BUSINESS & FINANCIAL SERVICES LITIGATION ALERT

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U.S. Brokers Doing Business Overseas

Recently, regulators have made inquiries about the lawfulness of U.S. brokerage firms soliciting foreign clients. The regulators want to know under what exemptions or rules U.S. firms can do business overseas. This is a new trend.

Background

In years past, U.S. financial firms, when doing business overseas, largely concerned themselves with the question, Does the firm need to be registered in the countries where it has clients? Historically, if the firm had no bricks and mortar in a foreign country, the investor had a high net worth, or it could be shown that the customer was not solicited for securities transactions (but instead had reached out to the U.S. firm), then the issue of registration was considered resolved.

The Times They are A-Changin' in the International Regulatory Sphere

Particularly since the 2008-09 financial crisis, there has been a confluence of events that should make U.S. firms more attuned to rules about doing business outside the U.S. For example, (i) the regulatory sanctions against non-U.S. firms doing business in the U.S. have heightened awareness; (ii) the emergence of "colleges" of regulators that now meet to exchange best practices; and (iii) the unprecedented cooperation among regulators (witness the numerous MOUs entered into by FINRA and the SEC in the past few years) has led to an increased focus on licensing. Given this focus, we describe current rules in some popular jurisdictions below. If you would like more information on a particular jurisdiction or specific advice on risk mitigants in this regard (for example, customer certifications that may be required), please contact us.

Rules of the Road for Certain English-Speaking Jurisdictions (United Kingdom, Canada, Australia and New Zealand)

United Kingdom

US financial advisers who wish to solicit potential UK clients must ensure that their approach to the potential client falls within an exemption in the UK's financial promotion rules prior to making contact with the potential client. The rules on financial promotion in the UK mean that unless a US adviser is telephoning a client who was previously based outside of the UK (and other conditions are met) it is practically impossible to make unsolicited telephone calls to potential UK clients and it is a criminal offence to do so.

It is however possible for a US adviser to rely on certain exemptions when communicating promotional documents (rather than making telephone calls) on either a solicited or an unsolicited basis. Two popular exemptions apply when communicating with persons in the UK who are either "high-net-worth" individuals or "sophisticated investors". The threshold requirements for an individual to qualify as "high net worth" are that the individual, for the preceding financial year, had either an annual income of more than £100,000 or net assets of at least £250,000 (ignoring primary residence, life insurance policies and pensions). To qualify as a "self-certified sophisticated investor," he/she must have: (i) been a member of a network of business angels for six months preceding the date of the statement; (ii) made more than one investment in an unlisted company in the two years preceding the date of the statement; (iii) worked or be working in the two years preceding the date of the statement in a professional capacity in the private equity sector or in the provision of finance for small and midsize enterprises; or (iv) been currently, or in the two years preceding the date of the statement, a director of a company with an annual turnover of at least £1 million. Prior to relying on either exemption the UK individual must have signed a prescribed certificate and provided it to the US financial adviser prior to the US adviser communicating the promotional document. The promotional document itself must contain certain prescribed warnings. There are other exemptions from the UK's financial promotions regime including the possibility of asking a UK Financial Conduct Authority authorized firm to "approve" the promotion.

Importantly, even if the potential UK client has been solicited by a US financial adviser in a manner which does not contravene the UK's financial promotion regime the adviser must also ensure that the services that they are performing from the US do not require authorization from the UK's Financial Conduct Authority. The UK's regulatory regime includes a 'characteristic performance' test which takes account of both where services are provided and, importantly, where they are performed and works in different ways for different UK regulated activities. There is an exclusion from the requirement to obtain FCA authorization which can often be relied on by US advisers where they have no established presence in the UK, where all they are doing is giving investment advice, and where they have only contacted the UK client in reliance on one of the financial promotion exemptions mentioned above. However, where a US adviser wishes to arrange for a UK client to also buy or sell securities then the UK exemption is more difficult to rely on and advice should be sought about the application of the 'characteristic performance' test and the extent of the US adviser's presence in the UK.

Australia

Under Australian legislation a person dealing with certain professional and high-net-worth Australian clients will usually needs to hold a financial services license. However, a class order issued by the Australian Securities and Investments Commission ("ASIC") exempts some "U.S. SEC-regulated financial services providers" if they meet certain conditions, specifically by:

1. Filing a deed with ASIC in which the broker dealer covenants, among other things, to comply with any order of an Australian court with respect to matters relating to the provision of financial services to

Australians;

2. Appointing an agent for service of process in Australia (unless they otherwise have an office in the jurisdiction); and

3. For a broker dealer, disclosing to the prospective Australian clients that it is exempt from registration in Australia before providing the financial services.

Moreover, the U.S. firm must deal only with "wholesale clients." This includes most professional and institutional investors. It also includes high net worth investors meeting threshold asset or income requirements being (a) a gross income of $250,000 or more per year in each of the previous two years, or (b) net assets of at least $2.5 million.

New Zealand

Like Australia, New Zealand exempts certain overseas firms from licensing if the firm deals only with wholesale clients.

The term "wholesale client" refers to various categories of investor including an entity to which at least one of the following applied at the end of each of the last two completed accounting periods,

a. at the balance date, the net assets of the entity exceeded $1 million; or

b. the turnover of the entity for the accounting period exceeded $1 million.

A person will also be a "wholesale client" if they are an "eligible investor" which includes, amongst other categories of investor, a person who certifies that he/she –

a. has sufficient knowledge, skills, and experience in financial matters to assess the value and risks of financial products; and

b. has sufficient knowledge, skills, or experience in financial matters to assess the merits of the service or services to be provided (including to assess its value and the risks involved); and

c. understands the consequences of certifying to be an eligible investor (including that the competency standards and requirements of the code will not be applicable to the foreign franchise adviser or broker dealer and that the financial adviser or broker dealer may not be a member of an approved dispute resolution scheme).

Canada

The regulation of securities in Canada is a matter of provincial and territorial jurisdiction. Each of Canada's ten provinces and three territories has its own securities laws, instruments and rules which are administered by a local securities regulator. In addition, the respective provincial and territorial securities regulators have issued national instruments and national policies that are applicable in each of the provinces and territories of Canada and multilateral instruments and multilateral policies that are applicable in more than one, but not all, of the provinces and territories of Canada.

There is a distinction in Canada between "dealing" and "advising" on securities. A person or entity "in the business" of trading will be subject to the dealer registration requirements, and a person or entity "in the business" of advising on securities will be subject to the adviser registration requirements. In addition, in several jurisdictions, including Ontario, futures are not regulated as securities and are regulated under separate legislation than that which applies to the regulation of securities.

Each jurisdiction in Canada provides for an exemption from the dealer registration requirements for non-Canadian dealers regulated in their home jurisdiction for dealing with "permitted clients" in, generally, securities of non-Canadian issuers (the "international dealer exemption"). The definition of permitted client includes a wide range of institutional investors and very high net worth individuals, including: (i) an individual who beneficially owns financial assets having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds C$5 million, and (ii) a person or company (other than an individual or an investment fund) that has net assets of at least C$25 million as shown on its most recently prepared financial statements.

Reliance on the "international dealer exemption" requires a firm to appoint a local agent for service of process in each jurisdiction of Canada in which reliance is to take place, and that a notice filing of reliance be made with the applicable Canadian securities regulator prior to engaging in any dealing activities in Canada. Furthermore, reliance on the "international dealer exemption" requires a notice to be sent to Canadian resident investors, compliance with Canadian anti-money laundering legislation, and annual renewals, including, in certain jurisdictions, payment of annual renewal fees.

In the context of a private placement the most commonly relied upon exemption from the requirement to file a prospectus in Canada is the "accredited investor" exemption. Any sale of securities into Canada made in reliance on the "accredited investor" exemption from the requirement to file a prospectus in Canada will trigger a requirement to make a post-trade filing in respect of the sale with the applicable Canadian securities regulator, as well as, in certain jurisdictions, a requirement to file any offering memorandum that was sent into Canada. Where an offering memorandum is sent into Canada it is required to contain Canadian-specific disclosure, including disclosure in respect of rights of action for a misrepresentation in certain jurisdictions. In addition, investment funds are regulated in Canada, and sales of units of such funds may require action to be taken on behalf of the entity that qualifies as the "investment fund manager" of such investment fund.

Canada recently implemented anti-spam legislation that prohibits sending a commercial electronic message to a recipient unless the sender has a prior interactive relationship with the recipient. The anti-spam legislation provides several exemptions from the prohibition in a business context. Canadian counsel should be consulted with before engaging in marketing to prospective investors in Canada in order to ensure compliance with anti-spam legislation.

General Comments

It is worth noting that other considerations may apply, in addition to the general precepts above. The good news is that exemptions are available for U.S. firms to lawfully do business in foreign jurisdictions. The bad news is the analysis is often nuanced – cash accounts may be lawful, but margin accounts may be considered banking and require a license; option accounts may be allowed, but only if onerous risk disclosures are provided; and managed accounts may be allowed, but only if an investment advisory license is obtained. Beyond licensing, firms have to be mindful of not aiding and abetting exchange control violations, income tax evasion in the investors' home country, unlawful avoidance of estate taxes, and the ever-present risks of facilitating payments in violation of OFAC proscriptions or the FCPA. And of course the rules change all the time in the nearly 200 countries and jurisdictions around the globe.

Summary

Firms need to pay attention to the non-U.S. licensing requirements when doing business overseas, not only for fear of foreign regulators imposing sanctions (or a customer effectively having a put on unfavorable transactions), but because U.S. regulators are inquiring about it.

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