Foreign Brokers Doing Business in the United States

M&E Business & Financial Services Litigation Alert

09.05.2014

Related People:
Howard Kailes
Ward C. Laracy
David F. Broderick
Theodore M. Grannatt
Joel E. Horowitz
John C. Kelly

Foreign brokers that engage in securities transactions with U.S. investors based in the United States must be registered with the Securities and Exchange Commission (SEC). There are two major exceptions to this rule. The first exception is if the U.S. customer buys or sells securities offered by the foreign broker in an unsolicited transaction. In other words, if the U.S. investor affirmatively reached out to the foreign broker and the U.S. investor, without prompting by the foreign broker, decided to make a purchase or sell a security, then the foreign broker need not be registered with the SEC. Practically speaking, this exception is very limited.

Most brokers, foreign or domestic, interact with their customers on some communicative basis, so the line between when a transaction is recommended or solicited may get blurred, particularly if the customer sustains a loss and is looking to rescind a transaction based on the fact that the broker involved was not registered properly. Consequently, few rely on the "unsolicited transaction" exemption found in SEC Rule 15a-6(a)1. The second exemption – SEC Rule 15a-6(a)3 – is more common and is discussed in depth below. The exemption is designed for – and limited to – institutional investors and contains a host of important requirements.

The 15a-6 Institutional Investor Exemption

The only way to understand the 15a-6 exemption is to examine its underlying purpose. The idea is to protect U.S. investors from potentially unscrupulous foreign brokers by making a U.S. broker responsible for the foreign broker in a number of material ways, including keeping records of the foreign broker's transactions with the U.S. investor, "chaperoning" sales pitches, and forcing a U.S. broker to take a capital charge if the foreign broker fails to deliver stock that a U.S. investor bought or fails to deliver money if a U.S. investor sold a security through the foreign broker. Keep in mind the exemption is limited to institutional investors such as banks, insurance companies and "major" institutional investors with over $100 million in assets under management.

By way of example, let's say the Boston Fireman's Pension Fund wants to buy a million shares of a South African telecom company. The South African broker, if it has a written agreement in place with a U.S. broker (the "chaperone broker"), can sell the Boston Fireman's Pension Fund those shares if (1) the chaperone broker has vetted the South African firm and its personnel; (2) the South

African firm and its personnel have consented to service of process in the U.S. and agreed to produce records to U.S. regulators if asked; (3) the chaperone broker makes a record of the transaction on its books and sends a Rule 10b-10-compliant confirmation of the transaction (or assures itself one has been sent by the foreign broker and it has a record of that); and (4) the U.S. firm (or its clearing firm) is ready to step up to the plate and take a capital charge if the South African firm fails to deliver the shares that the pension fund bought. An introducing firm with only a $5,000 minimum net capital requirement can act as a 15a-6 chaperone broker if the clearing firm, in writing, agrees to take capital charges on a foreign broker-dealer's fail. If the clearing firm does not do this, an introducing firm can still act as a 15a-6 chaperone broker, but the introducing firm must have $250,000 in net capital and must take a capital charge if there is a fail.

So if one thinks about the underlying policy of protecting Boston firefighters, then these rules start to make sense. The foreign broker consented to service of process in the U.S. so the U.S. regulators can get to the foreign broker if things go awry. Records of transactions are with a U.S. broker that regulators in the U.S. have jurisdiction over. Therefore, U.S. regulators can access those records if a U.S. investor is defrauded. If the Boston Fireman's Pension Fund doesn't get its shares of the South African firm, a U.S. broker will feel pain and make sure delivery happens in order to eliminate the required capital charge. In another risk mitigant, Rule 15a-6 puts a measure of gatekeeper liability on the chaperone broker. The chaperone broker will have vetted the foreign broker and its personnel prior to any transactions with the Boston Fireman's Pension Fund to make sure they are good citizens of the financial community. If that due diligence is ineffective, rest assured that U.S. regulators will intervene and potentially fine the chaperone broker. Last, in some limited circumstances, the U.S. broker is actually required to participate in sales pitch visits should the foreign broker's personnel visit the U.S. to meet with clients and prospects. With all the obligations on U.S. brokers outlined above, it is important for foreign brokers, when choosing a U.S. chaperone to assist them in doing business in the U.S., to select a firm with the appropriate capabilities. Equally important, a foreign broker must select a U.S. broker that has been approved by the Financial Industry Regulatory Authority ("FINRA") to be a 15a-6 chaperone. Foreign brokers should request verification of a U.S. broker's FINRA membership agreement as part of the foreign broker's due diligence.

Recent Enforcement Actions

Regulators in the U.S. have brought actions against foreign brokers illegally doing business in the U.S. In 2012, a notable action was brought against a number of Indian brokers who did not have proper chaperone broker arrangements. *See* SEC Press Release 2012-241, "SEC Charges India-based Brokerage Firms with Violating U.S. Registration Requirements," dated November 27, 2012. Most recently, a large European firm was sanctioned for providing unlicensed services in the U.S. *See* SEC Press Release 2014-39, "Credit Suisse Agrees to Pay $196 Million and Admits Wrongdoing in Providing Unregistered Services to U.S. clients," dated February 21, 2014. In light of these enforcement actions, foreign brokers must assure themselves that they and their U.S. chaperones are following the rules.

Conclusion

The requirements for foreign broker-dealers doing business in the U.S. are complex. With the right written agreements and some attention to detail however, it is relatively easy for foreign brokers to do business with banks, insurance companies, large pension funds and the like. This document should not be used without further consultation with licensed counsel.