Regulation Of Non-U.S. Broker-Dealers Doing Business In The U.S. – Part I

Benjamin J. Catalano and Rachel S. Lerner

PROSKAUER ROSE LLP

This is the first of a two-part article. Part II will appear in the May issue of The Metropolitan Corporate Counsel.

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. And "interstate commerce" is defined broadly 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 for their customers;
- Unsolicited transactions. (However, "solicitation" is a very broad concept that includes any effort to induce transaction 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 by the Rule, if the account is maintained by a U.S. registered broker-dealer (that may be affiliated or unaffiliated with the non-U.S. firm). Moreover, as a result of a previous interpretation reaffirmed in the 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 (or "Blue Sky Laws") contain various, possible 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 trades, and an isolated transaction 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 the self-regulatory organization ("SRO"), Financial Industry Regulatory Authority, Inc. ("FINRA"). 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 an order granting registration or institute proceedings to determine whether registration should be denied.[1] An order granting registration does not become "effective" until the broker-dealer becomes a member of FINRA. Unless the SEC issues an exemption, it is unlawful to effect securities transactions until the broker-dealer is a member of FINRA.

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, 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), to obtain a fidelity bond, and to 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. Registered representatives must pass the Series 7 examination; assistant representatives accepting unsolicited customer orders for processing, must pass the Series 11.

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) to prevent insider trading as required by Section 15(f) of the Exchange Act, (2) to serve as the broker-dealer's system of supervision required by NASD[2] Rule 3010, and (3) to provide a defense against liability for the failure to supervise by the firm 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.

NASD Rule 1120 requires the continuing education of certain registered persons associated with the broker-dealer. The NASD Rule 1120 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 FINRA, the broker-dealer and its agents dealing with public customers must register in any state in which the broker-dealer intends to conduct a securities business 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 necessary disciplinary information covering the broker-dealer's employees and affiliates. The initial FINRA filing fee is $3,000 for the broker-dealer,[3] plus additional fees for principal and representative registrations and exams. Each state has its own broker-dealer and representative filing fees.

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.

Part II of this article will deal with net capital and operations for registered broker-dealers.

***Benjamin J. Catalano** is a Partner in the Litigation and Dispute Resolution Department and **Rachel S. Lerner** is an Associate in the Corporate Department of Proskauer Rose LLP, resident in New York City.*

[1] *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.*

[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"). Until a consolidated rule book is adopted by FINRA, the relevant rules continue to be the "NASD Rules."*

[3] *The initial filing fee is $5,000 for self-clearing broker-dealers.*

Please email the authors at bcatalano@proskauer.com or rlerner@proskauer.com with questions about this article.