Barbarians at the Gate – The SEC's Proposed Revision of Exchange Act Rule 15a-6

By Stephen J Nelson, The Nelson Law Firm, LLC

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Traders enjoy complaining about regulation and are justified in doing so. There is hardly any action that a trader can take during the day, no matter how basic, that is not the subject of some regulation. And, with every regulation, there is a cost.

To curry favor with clients, lawyers like to complain about regulation, too. But, this is disingenuous. Heavily regulated industries need lawyers to help their regulated clients decipher their responsibilities. Complex regulation requires smarter and higher-priced lawyers to navigate through the maze and defend clients that run afoul of the regulations. Simpler or less regulation would cause a decline in our billing rates.

Despite all the venom flowing around, the fact is that the financial services industry receives one enormous benefit from regulation. Regulation offers a competitive advantage to the regulated. The unregulated are not permitted to play. It is that fact that makes the SEC's proposed changes to Exchange Act Rule 15a-6, released early this week, important. The proposal would permit foreign broker-dealers that are not registered with the SEC to invade turf that under current rules can only be occupied by registered broker-dealers.

At present, a US person who wants to open a foreign brokerage account with a foreign broker-dealer and trade foreign securities is free to do so. But, the US person has to take the initiative. The foreign broker-dealer cannot advertise its services to US persons, provide research to US persons, make sales calls on US persons or do any of the activities that fall within the broad category of "solicitation."

There is a limited exception to all of this for "major US institutional investors," generally defined as investment companies and registered investment advisers with assets under management greater than $100 million. It is worth noting that hedge funds whose investment managers are unregistered are not included in this definition. If a foreign broker-dealer wishes to make a sales call on one of these major US institutional investors, a US broker-dealer must accompany them. If research is provided, the US broker-dealer must review it for compliance with US rules. If the solicitation by a foreign broker-dealer to a major US institutional investor results in an order, that order must be executed through a US broker-dealer and the customer's assets must be in the custody of a US broker-dealer and are

subject to US customer protection rules. Finally, margin must be provided by the US broker-dealer, rather than the foreign broker-dealer.

The proposed rule would expand this exemption significantly. First, it would expand the exemption for solicitation to just about any company, partnership or trust with an investment portfolio greater than $25 million. The exemption would also allow foreign broker-dealers to solicit high net worth individuals with an investment portfolio greater than $25 million. These institutions and high net worth individuals are defined in the rule as "qualified investors." Second, and most importantly for the trading community, the proposed rule would also limit the role of US broker-dealers in this process.

The proposal divides the world of foreign broker-dealers into two camps: Foreign broker-dealers that conduct a "foreign business" and other foreign broker-dealers. A foreign broker-dealer is defined as a broker-dealer regulated by a foreign regulatory authority. A foreign broker dealer conducts a "foreign business" if 85% of the securities purchased and sold by or on behalf of its clients are "foreign securities."

Foreign broker-dealers that conduct a "foreign business" could engage in a wide-range of solicitation activities to US clients that are "qualified investors." The rule would permit them to provide research, make sales calls, maintain custody of client cash and securities, provide margin and execute trades. The US broker-dealer's role would be limited to an agreement with the foreign broker-dealer that it would have access to the records of the foreign broker-dealer so that the SEC could obtain them easily. However, those records need not comply with the elaborate record-keeping requirements of Exchange Act Rules 17a-3 and 17a-4. Instead, the foreign broker-dealer would only have to comply with its home country record-keeping regulations, and those are all the records that the US broker-dealer and the SEC would be able to access.

Foreign broker-dealers that do not conduct a "foreign business" would be permitted to provide research, make sales calls and execute trades for qualified investors. But, they would not be permitted to maintain custody of client assets, or provide margin to US clients, and a US broker-dealer would be required to maintain books and records for the client.

It is true that US broker-dealer registration would still be required to be a member of a national securities exchange or provide quotes in automated interdealer quotation systems in the over-the-counter market. But, as we all know, access for non-member firms through member firms has eased considerably. A lack of market access can no longer be considered a serious barrier to entry.

I think that part of the rule that permits foreign broker-dealers that do not conduct a "foreign business" to solicit US qualified investors should be the most interesting for most of the US broker-dealer community. This would permit any foreign broker-dealer to establish an introducing relationship with a US clearing firm and compete for institutional order flow. Most mid-sized and smaller US broker-dealers are introducing firms, and many of them compete for institutional and high net worth order flow. If the compliance costs of US introducing firms are greater than those of foreign broker-dealers, and I suspect they are, US broker-dealers will be placed at a competitive disadvantage to their foreign competitors. You should expect to see institutional introducing firms relocate "off-shore" in places like Bermuda or the Cayman Islands to take advantage of the reduced cost of regulation available in such jurisdictions.

So, why is the SEC doing this?

In the release for the proposed rule, the SEC refers to a roundtable conducted last year. Some of the firms invited to participate in the roundtable would end up with uncompetitive business models as a result of the proposal. But, the participants in the roundtable really pressing for the rule change belonged to large international firms or were members of the law firms that represent them.

Many "Wall Street" investment banks have overseas operations in London, Paris or Tokyo that are greater than their US operations. For them, the current SEC registration requirements are an expensive nuisance. I am amazed by the number of "Wall Street" law firms that now describe their New York office as a "regional office," rather than headquarters.

I believe this proposal will become the rule with some amendments. The big question is what happens next. My guess is that the same pressures to allow foreign competition to US broker-dealers for institutional order flow will be directed at competition for retail business. Retail customers will clamor to be allowed the same access to foreign broker-dealers as high net-worth individuals. If I am right, the entire world of broker-dealers will end up competing for US clients.

Unfortunately, US broker-dealers will not have the same ability to compete for foreign clients – not without obtaining a license from a foreign regulator. Many other jurisdictions see it as their mandate to protect local firms from competition. Larger firms have been able to obtain these permissions in most parts of the world, but the process is way too expensive and difficult for mid-sized and smaller firms.

It seems to me that the proposal could be improved substantially by balancing the scales. It should not be enough that a foreign broker-dealer is regulated by a foreign regulatory authority. Instead, that foreign regulatory authority should

provide the same access to foreign clients for US broker-dealers that this proposal would provide to US clients for foreign broker-dealers.

Ultimately, the benefits of regulation must exceed their costs.