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Date: July 9, 2008

To: Interested Persons

Re: **SEC Proposes to Liberalize Exchange Act Rule 15a-6 Concerning U.S. Activities of Non-U.S. Broker-Dealers**

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On June 25, 2008, the Securities and Exchange Commission (the "**SEC**") proposed amendments to Rule 15a-6 ("**Rule 15a-6**" or the "**Rule**") under the Securities Exchange Act of 1934 (the "**Exchange Act**").[1] If adopted, the proposal would liberalize the permitted activities of non-U.S. broker-dealers engaging in securities business with U.S. investors without requiring registration under the Exchange Act. However, the proposal would also establish new requirements that could impact existing arrangements by which non-U.S. broker-dealers currently interact with U.S. investors.

***Highlights of the Proposal***

Important proposed areas of liberalization include:

- **Solicitation of Companies and Natural Persons with $25 Million in Investments.** The proposal would enable unregistered non-U.S. broker-dealers to solicit securities business from a broader range of U.S. investors than at present, including companies and natural persons that own and invest on a discretionary basis $25 million in investments. Current restrictions that limit solicitation activities to "U.S. institutional investors" and "major U.S. institutional investors" would be replaced with a requirement to limit solicitation to "qualified investors," a generally less restrictive standard.[2] Non-U.S. broker-dealers would also be permitted to send securities research directly (*i.e.*, not through a registered broker-dealer) to qualified investors in the U.S.

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[1] Securities Exchange Act Release No. 58047 (June 27, 2008), available at http://www.sec.gov/rules/proposed/2008/34-58047.pdf

[2] The Annex to this memorandum contains the full definitions of "U.S. institutional investor," "major U.S. institutional investor," "qualified investor" and certain other terms used herein.

- **Registered Broker-Dealer No Longer Needs to "Effect" Transactions.** Although a non-U.S. broker-dealer will still need to establish a relationship with an SEC-registered broker-dealer in order to engage in most solicitation activities with investors in the U.S., the proposal would eliminate the existing requirement that the registered broker-dealer "effect" transactions.

- **"Chaperoning" Requirements would be Eliminated.** The proposal would eliminate the existing requirement that a registered broker-dealer "chaperone" certain contacts with U.S. investors by representatives of the non-U.S. broker-dealer.

- **Non-U.S. Broker-Dealers That Satisfy an 85% Foreign Business Test Permitted to Handle and Custody Customer Funds and Securities.** A non-U.S. broker-dealer that conducts a "foreign business" (*i.e.*, whose securities business with qualified investors and U.S. fiduciaries for foreign resident clients over a rolling two-year period consists of 85% foreign securities) may elect to take advantage of a new provision under which it would be relieved from the current requirement that a registered broker-dealer must assume responsibility for receiving, delivering and safeguarding customer funds and securities. For firms operating under this new provision, the proposal would eliminate many significant obligations and uncertainties concerning the application of Exchange Act rules, including Rule 15c3-3, to transactions effected under Rule 15a-6(a)(3).

- **Non-U.S. Broker-Dealers' Dealings With U.S. Fiduciaries Acting for Foreign-Resident Clients Not Limited to Foreign Securities.** The proposal would codify, and amend, current SEC no-action guidance that permits, in certain cases, direct dealings (*i.e.*, without the involvement of a registered broker-dealer) between non-U.S. broker-dealers and U.S. fiduciaries managing certain non-U.S. accounts. Such direct dealings would be limited to non-U.S. broker-dealers that meet the foreign business test described above, but would not be limited to foreign securities.

- **Certain Confirmation, Account Statement and Records Requirements Liberalized.** The proposal would shift to the non-U.S. broker-dealer certain responsibilities, such as determining that foreign associated persons are not subject to regulatory sanctions, which the Rule currently imposes upon the registered broker-dealer with which the non-U.S. broker-dealer has established a relationship. The proposed Rule would no longer specify that the registered broker-dealer is responsible for issuing

confirmations, and in certain instances account statements, to U.S. customers, but the registered broker-dealer would maintain certain recordkeeping obligations.

Areas in which the proposal may affect current business arrangements or impose new requirements include:

- **Securities Activities of Non-U.S. Broker-Dealers Must Be Regulated in a Non-U.S. Jurisdiction.** In order to solicit securities business from qualified investors in the U.S., a non-U.S. broker-dealer will need to be regulated as to the conduct of securities activities (including those conducted with qualified investors under the Rule) in a foreign jurisdiction. This may require many firms to change the entities through which they currently conduct business with U.S. customers under the Rule.

- **New Customer Notice Requirements**. In most cases, non-U.S. broker-dealers would be required to notify U.S. customers that they are regulated by a foreign securities authority and not by the SEC. Non-U.S. broker-dealers that elect to operate under the new provision for firms that satisfy a foreign business test would be required to make additional disclosures.

- **Firms Must Modify Existing Agreements and Compliance Procedures.** All non-U.S. broker-dealers and the registered broker-dealers with whom they maintain a relationship for Rule 15a-6 purposes will need to review their Rule 15a-6 operating agreements and compliance procedures to reflect the notice provisions and the reallocation of certain responsibilities to the non-U.S. broker dealers noted above, and to incorporate new liberalized requirements concerning solicitation activities and U.S. visits.

The proposal requests public comment on many significant issues relating to foreign financial institutions' access to U.S. investors, but it does not specifically discuss, or request comment on, the SEC's recent initiative regarding "mutual recognition" of non-U.S. securities exchanges and broker-dealers. **The public comment period on the proposal ends on September 8, 2008.**

***Discussion of the Proposal***

## I. Background – Current Rule 15a-6

Section 15(a) of the Exchange Act generally requires "brokers" and "dealers" in securities that have certain U.S. contacts to register with the SEC, unless an exemption applies. The SEC takes the view that non-U.S. broker-dealers that induce or attempt to induce securities transactions with persons in the U.S. are subject to this registration requirement unless they comply with an

exemption. The SEC adopted Rule 15a-6 in 1989 to establish a conditional exemption from registration for non-U.S. broker-dealers having specified limited contacts with U.S. investors.[3]

Currently, Rule 15a-6 has four main provisions:

**Unsolicited Transactions.** Rule 15a-6(a)(1) permits non-U.S. broker-dealers to "effect transactions in securities on an unsolicited basis." The SEC has repeatedly indicated that it interprets this exception narrowly.

**Research Reports.** Rule 15a-6(a)(2) permits non-U.S. broker-dealers to send research reports to major U.S. institutional investors (essentially, institutions that have at least $100 million in securities investments), subject to certain limitations. Because the provision of research is viewed as a possible form of solicitation, the Rule prohibits (i) following up with investors concerning the research reports (other than in the context of a Rule 15a-6(a)(3) Arrangement, as defined in the following paragraph), and (ii) providing research on the understanding that U.S. persons will direct commission income to the non-U.S. broker-dealer. If a firm has a Rule 15a-6(a)(3) Arrangement, any transactions in securities discussed in a research report must be effected by the registered broker-dealer with whom it maintains such arrangement.

**Solicitation of U.S. Institutional Investors and Major U.S. Institutional Investors through Access BDs.** Rule 15a-6(a)(3) permits non-U.S. broker-dealers to solicit U.S. institutional investors and major U.S. institutional investors (but not other entities or natural persons) under an arrangement (a "**Rule 15a-6 Arrangement**") with a registered broker-dealer (an "**Access BD**"), under which the Access BD is responsible for all aspects of "effecting" transactions with U.S. investors other than the negotiation of terms and (in the case of foreign securities) execution. The Access BD must create and maintain records in accordance with U.S. requirements, comply with Exchange Act Rule 15c3-3 (the "**Customer Protection Rule**") and the SEC's net capital rule, extend or arrange any securities credit, obtain consents to service of process from the non-U.S. broker-dealer and its foreign associated persons who participate in the solicitation of U.S. investors under Rule 15a-6(a)(3) ("**Foreign Associated Persons**") and procure certain disciplinary and other information and ensuring that such persons are not subject to "statutory disqualifications." Rule 15a-6(a)(3) requires that all activities of the non-U.S. broker-dealer be conducted from outside the United States (though it permits U.S. visits up to 30 days per year, subject to certain conditions), and requires that certain contacts between personnel of the non-U.S.

[3] Securities Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013 (July 18, 1989) (the "**Rule 15a-6 Adopting Release**").

broker-dealer and U.S. investors be "chaperoned" by associated persons of the Access BD. Via a 1997 no-action letter (the "**U.S. Affiliates Letter**"), the SEC has liberalized to some extent the chaperoning requirements and also in certain cases permits direct settlement of transactions in foreign securities by non-U.S. broker-dealers that are affiliates of registered broker-dealers, subject to various conditions (including a prohibition on maintaining custody of customer securities).

**Solicitation and Other Dealings with Certain Persons Permitted Without Involvement of a Registered Broker-Dealer.** Rule 15a-6(a)(4) allows non-U.S. broker-dealers to solicit and otherwise deal with certain persons without the involvement of an Access BD, including: (i) a registered broker-dealer, whether acting as principal or agent; (ii) a U.S. bank (including a licensed branch or agency of a non-U.S. bank) acting pursuant to specified exemptions from the Exchange Act's broker-dealer registration requirements that apply to bank securities activities; (iii) the United Nations and certain other organizations and their pension funds; (iv) foreign persons temporarily present in the U.S.; (v) non-U.S. branches or agencies of U.S. persons outside the U.S. provided that transactions occur outside the U.S.; and (vi) with certain exceptions, U.S. citizens resident outside the U.S. In addition, under a 1996 no-action letter (the "**U.S. Fiduciaries Letter**"), the SEC permits certain non-U.S. broker-dealers to deal with U.S. fiduciaries who advise discretionary or similar accounts for "offshore clients" in transactions in certain "foreign securities," subject to various conditions.

The SEC has also issued a number of no-action letters to non-U.S. options exchanges that permit those exchanges to engage in limited activities in the U.S. without subjecting them or their members or clearing organizations to various U.S. registration requirements.[4]

## II. The Proposal

Promulgated almost 30 years ago, Rule 15a-6 contains procedural requirements that investment firms have found difficult or impractical to comply with, and that are believed by many to unnecessarily restrict business and raise the cost of cross-border securities transactions. Recognizing the vast increase in U.S. investor interest in foreign securities, developments in technology and communications and the general increase in the globalization of investments, the SEC is proposing to amend Rule 15a-6 in a manner that it believes will further

[4] Rule 15a-6 is only an exemption from federal registration requirements under the Exchange Act. According to the Rule 15a-6 Adopting Release, non-U.S. broker-dealers whose activities are exempt under the Rule must still consider the application of broker-dealer registration requirements under state securities laws to their activities.

promote direct U.S. investor access to foreign markets (and non-U.S. broker-dealer access to U.S. investors) without compromising investor protection.

While the SEC has proposed major changes to certain sections of Rule 15a-6, the basic structure of the Rule would remain the same. The exemptions for unsolicited transactions, distribution of research reports, and dealing with certain U.S. investors, would only be modified in relatively minor ways, as discussed in detail below. The principal proposed revisions to the Rule pertain to the requirements of Rule 15a-6(a)(3) regarding a non-U.S. broker-dealer's solicited transactions with U.S. investors.

A. Unsolicited Transactions under Rule 15a-6(a)(1)

The exemption for unsolicited transactions would remain unchanged by the proposal. However, the SEC proposes to codify prior no-action guidance contained in the U.S. Affiliates Letter, that U.S. distribution of a non-U.S. broker-dealer's quotations by a third-party system (which does not allow securities transactions to be executed through the system) would not, by itself, be viewed as a form of solicitation.

B. Distribution of Research under Rule 15a-6(a)(2)

The exemption for non-U.S. broker-dealers furnishing research directly to major U.S. institutional investors would be modified to provide that the research may be delivered directly to qualified investors. This would greatly increase the scope of persons to whom non-U.S. broker-dealers may send their research. This expansion could limit the need for non-U.S. broker-dealers to rely on Access BDs to review and distribute foreign research to U.S. customers. Currently, registered broker-dealers must "accept responsibility" for and provide such research if the research is to be delivered to persons other than major U.S. institutional investors.[5] Also, the provision allowing execution of orders in securities discussed in the research through Rule 15a-6(a)(3) Arrangements would eliminate the requirement that an Access BD must "effect" transactions in the securities referred to in the research reports.

[5] Review and distribution by an Access BD of research produced by a non-U.S. broker-dealer may trigger obligations for the Access BD under applicable SRO rules and the SEC's Regulation AC. Thus, there are compliance and operational advantages for non-U.S. broker-dealers and their Access BDs if the Access BDs do not have to review or distribute research reports.

C. Solicited Transactions under Rule 15a-6(a)(3)

The proposal would continue to require non-U.S. broker-dealers that solicit securities business from most U.S. investors to establish and maintain a relationship with an Access BD. However, under the proposal, a non-U.S. broker-dealer would be required to conduct its U.S. activities under one of two alternative approaches. The first alternative (the "**(A)(1) Alternative**") would be available for non-U.S. broker-dealers (**"FBT Firms"**) that conduct a "foreign business." This exemption would permit the non-U.S. broker-dealer to effect solicited transactions, and custody funds and securities, of qualified investors. The second alternative (the "**(A)(2) Alternative**") would be available regardless of the non-U.S. broker-dealer's business mix. Under this exemption, the Access BD would have a greater role. Specifically, the non-U.S. broker-dealer would be allowed to effect solicited transactions with qualified investors but the Access BD would be responsible for receiving, delivering and safeguarding funds and securities in compliance with the Customer Protection Rule. The non-U.S. broker-dealer would not be permitted to custody funds and securities of the U.S. investor.

1. Provisions Applicable to All Non-U.S. Broker-Dealers

a. Expansion of Exemption to Qualified Investors. The SEC is proposing to expand the category of U.S. investors with which a non-U.S. broker-dealer may interact under Rule 15a-6(a)(3) by replacing the current categories of "major U.S. institutional investor" and "U.S. institutional investor" with the category of "qualified investor," which is defined in Section 3(a)(54) of the Exchange Act. These definitions are set forth in the Annex to this memorandum.

Qualified investors include investment companies registered under the Investment Company Act of 1940, banks, registered broker-dealers and their affiliates, certain other entities that are engaged in financial activities, as well as corporations, companies, partnerships and natural persons who own and invest, on a discretionary basis, $25 million in investments. The key differences are the inclusion of natural persons and a decrease in the threshold value of investments (from $100 million required for major U.S. institutional investors) that must be owned by the U.S. investors. However, eliminating the categories of U.S. institutional investors and major U.S. institutional investors will have the effect of excluding certain entities that are currently included in the definition of U.S. institutional investor, such as certain self-directed employee benefit plans and trusts.

b. Limitation of Exemption to Foreign Regulated Entities. The proposal would amend the definition of "foreign broker or dealer"

to require non-U.S. broker-dealers relying on Rule 15a-6(a)(3) to be regulated for their securities activities conduct, including the specific activities engaged in with qualified investors, by a foreign securities authority. As a result, non-U.S. broker-dealers that currently rely on Rule 15a-6(a)(3) but that are not regulated by a foreign security authority as to their securities activities (including those with U.S. investors) and regulated non-U.S. broker-dealers operating through unregulated non-U.S. branches, would not be able to continue to rely on the exemption.

c. Elimination of Chaperoning Requirements. In response to industry criticism, the proposal would eliminate the requirement that Foreign Associated Persons communicate with U.S. investors in conjunction with a chaperone associated with the Access BD (subject to various exceptions). In particular, Foreign Associated Persons would be able to: (i) directly communicate (both orally and electronically) with qualified investors from outside of the United States without any time restrictions, and (ii) visit qualified investors inside of the United States. The SEC proposes to interpret a "visit" as one or more trips to the United States over a calendar year that do not last more than 180 days in the aggregate (which would represent a substantial liberalization from the current 30 day per year limit). This limitation is intended to ensure that non-U.S. broker-dealers do not establish a permanent U.S. sales force without appropriate regulatory oversight.

d. Supplying Information to the SEC. The proposal continues to require that the non-U.S. broker-dealer provide the SEC, either upon request or pursuant to an agreement between the SEC or the United States and a foreign securities authority, with any information or documents within its possession, and any assistance in taking evidence, relating to transactions under Rule 15a-6(a)(3). Under the proposal, however, the non-U.S. broker-dealer (rather than the Access BD, as under the current Rule) would be required to maintain information specified in Rule 17a-3(a)(12) under the Exchange Act with respect to its Foreign Associated Persons, and make such information available upon request.[6]

e. Determination that Foreign Associated Persons are not Subject to Statutory Disqualification. Under the current Rule, Access BDs are required to determine that Foreign Associated Persons effecting transactions with

[6] Rule 17a-3(a)(12) information includes the Foreign Associated Person's name, address, social security number or foreign equivalent, starting date of employment or association with the non-U.S. broker-dealer, disciplinary actions taken, or sanction imposed, upon the Foreign Associated Person, and a record of any arrest or indictment for any felony or foreign equivalent, or any misdemeanor or foreign equivalent pertaining to securities, commodities, banking, insurance and certain other matters.

the U.S. institutional investors or major U.S. institutional investors are not subject to statutory disqualification under Section 3(a)(39) of the Exchange Act. The proposal would shift the responsibility for this determination to the non-U.S. broker-dealer. However, the proposal would require the Access BD to obtain a representation from the non-U.S. broker-dealer that it has made the determination.

f. Customer Disclosure. Under the proposal, all non-U.S. broker-dealers operating under Rule 15a-6(a)(3) Arrangements would be required to disclose to the qualified investors that the firm is regulated by a foreign securities authority and not by the SEC.

g. Agreement Between Non-U.S. Broker-Dealer and Access BD. In order for a non-U.S. broker-dealer to rely on Rule 15a-6(a)(3), it will still need an Access BD to satisfy certain requirements, though the role of the Access BD will be more limited than at present. In particular, Access BDs would be required to: (i) maintain certain books and records, as further discussed below; (ii) obtain from the non-U.S. broker-dealer, and each of its Foreign Associated Persons, written consent to service of process for any civil action; (iii) obtain from the non-U.S. broker-dealer a representation that its Foreign Associated Persons are not subject to statutory disqualification and that the non-U.S. broker-dealer has in its files and will make available upon request information required under Rule 17a-3(a)(12) of the Exchange Act; and (iv) maintain records of written consents to service of process and of the representations discussed above. Although Rule 15a-6 does not require non-U.S. broker-dealers to have agreements with their Access BDs, these and other responsibilities of the non-U.S. broker-dealers and their Access BDs are generally memorialized in service agreements, which would require modification to reflect the new allocation of responsibilities under the proposal.

h. Significant Liberalization of Operational Requirements for Access BDs. Overall, the proposal would liberalize operational requirements for Access BDs. In particular, an Access BD would no longer be responsible for "effecting" the transaction with the qualified investors. Thus, the Access BD would no longer be required to comply with the provisions of the federal securities laws or the SRO rules applicable to executing transactions in securities (unless it otherwise participates in executing the transaction).[7] This

[7] It may be that OTC options transactions effected directly by a non-U.S. broker-dealer with qualified investors in the United States under Rule 15a-6(a)(3) will no longer be subject to SRO option position limits that would otherwise be applicable if a registered broker-dealer were to effect the transaction. NASD Notice to Members 98-62 states that "member firms that intermediate transactions under Rule 15a-6(a)(3) are "effecting" such transactions within the meaning of [NASD] Rule 2860(b)(3)," and that position limits should therefore apply.

change is particularly significant for OTC transactions not executed on the U.S. securities markets or where no registered broker-dealer is involved with the execution. The proposal would also eliminate requirements under current Rule 15a-6(a)(3) that the Access BD be responsible for extending or arranging any margin credit to U.S. investors and complying with the SEC's net capital rule in connection with transactions effected under that provision.

2. Proposed (A)(1) Alternative

a. The Foreign Business Test. If a non-U.S. broker-dealer wishes to operate under the (A)(1) Alternative, it must satisfy a "foreign business test." That is, at least 85% of the aggregate value of the securities purchased and sold by the non-U.S. broker-dealer under Rules 15a-6 (a)(3) and proposed Rule 15a-6(a)(4)(vi) (discussed in section II.D. below) must be derived from transactions in "foreign securities." The proposed definition of "foreign security" (which is set forth in the Annex to this memorandum) would include: (i) both debt and equity securities of foreign private issuers; (ii) debt securities of issuers organized or incorporated in the U.S. where distribution of the securities is wholly outside the U.S. in compliance with Regulation S under the Securities Act Securities Act of 1933 (the "**Securities Act**"); and (iii) certain securities issued by foreign governments. The definition specifically includes derivative instruments on such foreign securities.[8]

The foreign business test would be calculated on a rolling two-year basis, except that the non-U.S. broker-dealer may rely on the calculation for the prior year for the first 60 days of the new year.[9] The non-U.S. broker-dealer would have the flexibility of using the calendar year or the firm's fiscal year for purposes of complying with this test. Non-U.S. broker-dealers will need to develop new procedures to collect the information necessary to track and demonstrate compliance with the foreign business test.

b. Custody and the Customer Protection Rule. Under the (A)(1) Alternative, the Access BD would no longer be responsible for receiving, delivering and safeguarding funds for U.S. investors in accordance with the Customer Protection Rule. Thus, a non-U.S. broker-dealer would be allowed to settle transactions directly with, and provide custody and maintenance of funds and securities for, qualified investors.[10] U.S. segregation and possession and

[8] Non-securities such as certain "swap agreements" would be excluded.

[9] The proposal does not indicate how non-U.S. broker-dealers would calculate the foreign business test for the transition period following the adoption of the proposed Rule.

[10] Permitting FBT Firms that utilize the (A)(1) Alternative to hold custody of U.S. customer assets is an important step forward from the perspective of non-U.S. financial (…continued)

control requirements would not apply to customer securities held by the non-U.S. broker-dealer. Therefore, U.S. rules should not apply to rehypothecation, securities borrowing and other practices.

c. Books and Records. The Access BD would be required to maintain copies of all books and records, including confirmations and account statements, issued by the non-U.S. broker-dealer, relating to any transactions effected under Rule 15a-6(a)(3). The books and records should be in the form prescribed by the foreign securities authority that regulates the non-U.S. broker-dealer. The Access BD may meet this requirement by maintaining copies of the books and records itself or by making a reasonable determination that the non-U.S. broker-dealer will maintain such records and promptly furnish those records to the SEC on request. In making this determination, the Access BD will need to consider whether there are any legal restrictions in the foreign jurisdiction that would limit the ability of the non-U.S. broker-dealer to disclose the relevant information to the SEC.

d. Customer Disclosure. In addition to the general customer disclosure requirement of non-U.S. broker-dealers relying upon Rule 15a-6(a)(3) described in Section II.C.1.f. above, non-U.S. broker-dealers operating under the (A)(1) Alternative would be required to disclose that U.S. segregation requirements, U.S. bankruptcy protections, and protection under the Securities Investor Protection Act do not apply to the funds and securities held by the non-U.S. broker-dealer.

3. Proposed (A)(2) Alternative

a. No Foreign Business Test. The foreign business test would not be applicable to non-U.S. broker-dealers operating under the (A)(2) Alternative.

b. Custody and the Customer Protection Rule. The A(2) Alternative would require the Access BD to receive, deliver and safeguard in accordance with the Customer Protection Rule funds and securities on behalf of the U.S. investor relating to any transactions executed under the exemption. Thus, the non-U.S. broker-dealer would not be permitted to maintain customers' funds

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institutions. Historically, the SEC's Division of Trading and Markets (formerly, the Division of Market Regulation) has been extremely reluctant to concede that unregistered foreign financial institutions may act as securities custodians directly for U.S. customers. However, limiting relief to these firms will not address the long-standing concerns raised by non-U.S. banks that act as custodians for foreign and U.S. securities of U.S. customers that are not qualified investors, or that do not maintain a relationship with an Access BD.

and securities under this provision. Moreover, if the SEC revokes the no-action guidance in the U.S. Affiliates Letter that permits direct settlement by a non-U.S. broker-dealer in respect of foreign securities in some circumstances, there will be a question regarding whether firms that currently rely on this relief would be permitted to continue to do so. If this is the case, direct settlement would be effectively limited to FBT Firms operating under the (A)(1) Alternative.

c. Books and Records. The Access BD would be responsible for maintaining the books and records for all transactions, including copies of all confirmations issued by the non-U.S. broker-dealer.[11] The Access BD would not have the option of relying on the non-U.S. broker-dealer to meet this requirement.

d. Customer Disclosure. As noted above, the non-U.S. broker-dealer would be required to disclose that it is regulated by a foreign securities authority, and not by the SEC.

D. Transactions with Certain Persons under Rule 15a-6(a)(4)

The proposal does not amend significantly the current exemption under Rule 15a-6(a)(4). However, the proposal would add a new Rule 15a-6(a)(4)(vi), which would permit an FBT Firm to effect transactions in securities with any U.S. person, other than a registered broker-dealer or U.S. bank that acts in a fiduciary capacity for an account of a "foreign resident client," including: (i) any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for federal income tax purposes; (ii) any natural person not a U.S. resident for federal income tax purposes; and (iii) any entity not organized or incorporated under the laws of the United States 85% or more of whose outstanding voting securities are beneficially owned by persons in clauses (i) and (ii). In order to rely on the exemption, the proposal requires that the non-U.S. broker-dealer obtain from the U.S. fiduciary a written representation that the account is managed in a fiduciary capacity for a foreign resident client.[12] Proposed Rule 15a-6(a)(4)(vi) raises two major issues. Whereas the U.S. Fiduciaries Letter limits transactions to foreign securities, the proposal would allow an FBT Firm to effect transactions with the U.S. fiduciary in all securities, including, for example, U.S. stocks. However, unlike the relief provided for in the U.S. Fiduciaries Letter, only an FBT Firm may rely on this exception.

[11] Of course, if a registered broker-dealer carries customer assets, it must issue its own account statements under applicable SRO rules.

[12] A somewhat different form of certification is required from the U.S. fiduciary under the current U.S. Fiduciaries Letter. Also, the definition of "foreign resident client" differs in certain, relatively minor, respects from the U.S. Fiduciaries Letter's definition of "offshore client."

E. Non-U.S. Securities Exchanges

1. Foreign Option Exchanges under Proposed Rule 15a-6(a)(5)

The proposal would add a new exemptive provision, Rule 15a-6(a)(5), which would codify, in somewhat modified form, no-action guidance that the SEC staff has issued to various non-U.S. options exchanges over the years. The no-action letters state that such exchanges may conduct limited "familiarization" activities in the U.S. without subjecting the exchanges or members to U.S. registration and certain other requirements applicable to national securities exchanges, clearing organizations and broker-dealers, respectively. This codification, together with proposed interpretive guidance, would eliminate the need for non-U.S. options exchanges to seek no-action relief on an individual basis.

Proposed Rule 15a-6(a)(5) provides that a non-U.S. broker-dealer may effect transactions in foreign securities on an unregistered non-U.S. options exchange (including an OTC options processing service) for qualified investors provided that such transactions have not been solicited by such non-U.S. broker-dealer. The non-U.S. options exchange may, from a foreign office or a representative office in the U.S., communicate with qualified investors regarding the exchange, its options products involving foreign securities and the exchange's OTC options processing service, including making available to such investors a descriptive brochure and (upon request of investors) a list of exchange participants without such activities being treated as solicitation. In addition, under proposed Rule 15a-6(a)(5)(ii), a non-U.S. broker-dealer that is an exchange member would also be able to make available to qualified investors the foreign options exchange's OTC options processing service, and provide qualified investors (in response to an unsolicited inquiry) with a descriptive brochure.

The proposal to adopt new Rule 15a-6(a)(5) will be welcomed by non-U.S. options exchanges and their participants because, among other things, it permits dealings with qualified investors, whereas the relevant no-action letters apply a "qualified institutional buyer" standard, which excludes individuals and in most cases requires $100 million in investments. However, the proposal probably does not go as far as some foreign options exchanges might wish. For example, the proposed exemption is limited to options on foreign securities traded on the non-U.S. options exchange, and does not address whether an option on an index comprised, in whole or in part, of foreign securities would be eligible. Moreover, the proposal does not advance the long-standing goal of foreign markets to secure SEC blessing for direct investor access to a non-U.S. options exchange by means of a U.S.-based trading screen. Finally, rather unhelpfully, the proposal notes that foreign option transactions effected through the facilities of a foreign exchange will generally involve the offer or sale of a security for purposes of the

registration requirements of the Securities Act, and that such offers or sales may require registration under that Act, unless an exemption is available, such as the "private placement" exemption under Section 4(2). This leaves the marketplace in unnecessary doubt regarding whether a particular sale of a foreign listed option could be made to a qualified investor in the U.S. without Securities Act registration.

2. Alternative Trading Systems

A further item in the proposal that will be of interest to the securities exchange community is the SEC's solicitation of comments on whether Regulation ATS should be amended to allow a non-U.S. broker-dealer relying on a Rule 15a-6 exemption to operate an alternative trading system ("**ATS**") without registering as a broker-dealer. An ATS generally has the choice of either registering as a national securities exchange or being regulated as a registered broker-dealer that is subject to additional regulatory requirements. An unregistered non-U.S. broker-dealer is not currently eligible for the exemption from registration as a national securities exchange for entities operating in compliance with Regulation ATS. If this restriction were liberalized, it could, in theory, allow some non-U.S. securities markets to effectively operate a securities market in the United States without registering as a broker-dealer or as a national securities exchange.[13] Although this raises competitive concerns for existing U.S. market participants, it could represent a significant business opportunity for qualified foreign markets.

***Comments***

The SEC seeks comment on the proposal as a whole, as well as on over 45 categories of issues, including whether the qualified investor standard and the foreign business test are appropriate. We believe that many financial institutions will view the proposal as a significant step forward in terms of liberalizing cross-border access to brokerage and other securities services and products without compromising the protection of U.S. investors. In addition, many unnecessary procedural requirements that have caused compliance and operational problems would be eliminated. As such, many firms will likely respond favorably to the proposal. Nonetheless, we believe that some financial institutions will feel that the proposal does not go far enough to accommodate legitimate cross-border securities business, leaves certain ambiguities in the current regulation unresolved

[13] Although Section 5(2) of the Exchange Act permits the SEC to exempt "limited volume" exchanges from certain requirements, this type of exemption has historically been cumbersome to obtain and operate under. Currently, only non-U.S. exchange operates under a limited volume exemption.

and creates new ambiguities, and in some cases imposes additional barriers and requirements.

Interestingly, the proposal is silent on the SEC's announced "mutual recognition" initiative under which non-U.S. securities exchanges and non-U.S. broker-dealers would be permitted to do business in the United States on the basis of home country rules, rather than U.S. registration and other requirements.[14] Such an approach, though more difficult to achieve than amending Rule 15a-6, could alleviate many of the technical issues that have always been inherent in Rule 15a-6, such as what constitutes "solicitation" in an era when vast amounts of financial information (including research) on foreign securities, markets and intermediaries are available to all U.S. investors instantaneously and at all times. Similarly, concerns about securities custody and settlement could potentially be ameliorated in a mutual recognition model because the SEC could limit the availability of mutual recognition to jurisdictions that it believes has adequate regimes for protection of customer assets and broker insolvency. Issues regarding cross-border enforcement, information sharing among regulators and resolution of disputes between non-U.S. broker-dealers and U.S. investors, which are not addressed at all in the proposal, could also be resolved in a mutual recognition model through bilateral or multilateral cooperation agreements and even treaties. It might also be possible to resolve questions about the application of state securities laws to non-U.S. broker-dealers in the context of mutual recognition. Finally, a mutual recognition model could and should establish a framework for non-U.S. securities markets to make their services available on a direct basis in the United States in a manner that is consistent with investor protection.

The proposal, in effect, does make a few tentative steps in the direction of recognizing foreign regulation, by allowing FBT Firms operating under Alternative (A)(1) to hold custody of assets for, and to effect settlement with, qualified investors without the involvement of an Access BD, and by limiting the use of 15a-6(a)(3) to regulated entities. However, the proposal does not differentiate among the quality of foreign regulation, the affiliation of a non-U.S. broker-dealer with a U.S.-regulated entity or the size or financial wherewithal of non-U.S. broker-dealers – leaving these matters for qualified investors to investigate and evaluate on their own. Therefore, under the proposal, it appears that a thinly capitalized non-U.S. broker-dealer based in a jurisdiction that has a

[14] *See e.g.*, Spotlight On: Roundtable Discussions Regarding Mutual Recognition (June 12, 2007), available at: http://www.sec.gov/spotlight/mutualrecognition.htm; SEC Announcement Regarding Next Steps for Implementation of Mutual Recognition, SEC Concept Release No. 2008-49, available at http://www.sec.gov/news/press/2008/2008-49.htm (March 24, 2008); SEC Press Release Regarding Schedule Announced for U.S. Canadian Mutual Recognition Process Agreement, SEC Press Release No. 2008-98 (May 29, 2008), available at http://www.sec.gov/news/press/2008/2008-98.htm.

rudimentary or unenforced regulatory regime, may be able to rely upon Rule 15a-6(a)(3) to solicit qualified investors; such an entity could also qualify as an FBT Firm and therefore hold qualified investors' customer assets and deal directly with U.S. fiduciaries for foreign resident clients. However, under the proposal, a well capitalized non-U.S. bank that is comprehensively regulated in its home jurisdiction, but not with respect to offshore securities transactions, would not be able to rely upon Rule 15a-6(a)(3) at all.

With regard to securities markets, the SEC's request for comments on whether non-U.S. broker-dealers should be permitted to operate an ATS without registration either as a registered broker-dealer or as a national securities exchange, is signal that the SEC is at least considering ways in which foreign market activities might be legitimately expanded.

Finally, it is significant to note that **all** non-U.S. broker-dealers that currently conduct business under Rule 15a-6(a)(3) must examine how the proposal will affect them. Certain firms that currently interact with U.S. investors under Rule 15a-6 out of non-U.S. entities that are not regulated as to their securities activities with U.S. investors (or that use unregulated offices of regulated entities), and non-FBT Firms that rely upon the Fiduciaries Letter and the U.S. Affiliates Letter will find that the proposal, if adopted, will affect their current operations. In addition, the proposal will effectively require all non-U.S. broker-dealers that maintain relationships with Access BDs to change their Rule 15a-6 operating procedures and agreements, and non-U.S. broker-dealers that seek to operate as FBT Firms under the (A)(1) Alternative will require significant new recordkeeping regimes to track and demonstrate compliance.

* * *

Please call your primary contact at Davis Polk if you would like to discuss these issues further.

## Annex

CERTAIN CURRENT AND PROPOSED DEFINITIONS IN RULE 15a-6

*Rule 15a-6 defines major U.S. institutional investor to mean a person that is*:

(i) A U.S. institutional investor that has, or has under management, total assets in excess of $100 million; provided, however, that for purposes of determining the total assets of an investment company under this rule, the investment company may include the assets of any family of investment companies of which it is a part; or

(ii) An investment adviser registered with the SEC under Section 203 of the Investment Advisers Act of 1940 that has total assets under management in excess of $100 million.

In the U.S. Affiliates Letter and a subsequent 1997 no-action letter, this definition was effectively expanded to include *any* entity that owns, controls, or has assets under management in excess of $100 million in aggregate financial assets.

*Rule 15a-6 defines U.S. institutional investor to mean a person that is*:

(i) An investment company registered with the Commission under Section 8 of the Investment Company Act of 1940; or

(ii) A bank, savings and loan association, insurance company, business development company, small business investment company, or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act of 1933; a private business development company defined in Rule 501(a)(2) under the Securities Act; an organization described in Section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3) under the Securities Act; or a trust defined in Rule 501(a)(7) under the Securities Act.

*Section 3(a)(54) under the Exchange Act defines qualified investor to mean a person that is*:

(i) Any investment company registered with the Commission under Section 8 of the Investment Company Act;

(ii) Any issuer eligible for an exclusion from the definition of investment company pursuant to Section 3(c)(7) of the Investment Company Act;

(iii) Any bank (as defined in Section 3(a)(6) of the Exchange Act), savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act), broker, dealer, insurance company (as defined in Section 2(a)(13) of the Securities Act), or business

development company (as defined in Section 2(a)(48) of the Investment Company Act);

(iv) Any small business investment company licensed by the United States Small Business Administration under Section 301 (c) or (d) of the Small Business Investment Act of 1958;

(v) Any State sponsored employee benefit plan, or any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in Section 3(21) of that Act, which is either a bank, savings and loan association, insurance company, or registered investment adviser;

(vi) Any trust whose purchases of securities are directed by a person described in clauses (i) through (v) above;

(vii) Any market intermediary exempt under Section 3(c)(2) of the Investment Company Act;

(viii) Any associated person of a broker or dealer other than a natural person;

(ix) Any foreign bank (as defined in Section 1(b)(7) of the International Banking Act of 1978);

(x) The government of any foreign country;

(xi) Any corporation, company, or partnership that owns and invests on a discretionary basis not less than $25 million in investments;

(xii) Any natural person who owns and invests on a discretionary basis not less than $25 million in investments;

(xiii) Any government or political subdivision, agency, or instrumentality of a government that owns and invests on a discretionary basis not less than $50 million in investments; or

(xiv) Any multinational or supranational entity or any agency or instrumentality thereof.

*Proposed Rule 15a-6 would define <u>foreign security</u> to mean:*

(i) An equity security (as defined in Rule 405 under the Securities Act) of a foreign private issuer (as defined in Rule 405 under the Securities act);

(ii) A debt security (as defined in Rule 902 under the Securities Act) of a foreign private issuer;

(iii) A debt security issued by an issuer organized or incorporated in the United States in connection with a distribution conducted solely outside the United States pursuant to Regulation S of the Securities Act;

(iv) A security that is a note, bond, debenture or evidence of indebtedness issued or guaranteed by a foreign government (as defined Rule 405 under the Securities Act) that is eligible to be registered with the SEC under Schedule B of the Securities Act; and

(v) A derivative instrument on a security described in paragraphs (i) (ii), (iii), (iv) of this paragraph.