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July 14, 2008

The SEC Proposes Amendments to Exemptions to Registration for Foreign Broker-Dealers under Rule 15a-6

The SEC has proposed amendments to the provisions (set forth in Rule 15a-6) that permit broker-dealers outside the United States ("foreign broker-dealers") to conduct certain activities in the United States without triggering the broker-dealer registration requirements under the Securities Exchange Act of 1934 (the "Exchange Act"). These proposed rule changes are, in large part, a response to the increasing internationalization of the securities markets and significant advances in technology and communication services. The proposed rule changes also reflect the recent focus by market participants and securities regulators, as more fully discussed below under "An Evolving New International Approach," on minimizing the regulatory constraints on participants in the global capital markets that arise due to different, and in some cases, conflicting sets of national or regional regulations.

The proposed rule changes generally would expand the category of U.S. resident investors that foreign broker-dealers can contact for purposes of providing research reports and soliciting securities transactions. These changes would also reduce the role U.S. registered broker-dealers (the so-called "intermediating broker-dealers") must play in intermediating transactions effected by foreign broker-dealers on behalf of certain U.S. investors.

Overview of Existing Rule 15a-6

Under the Exchange Act, it is unlawful for a broker-dealer to effect any transaction or induce the purchase or sale of any security, unless the broker-dealer is registered under the Exchange Act. For broker-dealers located outside the United States, this means that those that induce or attempt to induce transactions in securities with persons in the United States must register with the SEC, unless an exemption is available.

In 1989, the SEC promulgated Rule 15a-6 to provide conditional exemptions from registration for foreign brokers-dealers undertaking activities in the United States in certain limited circumstances. Under Rule 15a-6, foreign broker-dealers may undertake, without triggering registration requirements, activities in the United States falling within one of four categories. These activities include:

- Effecting trades that are unsolicited by the foreign broker-dealer (on the theory that registration can only be triggered if the broker-dealer solicits securities transactions) (Rule

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15a-6(a)(1)). In this case, there can be no affirmative effort to induce any transaction, and because the concept of "solicitation" is so broad, this exemption has little value for a foreign broker-dealer seeking to conduct an ongoing business in the United States.

- Providing research reports to "major U.S. institutional investors," as long as (i) the research report does not recommend the use of the foreign broker-dealer, (ii) the foreign broker-dealer does not initiate follow-up contacts with such investor or otherwise induce or attempt to induce the purchase or sale of any security by such investor, (iii) transactions in securities covered by the report are effected in accordance with the exemption for solicited transactions under Rule 15a-6(a)(3) (see below), and (iv) such research report is not provided with the understanding, expressed or implied, that such U.S. person would direct commission income to the foreign broker-dealer (Rule 15a-6(a)(2)).

- Soliciting transactions in securities with a "U.S. institutional investor" or a "major U.S. institutional investor" that are effected through a U.S. registered broker-dealer and subject to certain conditions (Rule 15a-6(a)(3)). This exemption is available where the foreign broker-dealer seeks to deal with U.S. investors from its overseas trading desk or where U.S. institutions seek direct contact with overseas traders. Generally, in these situations, the U.S. broker-dealer intermediating trades must handle most aspects of the transaction (other than negotiating the terms of the trade), which would include issuing confirmations and account statements, being responsible for extending credit, maintaining books and records, receiving, delivering and safeguarding funds and securities and handling key sales activities through "chaperoning" the contacts of foreign associated persons with certain institutional investors.

- Soliciting or effecting transactions for five categories of investors listed in Rule 15a-6(a)(4).

Proposed Amendments to Rule 15a-6

New Scope: "Qualified Investors"

The SEC proposes to expand the category of U.S. investors with which a foreign broker-dealer may interact by eliminating the definitions of "major U.S. institutional investor" and "U.S. institutional investor" and replacing them with an existing concept – the "qualified investor," as defined in Section 3(a)(54) of the Exchange Act.

A "major U.S. institutional investor" is a person that is (i) a U.S. institutional investor that has, or has under management, total assets in excess of $100 million; or (ii) a registered investment adviser that has over $100 million in total assets under management, while a "U.S. institutional investor" is (i) a registered investment company; or (ii) a bank, savings and loan association, insurance company, business development company, small business investment company, an employee benefit plan, a private business development company, an organization or a trust.

The proposed replacement of the concepts of major U.S. institutional investor and U.S. institutional investor with a qualified investor, among other things, would expand the universe of

U.S. investors with which a foreign broker-dealer can interact, without triggering registration, to include corporations, companies and partnerships that, or natural persons who, own and invest on a discretionary basis not less than $25 million in investments and government or political subdivisions, agencies or instrumentalities that own and invest on a discretionary basis not less than $50 million in investments. In other respects, the new definition would exclude certain persons that are included in the definition of major institutional investor and institutional investor.

Provision of Research Reports

The SEC proposes to maintain the exemption for providing research reports, but would expand the class of investors (from U.S. institutional investors to qualified investors) to which foreign broker-dealers could provide research reports.

Solicited Trades under Proposed Rule 15a-6(a)(3)

The SEC has proposed two new exemptions for foreign broker-dealers seeking to solicit trades from qualified investors, one ("Exemption (A)(1)") available for qualifying foreign broker-dealers that conduct a "foreign business" and a second ("Exemption (A)(2)") available to all qualifying foreign broker-dealers. In effect, Exemption (A)(1) would allow qualifying broker-dealers to offer full service brokerage services (i.e., effecting securities transactions and maintaining custody of funds and securities resulting from transactions effected under the exemption). Exemption (A)(2) would be available for qualified investors seeking access to foreign broker-dealers but wanting to maintain accounts, and custody of funds and securities, with a U.S. registered broker-dealer.

For purposes of Exemption (A)(1), a "foreign business" would require that at least 85% of the aggregate value of the securities purchased or sold in transactions with qualified investors and foreign resident clients under 15a-6(a)(3) and (a)(4)(vi), calculated on a rolling two-year basis, be derived from transactions in foreign securities (i.e., defined to include securities of foreign private issuers, debt securities of U.S. issuers sold offshore under Regulation S, debt securities of foreign governments eligible to be registered under Schedule B and derivatives in respect of the foregoing). The definition is intended to avoid opportunities for regulatory arbitrage in the U.S. markets as the U.S. securities business of a qualifying broker-dealer would be limited.

Both exemptions require the foreign broker-dealer to be regulated for conducting securities activities, including the specific activities for qualified investors, in a foreign country by a foreign securities authority and to disclose that it is regulated by a foreign securities authority and not by the SEC. A foreign broker-dealer relying on Exemption A(1) would also be required to disclose that U.S. requirements as to segregation of customer funds and assets from the broker-dealer's own funds and assets, U.S. bankruptcy protections and protections under the Securities Investor Protection Act would not apply to any funds or securities of qualified investors held by the foreign broker-dealer.

A foreign broker-dealer relying on Rule 15a-6(a)(3) would also need to continue to meet qualification standards. As under the current rule, such broker-dealer would need to provide to the SEC, upon request or under agreement between the SEC, or the United States, and any foreign securities authority, solicitation-related information. The proposed rule would also shift the

responsibility, from the intermediating U.S. registered broker-dealer to the foreign broker-dealer, to determine that the foreign broker-dealer's associated persons who effect transactions with qualified investors are not subject to statutory disqualification under Section 3(a)(39) of the Exchange Act (which also refers to certain foreign conduct and disciplinary action).

Exemption for Foreign Broker-Dealers conducting a Foreign Business (Exemption (A)(1)). Under Exemption (A)(1), a foreign broker-dealer would be able to effect transactions for qualified investors and maintain custody of funds and securities. As a result, the foreign broker-dealer would generate books and records in respect of such transactions. Although the rule would require a U.S. registered broker-dealer to maintain copies of the books and records, including confirmations and account statements, the U.S. broker-dealer could maintain such books and records with the foreign broker-dealer, provided that the U.S. registered broker-dealer makes a reasonable determination that copies of such books and records could be furnished promptly to the SEC.

Additionally, the intermediating U.S. registered broker-dealer, which would no longer be required to effect transactions solicited by the foreign broker-dealer (unless the transaction were to be effected on a U.S. national securities exchange, through a U.S. alternative trading system or with a market maker or OTC dealer in the United States – as would typically would be the case for U.S. securities), would no longer be required to comply, in respect of such transactions, with the U.S. federal securities laws or applicable SRO rules, except to the extent it were in fact involved in effecting securities transactions. The intermediating broker-dealer would also not be required to extend or arrange for the extension of credit, issue confirmations and account statements, receive, deliver and safeguard funds and securities, or maintain accounts for the customers of foreign broker-dealers relying on the exemption.

Exemption for Foreign Broker-Dealers using a U.S. Registered Broker-Dealer (Exemption (A)(2)). Proposed Exemption (A)(2) would allow foreign broker-dealers to solicit transactions from qualified investors that have accounts, and maintain custody of their funds and securities, with U.S. registered broker-dealers. Because a foreign broker-dealer acting under this exemption would not be acting as a full service broker-dealer, there is no proposed requirement that it conduct a foreign business.

Under proposed Exemption (A)(2), the maintenance of books and records, including copies of all confirmations issued by the foreign broker-dealer, would be performed by the U.S. registered broker-dealer. Furthermore, the U.S. registered broker-dealer would be responsible for receiving, delivering and safeguarding the funds and securities on behalf of the qualified investor.

Also, unlike under the current rule, but as is proposed under Exemption (A)(1), the intermediating U.S. registered broker-dealer in respect of Exemption (A)(2) transactions would not be required to effect resulting securities transaction solicited by the foreign broker-dealer.

Modification of the "Chaperon" Requirements

The SEC has proposed that the current requirement (known as the "chaperon" requirement) that foreign associated persons be accompanied by an associated person of a U.S. registered broker-dealer during visits to U.S. investors, and for an associated person of a U.S.

registered broker-dealer to participate in communications between foreign associated persons and U.S. investors, be eliminated for activities falling within Exemptions (A)(1) and (A)(2). Because such unchaperoned visits or communications would be considered as a form of solicitation, any resulting transaction with qualified investors from unchaperoned visits or communications would have to be effected under either Exemption (A)(1) or Exemption (A)(2).

As to how long a foreign associated person may stay in the United States and still have the stay qualify as a "visit" involves a facts and circumstances analysis of the purpose, length and frequency of stays. The SEC proposes to interpret "visit" as one or more trips to the United States over a calendar year not exceeding 180 days in the aggregate. The purpose of the limitation is to prevent a foreign broker-dealer from maintaining a permanent sales force in the United States without registering.

Fiduciary Accounts for Foreign Resident Clients

The SEC has proposed amending Rule 15a-6(a)(4) to allow foreign broker-dealers to effect transactions with U.S. resident fiduciaries for accounts of foreign resident clients in respect of non-U.S. securities.

Foreign Options Exchanges

The SEC has also proposed to include a new exemption, Rule 15a-6(a)(5), which would allow foreign broker-dealers who are members of foreign options exchanges to effect transactions in options on foreign securities for qualified investors who have not been solicited by the foreign broker-dealer. The exemption would permit a foreign broker-dealer, a foreign options exchange and representatives of the foreign options exchange to conduct certain activities and communicate with qualified investors without such activities or communications being deemed solicitations.

Additional Interpretive Guidance

The SEC has also proposed additional interpretive guidance on what qualifies as a form of solicitation. Specifically, the SEC has proposed that U.S. distribution of a foreign broker-dealer's quotations by a third-party system to U.S. investors would not be viewed as a form of solicitation, in the absence of other contacts with U.S. investors initiated by the third-party system or foreign broker-dealer. In effect, the SEC has lifted the requirement that the quotations be distributed primarily outside the United States. Note that it continues to be the case that the third-party system cannot allow securities trades to be executed between the foreign broker-dealer and U.S. residents through the system.

An Evolving New International Approach

In recent months, there has been a noticeable increase in the level of discussion and activity among market participants and regulators of the world's principal financial markets concerning efforts to develop a more efficient and more effective regulatory framework for the global financial markets. The hope is that regulators will be willing to move away from strictly national approaches to regulation of the financial markets to minimize the costs, burdens and other complexities faced by market participants as the financial markets become more global.

Proposals for a new framework to address the challenges presented by the increasingly global mindset of investors, the globalization of investment platforms and unprecedented advances in information and communications technology contemplate a three-pronged approach: harmonization, mutual recognition and exemption. It is important to note that each prong of the approach should not be considered only in its pure form, as each approach when implemented should promote the reform of the financial markets and regulatory competition, and avoid the risk of regulatory arbitrage.

Not surprisingly, given the range of issues falling under the general heading of financial market reform, the topics deemed ripe for attention vary by constituency. Among them are accounting principles and standards, capital raising and distribution of securities, regulation of financial intermediaries (including direct cross-border institutional access for capital markets intermediaries, conduct of business principles and regulatory enforcement powers) and cross-border access to trading venues.

The proposed amendments to Rule 15a-6 reflect, in part, efforts to address practical concerns that have evolved since the rule was promulgated in 1989. More importantly, they should be seen as a response to the more general concerns that underpin the broader global efforts to reduce the burdens and costs of the patchwork of national regulation, without sacrificing the protection of the markets and investors.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul, Weiss Securities Group including: Mark S. Bergman, 44-20-7367-1601.