker-dealer and its agents dealing with public customers in any state must register with the securities regulator in the state unless an appropriate exemption is available. An exemption for transactions with institutional customers is available in most states, but not all. In certain states, such as New York, the institutional exemption is so limited that it would be necessary to register in order to deal with most institutional customers.

A salesperson must pass the Series 63 Uniform State Law examination in order to qualify as a registered agent in the states.

D. Time and Expenses

It takes approximately one month to prepare the initial SEC and FINRA applications depending upon several factors, including the number of employees to be registered and the time it takes to obtain the relevant information on employees and affiliates.[7]

The SRO's evaluation should be expected to take approximately five to six months (measured from the time the completed application has been filed), but could take a longer or shorter time depending on the ability of personnel to take and pass the appropriate registration examinations and any requests for additional information by FINRA.

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[5] Until the process of consolidating the rule books of the NYSE and NASD is completed, certain of the NASD rules continue in effect.

[6] FINRA Rule 1250, effective October 17, 2011, replaces NASD Rule 1120.

[7] Each state has its own broker-dealer and representative filing fees. The initial FINRA filing fee is $3,000 for the member broker-dealer; $5,000 for self-clearing firms.

Net Capital and Operations

A. Net Capital Requirements

Different capital requirements apply to registered broker-dealers according to the extent of their involvement in customer transactions and whether they hold funds or securities for customers. SEC Rule 15c3-1 (the "Net Capital Rule") requires minimum net capital of (i) $250,000 for a broker-dealer that holds customer funds or securities, (ii) $100,000 for a broker-dealer that clears customer transactions on a delivery versus payment basis and does not offer margin accounts, (iii) $50,000 for a broker-dealer that introduces customer transactions and accounts to another registered broker-dealer that carries the accounts on a fully disclosed basis, or (iv) $5,000 for a broker-dealer that does not receive, hold or owe customer funds or securities or carry customer accounts or trade securities other than on an agency or riskless principal basis. A broker-dealer that limits its activities in customer-related transactions according to clauses (ii) or (iii) above is exempt from SEC Rule 15c3-3 (the "Customer Protection Rule").[8] Thus a broker-dealer that conducts an institutional brokerage business strictly on a delivery versus payment basis can operate with a minimum of $100,000 net capital with an exemption from the Customer Protection Rule under paragraph (k)(2)(i);[9] while a broker-dealer that conducts its business through a U.S. registered clearing firm can operate with a minimum of $50,000 net capital with an exemption from the Customer Protection Rule under paragraph (k)(2)(ii). A portion of this amount could consist of a subordinated loan in a prescribed form from the broker-dealer's parent or affiliate. A corporate finance advisory firm that does not deal with customer accounts can operate with a minimum of $5,000 net capital. A capital cushion of an additional 20 percent is ordinarily required by the SRO.

The broker-dealer also must comply with the "basic" or "alternative" maximum debt-to-equity ratio requirements as prescribed by paragraph (a)(1) of the Net Capital Rule. Under the basic method, the broker-dealer must limit its "aggregate indebtedness," as defined by the rule, to no more than 800 percent of net capital for the first year of operation; 1,500 percent of net capital thereafter. Under the alternative method, the broker-dealer must maintain net capital of not less than $250,000 or 2 percent of its customer-related receivables computed according to the "Special Reserve Formula" in Exhibit A to the Customer Protection Rule. The alternative method may be more advantageous to non-U.S. firms that expect to experience fails from time to time from transactions involving Regulation S or other restricted securities.

B. Execution and Support Services

To the extent that the registered broker-dealer would operate under paragraph (k)(2)(i) of the Customer Protection Rule, it could enter into an agreement with an affiliated non-U.S. securities dealer for the latter to provide execution services in non-U.S. markets without requiring the separate registration of the non-U.S. dealer in accordance with Rule 15a-6. In addition, research prepared by the non-U.S. dealer could be furnished to U.S. institutional investors under Rule 15a-6.[10] The U.S. broker-dealer also could enter into an

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[8] The Customer Protection Rule does not apply to $5,000 broker-dealers that do not receive or hold customer property or carry customer accounts.

[9] Under paragraph (k)(2)(i) of Rule 15c3-3, a broker-dealer is exempt from the Customer Protection Rule if it carries no margin accounts; promptly transmits (*i.e.*, by noon of the business day following receipt) all customer funds and securities received and does not otherwise hold or owe money or securities to customers; and effectuates financial transactions with customers through one or more bank accounts designated as a special account for the exclusive benefit of customers ("Special Account"). Subparagraph (i) allows a firm to clear customer transactions on a delivery versus payment basis. The transactions need not be conducted through use of the Special Account if the customer is an institution and the delivery takes place contemporaneously with the receipt of payment.

[10] Rule 15a-6(a)(2) offers an exemption from registration for a foreign broker-dealer that furnishes research reports to, and effects related transactions with, major U.S. institutional investors.

More generally, the SEC does not require registration by a foreign broker-dealer whose research is distributed to U.S. persons (whether or not institutional investors) by a U.S. registered broker-dealer (whether or not affiliated with the foreign broker-dealer) if, (i) the registered broker-dealer prominently states in the research report that it accepts responsibility for its contents, (ii) the report prominently states that persons receiving the report should effect transactions in securities discussed in the report with the registered

agreement with its non-U.S. parent or affiliate to provide back office support, such as accounting, record keeping and other administrative services. All such arrangements must adhere to SRO guidelines on expense sharing arrangements where the non-U.S. parent or affiliate is responsible for payment of services by third parties on behalf of the U.S. broker-dealer.

C. Clearance and Settlement

The U.S. registered broker-dealer can conduct its brokerage business as a self-clearing firm, or it can clear through another registered clearing firm. If the broker-dealer elects to clear its own transactions, it can do so on a delivery-versus-payment (DVP) basis using the services of an affiliated securities dealer to assist in the clearance and settlement of off-shore transactions pursuant to a service agreement between the parties.[11] (The affiliate may, in turn, use its own clearing provider to assist in this arrangement.)[12]

If the registered broker-dealer conducts institutional brokerage business on a DVP basis within the scope of the exemption set forth in Rule 15c3-3(k)(2)(i), no customer funds or securities are deemed to be held by the broker-dealer. Therefore, pursuant to SEC no-action letters, the broker-dealer need not comply with the Customer Protection Rule. *See, e.g., RMK International Securities, Inc.* (January 29, 1991); and *Dominion Securities, Inc.* (December 7, 1978).

Because the U.S. broker-dealer clears (albeit on a DVP basis) the relevant transactions in accordance with Rule 15c3-3(k)(2)(i), it is characterized as a "clearing firm" for purposes of Rule 15c3-1. Accordingly, the broker-dealer is subject to a minimum net capital requirement of $100,000. However, since the broker-dealer does not hold customer funds or securities, it is not characterized as a "carrying" firm. Therefore, the higher minimum net capital requirement of $250,000 for a carrying firm is inapplicable. *See* Securities Exchange Act Release No. 34-31511 (November 24, 1992).

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broker-dealer, and (iii) transactions in securities discussed in the report actually are affected only through the registered broker-dealer. *See* Securities Exchange Act Release No. 34-25801 (June 3, 1988).

Neither the exemption contained in Rule 15a-6(a)(2) nor the SEC's position with respect to the provisions of research to persons other than major U.S. institutional investors is available if the research is provided pursuant to a "soft dollar" arrangement – an express or implied understanding that commission income will be directed to the foreign firm providing the research.

[11] The relationship between the U.S. registered broker-dealer and its affiliate would not be that of an introducing broker/carrying broker, and the service agreement should not create such a relationship.

In SEC Release No. 34-31511 (November 24, 1992), the SEC characterized an introducing broker relationship as one in which the carrying firm takes responsibility for the proper administration of funds and securities between the trade date and settlement date. In such an arrangement, the carrying firm would also hold any customer funds and securities following the trade date.

With respect to the registered broker-dealer's customers, the broker-dealer – not its affiliate – would be responsible for the administration of funds and securities. In this regard, the broker-dealer would be subject to net capital charges for fails-to-deliver. No funds or securities would be held by the broker-dealer to the extent that it conducts a DVP business and does not otherwise carry customer accounts. If customer funds must be held overnight, the broker-dealer could utilize a bank account for the exclusive benefit of customers. In view of the foregoing, the service agreement should not be considered a "Clearing Agreement" or "Carrying Agreement." The relationship would resemble a typical correspondent relationship between a U.S. broker-dealer and a foreign securities dealer. Since the affiliate's contractual relationship does not extend beyond the U.S. registered broker-dealer, the affiliate should not be required to register as a broker-dealer in the United States.

Many foreign-owned, FINRA member firms, particularly Canadian-owned firms, operate on this basis with the approval of FINRA District Offices.

[12] Many securities dealers in non-U.S. jurisdictions have the ability to receive and deliver U.S. and non-U.S. securities through various non-U.S. depositories' links to the Depository Trust and Clearing Corporation ("DTCC") in the United States. For example, Canadian investment dealers that are members of the Canadian Depository for Securities ("CDS") and the Canadian Securities Clearing Corporation ("CSCC") have the ability to receive and deliver Canadian as well as U.S. securities through CDS's and CSCC's links to DTCC.

D. Extension of Credit

Regulation T promulgated by the Board of Governors of the Federal Reserve System (the "FRB") under the authority of the Exchange Act governs the extension of credit by broker-dealers. Regulation T imposes initial margin requirements on certain securities transactions. The credit regime calls for the recording of all financial transactions between broker-dealers and their customers in either a margin account or any one of four special purpose accounts, including a "cash account" for fully paid securities. Any transaction not permitted in a special purpose account must be recorded in a margin account.

The initial margin (cash or securities) for each long or short position in securities is set forth in the Supplement to Regulation T (12 CFR § 220.12). In general, the initial margin for U.S. equity securities, including foreign equity securities interlisted on a U.S. exchange or the Nasdaq Stock Market, is 50 percent of the market value of the securities. Foreign equity securities that are not interlisted in the United States are subject to a 100 percent initial margin requirement unless the securities appear on the FRB's list of Foreign Margin Stocks (in which case they are subject to the 50 percent margin requirement).

The U.S. broker-dealer may not offer margin accounts to the extent that it is operating under the (k)(2)(i) exemption from the Customer Protection Rule. Nevertheless, under certain circumstances, the U.S. firm may arrange for the extension of credit by the U.S. broker-dealer's parent or affiliate (or another non-U.S. person) to U.S. or non-U.S. customers with respect to the purchase or short sale of securities that are not "United States securities" within the meaning of Regulation X, promulgated by the FRB.[13] Specifically, Section 220.3(g) of Regulation T (11 CFR § 220.3(g)) permits a broker-dealer to "arrange for the extension or maintenance of credit to or for any customer by any person," provided the arrangement does not violate any other FRB regulation with respect to the extension of credit (including Regulation X).

The extension of credit by the non-U.S. securities dealer or other financial institution should not by itself cause the institution to be subject to U.S. credit regulations. On its face, Regulation T applies to the extension of credit to U.S. persons by all "brokers" and "dealers" as defined by Sections 3(a)(4) and 3(a)(5) of the Exchange Act, including non-registered, non-U.S. broker-dealers. However, the full compliment of FRB regulations regarding the extension of credit suggests that Regulation T is not intended to apply to the extension of credit to U.S. persons by non-U.S. securities dealers with respect to non-U.S. securities if the non-U.S. securities dealer is not otherwise conducting a securities business in the Unites States. Regulation X, which has as its stated purpose "to require that credit obtained within or outside the United States complies with the limitations of [Regulation T]" (12 CFR § 224.1(a)), nevertheless is limited in extraterritorial effect to "United States persons . . . who obtain credit outside the United States to purchase or carry *United States securities*." (12 CFR § 224.1(b).) In this regard, Regulation T should not apply to a non-U.S. securities dealer that extends credit to U.S. customers of its U.S. registered affiliate with respect to non-U.S. securities so long as the non-U.S. securities dealer and its registered affiliate operate within the limitations of the registration exemption under Rule 15a-6.[14]

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[13] The term "United States Security" is defined in Section 224.2(b) of Regulation X (12 CFR § 224.2(b)) to mean "a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State."

[14] Under Section 15(a)(1) of the Exchange Act, broker-dealer registration is required for any broker or dealer using U.S. jurisdictional means "to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security." An extension of credit to finance the purchase or sale of a security, however, should not ordinarily be viewed as effecting a transaction in securities. In particular, the extension of credit would not normally be viewed as a securities transaction if a bank or other non-brokerage lender were to provide such financing.

Rule 15a-6(a)(4)(i) provides an exemption from registration for a foreign broker-dealer that "[e]ffects transactions in securities with or for, or induces or attempts to induce the purchase or sale of any security by a registered broker or dealer . . . for its own account or as agent for others." As discussed above, a non-U.S. securities dealer would rely on this exemption to provide execution services to its U.S. registered broker-dealer affiliate. Other provisions of Rule 15a-6 suggest that the exemption should continue to be available if the registered broker-dealer arranges for an extension of credit to a customer by the non-registered dealer. Specifically, Rule 15a-

The SEC may take the position, however, that the broker-to-broker transaction exemption available under Rule 15a-6(a)(4)(i) is not intended to apply to situations in which the unregistered, non-U.S. securities dealer has a direct and ongoing contractual relationship – such as a lending agreement – in place with the U.S. customer. Additional links between the U.S. customer and the unregistered broker-dealer stemming from the foreign firm's status as execution and settlement agent for the U.S. registered broker-dealer may further support this position.[15]

Therefore, while the financial arrangement discussed above would appear to be permissible based upon a reasonable interpretation of FRB credit regulations and Rule 15a-6, we would suggest reviewing these issues with the SEC or FINRA staff, as appropriate, prior to implementing any specific arrangement.

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Please do not hesitate to contact us if you have any questions regarding the material discussed herein.

6(a)(3)(i) permits limited contacts with U.S. institutional investors provided that any resulting transactions are performed through a registered broker-dealer that, among other things, is responsible for "extending *or arranging for the extension of* any credit" to the investor.

The arranging language in Rule 15a-6, together with the interpretation of applicable FRB credit regulations, discussed above, suggest that a non-U.S. lender can engage in securities financing for U.S. persons with respect to non-U.S. securities without registration as a broker-dealer in the United States.

[15] We are aware of a situation in which U.S. broker-dealers presented a similar scenario to the SEC staff in a proposed request for no-action relief. Among other things, the broker-dealers asked the SEC staff to clarify that where a non-U.S. securities dealer merely provides custodial services for a U.S. investor (*i.e.*, where the non-U.S. dealer is not also effecting transactions in reliance on Rule 15a-6), the non-U.S. dealer is not required to register as a broker-dealer under Section 15 of the Exchange Act. The issue did not find its way into the final request for relief, apparently because the SEC staff was not prepared to offer any comfort in this regard. Presumably, the SEC staff would consider the role of margin lender with a similar amount of caution.