Broker-Dealer Compliance Issues: All Over The World

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Dear Ms. Compliance Officer:

Hi! The U.K. was great. I met some nice folks and told them we’d be happy to help them make investments in the U.S. No big deal, right? Also, can you let me know where I can get copies of our confirms? Somebody told me to contact someone in India but that didn’t sound right.

Have a great day and let me know when I can start taking orders.

Your Registered Rep.

Dear Registered Rep.:

I decided to put my thoughts in writing because I am not sure all this information can be easily conveyed over the phone (our calls always seem so short).

I’m glad you liked England. I assume your visit was a social one? Did you know that the U.K. has licensing requirements for folks who want to sell securities – yes, I’m sure you did.

Re: the confirms, I can help you with those; we do the data processing in India but copies of course are stored here in the U.S.

I’ll call you in a couple of days to discuss remaining issues – in the meantime, don’t take any orders.

Your Compliance Officer

Introduction

If you are a compliance officer working for a U.S. broker-dealer, you may have had a conversation similar to the one above. Globalization, with all its tremendous opportunities, creates new challenges for compliance officers working for U.S. broker-dealers and their affiliates. All of the issues that arise in connection with operating a broker-dealer in the United States - registering a sales force and home office personnel, designing systems for supervision, back office operations, handling customer funds and securities, commission payments, and communications with the public – have to be thought through in a...
different but similar context when sales efforts are directed at persons located outside the territory of the United States or when operations take place in a country other than the United States. This article discusses some of the obstacles for U.S. firms trying to do business outside the United States; revisits certain U.S. securities laws and rules that apply to persons trying to do business on a cross-border basis; and explores why these rules and regulations may soon be changing.

**Across the Pond – Trying to Do Business Outside the United States**

It should come as no surprise that countries all across the globe have an interest in protecting the financial health of their citizens. This interest expresses itself in rules and regulations that govern what investment products can be sold to their citizens, who is permitted to conduct solicitation activities, and how a country’s rules and regulations relating to various activities are enforced. The bottom line for U.S. broker-dealers is that sales activity outside the physical boundaries of the United States should not be undertaken without examining all of the rules and requirements of the foreign jurisdiction that may be applicable to that activity.

Virtually all foreign jurisdictions impose licensing and other requirements on entities (including the natural persons associated with those entities) who promote and sell securities in their countries. The laws of foreign countries typically require U.S. firms that want to promote and sell securities to potential investors in the foreign country to be authorized to conduct an investment business within the foreign jurisdiction, or be exempt from such authorization pursuant to applicable law. This authorization (or exemption therefrom) is needed not just to actually effect the purchase or sale of a security but to engage in promotional (i.e., marketing) efforts that are designed to encourage interest in the purchase or sale of a security. U.S. firms that engage in a regulated activity in securities in a foreign jurisdiction without authorization can be subject to civil and criminal penalties, including fines and imprisonment. Of equal importance is the fact that contracts that result from dealings with persons not authorized to do business in the foreign jurisdiction may be unenforceable.

In the United Kingdom, for instance, regulators consider a number of factors in determining whether an entity is actually engaged in regulated activity within the U.K. One factor is whether the firm has a permanent place of business in the U.K. A firm may be deemed to have a permanent place of business in the United Kingdom if its employees repeatedly use the same location for solicitation activities (thus giving the impression that the employee can be contacted at that location), or provide potential investors with contact information, such as telephone or facsimile numbers or e-mail addresses that originate from within the U.K.

The NASD (now FINRA) has reminded its members on various occasions about the need to comply with foreign country regulation. In 1998, the United Kingdom’s Financial Services Authority (“FSA”) asked the NASD to remind its members that their marketing activities, if directed to U.K. citizens, could bring NASD members within the scope of FSA registration requirements. In 2000, the NASD issued a very short, albeit cautionary notice to its members, reminding them again that they must comply with the laws of any foreign jurisdiction in which they are soliciting business. The 2000 Notice pointed out that “solicitation” activities that could cause a U.S. broker-dealer to be subject to the laws of a foreign jurisdiction could include not just direct contact with a citizen of another country, but indirect contacts, such as newspaper advertisements and postings on the Internet.

In 2001, the NASD created a source-book of sorts by publishing the answers to frequently asked questions regarding NASD rules that impact U.S. broker-dealers trying to do business in foreign locations. This Notice reminded members that they may pay transaction-based compensation to foreign finders, but members must assure themselves that the finder does not need to be registered as a broker-dealer in the United States. The Notice also reiterated a member firm’s obligation to supervise all of its associated persons, no matter where they are located or how they are paid. The NASD stated that foreign offices that are branch offices or offices of supervisory jurisdiction must be registered with the NASD, and that all foreign offices, regardless of location or registration status, need to be inspected by the U.S. broker-dealer member firm.
The Issuer’s Status

In addition to having to consider their own status under foreign law, U.S. broker-dealers have had to consider whether the issuer of the product they wish to sell needs to be licensed in the foreign jurisdiction as well. For example, the U.S. issuer of a variable insurance product may need to consider whether its activities in the foreign jurisdiction make it subject to certain foreign country rules. Depending on the kinds of promotional and sales activities that occur overseas, the U.S. insurance company issuer of a variable annuity sold overseas may be required to obtain authorization from the foreign jurisdiction to conduct an insurance business in that foreign jurisdiction.

Setting up a branch office in a foreign jurisdiction could have significant impacts on the U.S. insurance company, requiring it to provide the applicable foreign authority with certain undertakings, such as commitments to maintain the minimum level of working capital of the branch, to pay taxes to the local jurisdiction, to provide certain financial statements and to assume liability for the branch’s business operations. Foreign jurisdictions may also require the form of security, as well as its marketing materials and distribution plan, to conform to local law and regulations. In some cases, approvals will have to be obtained from the foreign regulator. Foreign jurisdictions are also likely to have rules and regulations that govern the source, flow and disclosure of compensation and revenue-sharing paid for the promotion and sale of investments. Failure of U.S. broker-dealers to take these issues into consideration may be problematic and could, among other things, trigger indemnification provisions in selling agreements with selling firms.

Outsourcing

Solicitation activities are not the only activities that require an examination of foreign country laws. For some time U.S. broker-dealers have “outsourced” certain of their functions to foreign jurisdictions. When operations occur outside the United States, for the benefit of, or on behalf of, a U.S. broker-dealer, the broker-dealer’s compliance systems must be organized in such a way that the broker-dealer can assure itself that its operations are compliant with both SEC and FINRA laws and rules as well as applicable laws and rules of the foreign jurisdiction. In the United States, these laws and rules include recordkeeping and retention rules, and rules designed to protect customer information, prevent money laundering and the authorized communication of confidential information, and rules to ensure business continuity in the event of a natural or unnatural disaster. U.S. broker-dealers that are dependent on operations being performed in a foreign jurisdiction must also be prepared for SEC and FINRA exams that will focus on how the broker-dealer is controlling the activity from the U.S. – for example, what U.S.-based internal control systems is the broker-dealer using to oversee the non-U.S. operations?

The Picture for Foreign Broker-Dealers

Is the picture for foreign broker-dealers trying to do business in the U.S. any easier? Do they face hurdles similar to those imposed on U.S. broker-dealers? These questions can be debated of course, but the short answer is yes – foreign broker-dealers face obstacles not unlike those faced by U.S. broker-dealers trying to solicit foreign investors.

The reasons for this can be found, first, in the Securities Exchange Act of 1934 (the “Exchange Act”). It defines “brokers” and “dealers” and prohibits any person coming within either of these definitions from acting in these capacities and engaging in interstate commerce without registering with the Securities and Exchange Commission (“SEC”).

The system as we know it, with nearly 5,000 SEC-registered broker-dealers operating in the United States in 2007, is a direct result of these definitions and SEC interpretations of these definitions.

Whether, and how, these definitions apply to persons not located in the United States were not front-burner issues for the SEC until the 1980s. For a long time U.S. investors dealt with U.S. broker-dealers in foreign jurisdictions, with all its tremendous opportunities, creates new challenges for compliance officers working for U.S. broker-dealers and their affiliates.
Brokers and were not so curious about investment opportunities outside the United States. Similarly, U.S. broker-dealers were well positioned and more than successful in developing the deepest and most liquid securities markets in the world; they did not have to worry about whether their counterparts located outside the United States could effectively compete with them.

By the mid-1980s however, the competitive picture for U.S. securities markets and securities professionals was beginning to change. U.S. broker-dealers wanted to be able to offer their clients more information about foreign securities and U.S. institutional investors wanted to invest in those securities in an efficient manner. One of the ways the SEC responded to these pressures was to adopt a rule under the Exchange Act – Rule 15a-6. Rule 15a-6’s purpose was to articulate principles that could support the lines the SEC wanted to draw around the territory of the United States and around each U.S. investor.  

The protection of U.S. investors lies at the heart of Rule 15a-6. It is not difficult to conclude that the SEC’s overriding interest was in ensuring that U.S. investors be protected no matter where they are located and regardless of their investment experience. The Rule was primarily designed to accommodate the interests of U.S. institutional investors, not retail investors. Even with regard to institutional investors, the Rule is not exactly liberal. For example, it permits research reports authored by foreign broker-dealers who are not registered in the United States to make their way into the hands of U.S. institutional investors, but the research reports can be provided only to major U.S. institutional investors,  

and investors are prohibited from effecting a securities transaction with the foreign broker-dealer; the transaction must instead be effected through a U.S. registered broker-dealer. Similarly, a foreign broker-dealer that is not registered in the United States may solicit securities transactions from a major U.S. institutional investor or a U.S. institutional investor, but the resulting transactions must be effected through a U.S. registered broker-dealer and the foreign broker-dealer must be “chaperoned” by a U.S. broker-dealer on any visits made to the United States. The SEC did not overstate its case when it said that it was “proceeding cautiously by adopting the limited exemptions incorporated in the Rule.”

The New Regulatory Construct

There are strong indications that in the future, U.S. broker-dealers and their foreign counterparts will be able to work within each others’ borders in a more efficient manner than is currently possible. Last year SEC Chairman Christopher Cox convened a roundtable of U.S. market experts to discuss how the SEC could begin to develop standards for “mutual recognition.” Mutual recognition is the idea that one country (the “home” country) could study another country’s (the “foreign” country’s) regulatory regime and come to a determination about “comparability.” In other words, is the foreign country’s regime more or less like the home country’s regime? Do the home and foreign countries share the same core values and enforcement attitude and give appropriate redress to customers who have been harmed? This is the theory of mutual recognition: if two or more countries’ rules, standards and regimes meet each others’ expectations, then it would not be necessary to make a financial intermediary (e.g., a broker-dealer) coming into the foreign country prove his or her worth all over again.

The fact that the Roundtable took place indicates a growing recognition on the part of U.S. regulators, markets and securities firms that the United States is at risk of losing its position as a dominant player in the world’s capital markets. The Roundtable participants expressed the concern that if U.S. markets and investors are not made more accessible to foreign intermediaries (and presumably foreign markets are more easily accessed by U.S. intermediaries), the United States will not be able to compete successfully on the international stage. The participants seemed united in believing that the starting place for the United States (the SEC in particular) is to agree on a set of core principles that U.S. regulators and U.S. markets believe are so important that they cannot be compromised – a good example is capital adequacy. Once these core principles are defined, then it is (simply) a matter of examining a foreign jurisdiction’s laws and rules to determine whether those rules embody the core principles.  

Oftentimes, an SEC initiative of this breadth would be years in the making. There is reason to believe, however, that “mutual recognition” is on the fast track for certain SEC staffers.
On February 1 of this year, SEC Chairman Cox and the European Commissioner for the Internal Market and Services Charlie McCreevy met to discuss current topics of interest to both regulators; mutual recognition of securities regulation was one of these topics. According to the press release issued by the SEC that day, the regulators “agreed that the goals of a mutual recognition arrangement would be to increase transatlantic market efficiency and liquidity while enhancing investor protection.” They agreed that the first step to be taken by the staffs of both regulators would be to develop a “framework for mutual recognition discussions . . . [they] jointly mandated their respective staffs to intensify work on a possible framework for EU-US mutual recognition for securities in 2008.” The announcement concluded by stating that SEC and European officials intend to hold regular meetings throughout 2008 for the purpose of developing a mutual recognition framework.

Approximately six weeks after the February 1 announcement, the SEC (composed of the individual Commissioners and Chairman Cox) outlined four specific steps the SEC intends to take in the pursuit of mutual recognition. These steps involve, first, exploring initial agreements with one or more foreign jurisdictions, based upon a comparability assessment by each jurisdiction and regulatory regime; second, considering how a formal process can be established for discussing mutual recognition with other regulators; third, developing a process for discussing mutual recognition with jurisdictions, including Canada, that have no single (central) securities regulator, but do have a common legal framework; and fourth, proposing changes to Rules 15a-6, with the goal of making it easier for U.S. investors to access foreign broker-dealers.

Importantly, the March 24 announcement spoke of mutual recognition for “high quality regulatory regimes in other countries,” signaling perhaps the SEC’s interest in making it clear at the outset that it does not intend to lessen its own regulatory regime, or weaken its ability to protect U.S. investors, by recognizing any regime that cannot be described as “high quality.”

The first country out of the gate so to speak for mutual recognition may be Australia. In a press release issued on March 29, 2008, the SEC announced that Chairman Cox has begun formal discussions for mutual recognition with the Australian Securities and Investment Commission and the Australian Treasury Department.

What to Expect

Judging by the Roundtable discussion and the press releases, mutual recognition is going to be a multi-step process – one of these steps will consist of the comparability assessment discussed above. Other steps we anticipate include a focus by the SEC on its own ability to “reach,” through some type of service of process or subpoena power, a foreign intermediary directly, instead of relying solely on a foreign regulator’s own power over that intermediary. In this regard we would expect the SEC to focus on countries with which it already has in place a “memorandum of understanding” (“MOU”) with respect to sharing information for investigative and enforcement purposes; notably, the press releases that announce the recent mutual recognition initiatives point out that the SEC has a long history of using MOUs to pursue its enforcement objectives. We also expect that the SEC will want to be confident that any foreign securities regulator whom it recognizes has resources that are adequate to enforce that jurisdiction’s regulatory regime. Even if the SEC has the power to reach all of the foreign intermediaries in a jurisdiction with which it has a mutual recognition agreement, the SEC will not want to expend its resources all over the world. The SEC may well use a disclosure approach to mutual recognition, i.e., it may recognize another country’s regulatory regime and use disclosure to alert U.S. investors to material differences between that regime and U.S. systems and laws, but at the end of the day we expect that the SEC will want to make sure that its enforcement powers – and the enforcement powers of another “high quality” regulatory regime, can be brought to bear in cases where disclosure is inadequate or fraud occurs.

Conclusion

Dorothy would have said “We aren’t in Kansas anymore,” and she would have been right. U.S.
broker-dealers may be on the verge of being able to “go global” in a way they never have been able to do before. It will take perseverance on the part of U.S. regulators, U.S. broker-dealers, U.S. issuers and each of their foreign counterparts, but clearly the potential pay-off appears worth the effort. In the meantime, just remember not to take any orders without making sure your firm has all the authorization it needs, both at home and abroad.

ENDNOTES

1 Sales of securities in the United Kingdom (U.K.), for instance, are largely governed by the Financial Services Act of 1986 (“Act”).
2 See NASD Notice to Members 98-91 (Nov. 1998), addressing cold calling and advertising regulations under the Act.
3 See NASD Notice to Members 00-02 (Jan. 2000). Interestingly, this Notice states that it is “not addressing whether soliciting business in a foreign jurisdiction in violation of that jurisdiction’s laws may constitute a violation of NASD rules.” See also NASD Notice to Members 00-75 (Oct. 2000), reminding members that in developing their continuing education plans, members should consider solicitation activities in foreign jurisdictions.
4 See NASD Notice to Members 01-81 (Dec. 2001) (“NTM 01-81”).
NTM 01-81 defines “foreign finders” as “non-registered foreign persons who refer non-U.S. customers to a member firm.” Foreign finders are not associated persons of the member firm.
6 In this regard see NASD Rule 1060(b), which sets out the terms and conditions pursuant to which a U.S. broker-dealer may pay transaction-based compensation to a foreign finder.
7 See NTM 01-81 at Q15, see also Joint Interpretive Guidance from NASD and the NYSE Relating to Uniform Branch Office Definition Under NASD Rule 3010(g)(2) and NYSE Rule 342.10 at Q22 available at http://finra.complinet.com/finra/display/display.html?dbid=1189&elementid=1159005612.
9 A “broker” is defined as “any person engaged in the business of effecting transactions in securities for the account of others.” See Section 3(a)(4)(A) of the Exchange Act.
10 A “dealer” is defined as “any person engaged in the business of buying and selling securities for such person’s own account through a broker or dealer otherwise.” See Section 3(a)(5)(A) of the Exchange Act.
11 See Section 15a(1) of the Exchange Act, which prohibits brokers and dealers from effecting transactions in securities, or attempting to do so, through any means of interstate commerce, unless the broker or dealer is registered with the SEC. Certain exceptions apply for exempted securities and certain commercial paper.
13 Rule 15a-6 defines “major U.S. institutional investor” as a person that is a U.S. institutional investor that has, or has under management, total assets in excess of $100 million. See Rule 15a-6(b)(4)(i). The Rule contains certain caveats with regard to determining the total assets of an investment company. The term “U.S. institutional investor” is defined separately in the Rule. See Rule 15a-6(b)(7).
14 See Rule 15a-6(a)(2).
15 See Rule 15a-6(a)(3).
16 See Adopting Release, supra n.13. On the same day that it adopted Rule 15a-6, the SEC published for comment a concept release that asked whether the SEC should be more open to the idea of permitting major U.S. institutional investors greater access to foreign broker-dealers. See Exchange Act Release No. 27018 (July 11, 1989). See also Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore, Release Nos. 33-7516, 34-39799, IA-1710, IC-23071 (March 27, 1998), discussing foreign broker-dealer reliance on certain provisions of Rule 15a-6 (the “Internet Release”). The SEC has cited the Internet Release in enforcement actions brought against non-U.S. registered broker-dealers.
19 Id.
22 Mar. 28 Announcement, supra n. 22.