Global Issues: Corporate Law – Law Firms

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

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This is the second of a two-part article. Part I, which appeared in the April issue of The Metropolitan Corporate Counsel *and can be seen on our website at www.metrocorpcounsel.com, dealt with jurisdiction over non-U.S. broker-dealers and their registration and SRO membership.*

Net Capital And Operations

A. Net Capital Requirements

Different capital requirements apply to registered broker-dealers according to the extent of their involvement in customer transactions and whether they hold funds or securities for customers. SEC Rule 15c3-1 (the "Net Capital Rule") requires minimum net capital of (i) $250,000 for a broker-dealer that holds customer funds or securities, (ii) $100,000 for a broker-dealer that clears customer transactions on a delivery versus payment basis and does not offer margin accounts, (iii) $50,000 for a broker-dealer that introduces customer transactions and accounts to another registered broker-dealer that carries the accounts on a fully disclosed basis, or (iv) $5,000 for a broker-dealer that does not receive, hold or owe customer funds or securities or carry customer accounts or trade securities other than on an agency or riskless principal basis. A broker-dealer that limits its activities in customer-related transactions according to clauses (ii) or (iii) above is exempt from SEC Rule 15c3-3 (the "Customer Protection Rule"). Thus a broker-dealer that conducts an institutional brokerage business strictly on a delivery versus payment basis can operate with a minimum of $100,000 net capital with an exemption from the Customer Protection Rule under paragraph (k)(2)(i);[1] while a broker-dealer that conducts its business through a U.S. registered clearing firm can operate with a minimum of $50,000 net capital with an exemption from the Customer Protection Rule under paragraph (k)(2)(ii). A portion of this amount could consist of a subordinated loan in a prescribed form from the broker-dealer's parent or affiliate. A corporate finance advisory firm that does not deal with customer accounts can operate with a minimum of $5,000 net capital.

The broker-dealer must also comply with the "basic" or "alternative" maximum debt-to-equity ratio requirements as prescribed by paragraph (a)(1) of the Net Capital Rule. Under the basic method, the broker-dealer must limit its "aggregate indebtedness," as defined by the Rule, to no more than 800 percent of net capital for the first year of operation; and 1,500 percent of net capital thereafter. Under the alternative method, the broker-dealer must maintain net capital of not less than $250,000 or 2 percent of its customer-related receivables computed according to the "Special Reserve Formula" in Exhibit A to the Customer Protection Rule. The alternative method may be more advantageous to non-U.S. firms that expect to experience fails from time to time from transactions involving Regulation S or other restricted securities.

B. Execution and Support Services

To the extent that the registered broker-dealer would operate under paragraph (k)(2)(i) of the Customer Protection Rule, it could enter into an agreement with a non-U.S. securities dealer (including an affiliated securities dealer) for the latter to provide execution services in non-U.S. markets without requiring the separate registration of the non-U.S. dealer pursuant to Rule 15a-6. Research prepared by the non-U.S. dealer could be furnished by the U.S. broker-dealer to U.S. institutional investors under Rule 15a-6.[2] The U.S. broker-dealer could also enter into an agreement with its non-U.S. parent or affiliate to provide back office support, such as accounting, record keeping and other administrative services. All such arrangements must adhere to SRO guidelines on expense-sharing arrangements where the non-U.S. parent or affiliate is responsible for payment of services by third parties on behalf of the U.S. broker-dealer.

C. Clearance and Settlement

The U.S. broker-dealer may conduct its brokerage business as a self-clearing broker, or it may clear through another U.S. clearing firm. If the broker-dealer elects to clear its own transactions, it may clear on a delivery-versus-payment (DVP) basis and use the services of its non-U.S. parent or affiliate securities dealer to facilitate clearance and settlement of off-shore transactions pursuant to a service agreement between the parties.[3] (The parent or affiliate may, in turn, use its own clearing provider to assist in this arrangement.)[4]

If the registered broker-dealer conducts institutional brokerage business on a DVP basis within the scope of the exemption set forth in Rule 15c3-3(k)(2)(i), no customer funds or securities are deemed to be held by the broker-dealer. Therefore, the broker-dealer need not comply with the Customer Protection Rule. *See RMK International Securities, Inc*. (January 29, 1991); and *Dominion Securities, Inc*. (December 7, 1978).

Because the U.S. broker-dealer clears (albeit on a DVP basis) the relevant transactions in accordance with Rule 15c3-3(k)(2)(i), it is characterized as a "clearing firm" for purposes of Rule 15c3-1. Accordingly, the broker-dealer is subject to a minimum net capital requirement of $100,000. However, since the broker-dealer does not hold customer funds or securities, it is not characterized as a "carrying" firm. Therefore, the higher minimum net capital requirement of $250,000 for a carrying firm is inapplicable. *See* Securities Exchange Act Release No. 34-31511 (November 24, 1992).

D. Extension of Credit

Regulation T promulgated by the Board of Governors of the Federal Reserve System (the "FRB") under the authority of the Exchange Act governs the extension of credit by broker-dealers. Regulation T imposes initial margin requirements on certain securities transactions. The credit regime calls for the recording of all financial transactions between broker-dealers and their customers in either a margin account or any one of four special purpose accounts, including a "cash account" for fully paid securities. Any transaction not permitted in a special purpose account must be recorded in a margin account.

The initial margin (cash or securities) for each long or short position in securities is set forth in the Supplement to Regulation T. In general, the initial margin for U.S. equity securities, including foreign equity securities interlisted on a U.S. exchange or the Nasdaq Stock Market, is 50 percent of the market value of the securities. Foreign equity securities that are not interlisted in the United States are subject to a 100 percent initial margin requirement unless the securities appear on the FRB's list of Foreign Margin Stocks (in which case they are subject to the 50 percent margin requirement).

The U.S. broker-dealer may not offer margin accounts to the extent that it is operating according to the (k)(2)(i) exemption under the Customer Protection Rule. Nevertheless, under certain circumstances, the U.S. broker-dealer may arrange for the extension of credit by the U.S. broker-dealer's parent or affiliate (or another non-U.S. person) to U.S. or non-U.S. customers with respect to the purchase or short sale of securities that are not "United States securities" within the meaning of Regulation X promulgated by the FRB.[5]

Section 220.3(g) of Regulation T permits a broker-dealer to "arrange for the extension or maintenance of credit to or for any customer by any person," provided the arrangement does not violate any other FRB regulation with respect to the extension of credit, including Regulation X.

The extension of credit by the non-U.S. securities dealer or other financial institution should not by itself cause the institution to be subject to U.S. credit regulations. On its face, Regulation T applies to the extension of credit to U.S. persons by all "brokers" and "dealers" as defined by Sections 3(a)(4) and 3(a)(5) of the Exchange Act, including non-registered, non-U.S. broker-dealers. However, the full compliment of FRB regulations regarding the extension of credit suggests that Regulation T is not intended to apply to the extension of credit to U.S. persons by non-U.S. securities dealers with respect to non-U.S. securities if the non-U.S. securities dealer is not otherwise conducting a securities business in the Unites States. Regulation X, which has as its stated purpose "to require that credit obtained within or outside the United States complies with the limitations of [Regulation T]," nevertheless is limited in extraterritorial effect to "United States persons . . . who obtain credit outside the United States to purchase or carry *United States securities*." In this regard, Regulation T should not apply to a non-U.S. securities dealer that extends credit to U.S. customers of its U.S. registered affiliate with respect to non-U.S. securities so long as the non-U.S. securities dealer and its registered affiliate operate within the limitations of the registration exemption under Rule 15a-6.[6]

The SEC may take the position, however, that the broker-to-broker transaction exemption available under Rule 15a-6(a)(4)(i) is not intended to apply to situations in which the non-U.S. securities dealer has a direct and ongoing contractual relationship – such as a lending arrangement – with the U.S. customer. Additional links between the *U.S. customer and the non-U.S. securities dealer stemming from the foreign dealer's status as execution and settlement agent for the registered broker-dealer may further support this position*.[7]

Therefore, while the financial arrangement discussed above would appear to be permissible based upon a reasonable interpretation of FRB credit regulations and Rule 15a-6, we would suggest reviewing these issues with the SEC or FINRA staff, as appropriate, prior to implementing the arrangement.

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[1] *Under paragraph (k)(2)(i) of Rule 15c3-3, a broker-dealer is exempt from the Customer Protection Rule if it carries no margin accounts; promptly transmits (i.e., by noon of the business day following receipt) all customer funds and securities received and does not otherwise hold or owe money or securities to customers; and effectuates financial transactions with customers through one or more bank accounts designated as a special account for the exclusive benefit of customers.*

Subparagraph (i) allows a firm to clear customer transactions on a delivery versus payment basis. Customer funds or securities can be maintained only under certain conditions for a limited period of time. The transactions need not be conducted through the bank account described above if the customer is an institution and the delivery takes place contemporaneously with the receipt of payment.

[2] *Rule 15a-6(a)(2) offers an exemption from registration for a foreign broker-dealer that furnishes research reports to, and effects related transactions with, major U.S. institutional investors.*

More generally, the SEC does not require registration by a foreign broker-dealer whose research is distributed to U.S. persons (whether or not institutional investors) by a U.S. registered broker-dealer (whether or not affiliated with the foreign broker-dealer) if, (i) the registered broker-dealer prominently states in the research report that it accepts responsibility for its contents, (ii) the report prominently states that persons receiving the report should effect transactions in securities discussed in the report with the registered broker-dealer, and (iii) transactions in securities discussed in the report actually are affected only through the registered broker-dealer. See Securities Exchange Act Release No. 34-25801 (June 3, 1988).

Neither the exemption contained in Rule 15a-6(a)(2) nor the SEC's position with respect to the provisions of research to persons other than major U.S. institutional investors is available if the research is provided pursuant to a "soft dollar" arrangement – an express or implied understanding that commission income will be directed to the foreign firm providing the research.

[3] *The relationships between the U.S. registered broker-dealer and its parent or affiliate would not be that of an introducing broker/carrying broker, and the service agreement should not create such a relationship.*

In SEC Release No. 34-31511, the SEC characterized an introducing broker relationship as one in which the carrying firm takes responsibility for the proper administration of funds and securities between the trade date and settlement date. In such an arrangement, the carrying firm would also hold any customer funds and securities following the trade date.

With respect to the registered broker-dealer's customers, the broker-dealer – not its parent or affiliate – would be responsible for the administration of funds and securities. In this regard, the broker-dealer may be subject to net capital charges for fails-to-deliver. However, no funds or securities would be held by the broker-dealer to the extent that it conducts a DVP business and does not otherwise carry customer accounts. If customer funds must be held overnight, the broker-dealer could utilize a bank account for the exclusive benefit of customers. In view of the foregoing, the service agreement should not be considered a "Clearing Agreement" or "Carrying Agreement."

The relationship between the U.S. broker-dealer and its parent or affiliate would resemble a typical correspondent relationship between a U.S. broker-dealer and a foreign securities dealer. Since the parent's or affiliate's contractual relationship does not extend beyond the U.S. registered broker-dealer, the parent or affiliate should not be required to register as a broker-dealer in the United States.

Many foreign-owned, FINRA member firms, particularly Canadian-owned firms, operate on this basis with the approval of FINRA District Offices.

[4] *Many securities dealers in non-U.S. jurisdictions have the ability to receive and deliver U.S. and non-U.S. securities through various non-U.S. depositories' links to the Depository Trust and Clearing Corporation ("DTCC") in the United States. For example, Canadian investment dealers that are members of the Canadian Depository for Securities ("CDS") and the Canadian Securities Clearing Corporation ("CSCC") have the ability to receive and deliver Canadian as well as U.S. securities through CDS's and CSCC's links to DTCC.*

[5] *The term "United States Security" is defined in Section 224.2(b) of Regulation X to mean "a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State."*

[6] *Under Section 15(a)(1) of the Exchange Act, broker-dealer registration is required for any broker or dealer using U.S. jurisdictional means "to effect transactions in, or to induce or attempt to induce the purchase or sale of, any security." An extension of credit to finance the purchase or sale of a security, however, should not ordinarily be viewed as effecting a transaction in securities. In particular, the extension of credit would not normally be viewed as a securities transaction if a bank or other non-brokerage lender were to provide such financing.*

Rule 15a-6(a)(4)(i) provides an exemption from registration for a foreign broker-dealer that "[e]ffects transactions in securities with or for, or induces or attempts to induce the purchase or sale of any security by a registered broker or dealer . . . for its own account or as agent for others." As discussed above, a non-U.S. securities dealer would rely on this exemption to provide execution services to its U.S. registered broker-dealer affiliate. Other provisions of Rule 15a-6 suggest that the exemption should continue to be available if the registered broker-dealer arranges for an extension of credit to a customer by the non-registered dealer. Specifically, Rule 15a-6(a)(3)(i) permits limited contacts with U.S. institutional investors provided that any resulting transactions are performed through a registered broker-dealer that, among other things, is responsible for "extending or arranging for the extension of any credit" to the investor.

The arranging language in Rule 15a-6, together with the interpretation of applicable FRB credit regulations, discussed above, suggests that a non-U.S. lender can engage in securities financing for U.S. persons with respect to non-U.S. securities without registration as a broker-dealer in the United States.

[7] *We are aware of a situation in which U.S. broker-dealers presented a similar scenario to the SEC staff in a proposed request for no-action relief. Among other things, the broker-dealers asked the SEC staff to clarify that where a non-U.S. securities dealer merely provides custodial services for a U.S. investor (i.e., where the non-U.S. dealer is not also effecting transactions in reliance on Rule 15a-6), the non-U.S. dealer is not required to register as a broker-dealer under Section 15 of the Exchange Act. The issue did not find its way into the final request for relief, apparently because the SEC staff was not prepared to offer any comfort in this regard. Presumably, the SEC staff would consider the role of margin lender with a similar amount of caution.*

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