US cross-border securities: Buyer (and seller) beware

As technology removes physical borders from the securities industry, international financial institutions must remain vigilant to ensure their business activities do not violate US regulations.

Since the financial crisis, the US has strengthened its position as the world's biggest and most liquid capital market and one of the most active destinations for M&A, equity fund-raisings and securities trading. This makes it an essential market for international financial institutions eager to build businesses and win market share.

In an increasingly electronic world where physical boundaries are no longer impediments to the efficient delivery of financial services, there are many ways in which non-US securities firms can target US investors and markets. However, they must be aware of significant legal and regulatory risk, particularly in light of an increased focus by the US Securities and Exchange Commission (SEC) on policing the activities of foreign securities firms.

International companies must formally register with US regulators if they are not exempt from registration, or they could face penalties, as illustrated by recent enforcement, actions by the SEC.

In 2016, Israeli based Bank Leumi was forced by the SEC to pay nearly US$5 million in penalties to settle charges that it provided investment advice and solicited investments from US customers without registering with federal regulators.

The SEC has brought similar cases in recent years against financial institutions targeting US investors and markets from other countries including Russia, Portugal and Switzerland.

> **"Non-US companies that are not exempt from registration with the SEC may face fines for providing investment advice or brokerage to US customers without registration**

Passing the registration test

Unless an exemption is available, US law requires any person soliciting or selling securities to persons in the US to register with the SEC as a broker. The basic test for "broker" status is whether a person performs any activity that could be deemed as "effecting a transaction" in securities and receives a fee based on the size or completion of the transaction—so called "transaction-based compensation." While there is no established list of activities that could be deemed "effecting a transaction," the SEC and US courts have cited the following activities as problematic:

- Identifying and/or introducing potential purchasers of securities
- Communicating with US investors via telephone or email, or traveling to the US to meet with investors
- Establishing or maintaining brokerage accounts for US residents
- Soliciting securities transactions (e.g., advertising a company for sale, offering brokerage services or financial products to US residents, etc.)
- Distributing securities research reports to US persons
- Participating in the negotiation of a securities transaction and
- Facilitating the execution/closing of a securities transaction

US$5m

Penalty imposed by the SEC on Bank Leumi for failure to register

Any person—based within the US or who engages in these or similar activities with US customers—should consider whether they must first register with the SEC as a broker, particularly when these activities are combined with transaction-based compensation.

Offering investment advice to US customers

If a person provides advice to US clients about buying and selling securities, or in relation to the valuation of securities, they will typically be required to register with the SEC as an investment adviser.

This may also apply to people who issue or distribute securities reports or analysis to US customers either in return for compensation or as part of a normal course of business.

While the need to register may be clear in the case of traditional separately managed account (SMA) advisory relationships with US customers, there are other less obvious cases where it applies such as:

- **Robo-advisors:** These are a relatively new class of automated investment advisers that provide advisory services to retail investors through online platforms. In general, these platforms gather personal background and investment profile information from their users, generate investment recommendations using algorithmic programs, and in some cases even implement the recommendations on a discretionary basis. These platforms are designed to enable the deployment of sophisticated investment algorithms to retail investors at a cost significantly lower than traditional advisory services. While business models vary, some robo-advisory platforms keep the costs low by providing limited or no human interaction with their customers.

The SEC has clearly articulated its view that the substantive and fiduciary obligations of US investment adviser regulations apply to robo-advisers. Non-US-based providers of robo-advisory platforms should therefore be aware of these requirements and consider whether they need to register with the SEC if their platforms accept US customers.

- **Private Fund Advisers:** The introduction of financial reforms in the Dodd-Frank Act in July 2010 forced many more private fund advisers to register with the SEC as investment advisers. Previously, advisers to private funds (such as hedge funds, venture capital funds, private equity funds, etc.) were granted an exemption as long as they advised 15 or fewer funds. Under Dodd-Frank, exemptions from full SEC registration only apply to advisers focused purely on venture capital funds, or those who focus solely on private funds with less than US$150 million of assets under management in the US.

  The registration requirements for private fund advisers are not limited to advisers with operations in the US. Non-US-based private fund advisers may be subject to registration requirements if the private funds they manage have more than 15 US investors or more than US$25 million in assets under management attributable to US investors. Non-US private fund advisers who wish to avoid SEC registration must therefore monitor their private funds to ensure they do not exceed these limits.

Sponsoring electronic trading platforms

Electronic platforms enabling the issuance and trading of various types of financial instruments have proliferated in recent years. These platforms began with online access to traditional brokerage services, and have evolved to include the provision of trading in all types of securities and derivatives, direct investing in start-up companies and venture capital funds and, most recently, trading in digital virtual coins and tokens. Because these platforms are offered via the internet, they are not subject to any physical or geographical boundaries and typically may be accessed by customers in multiple jurisdictions.

> “If an electronic platform permits the trading of securities and accepts US customers, the provider of the platform may be required to register with the SEC

If an electronic platform permits the trading of securities and accepts US customers, the provider of the platform should consider whether it is required to register with the SEC as a broker. For some platforms, the determination of whether they trade securities as defined under US law is clear: Instruments such as common and preferred stock, notes and bonds, and interests in private funds are generally within the definition of securities. Other platforms may require a more nuanced analysis. For example, platforms that facilitate the trading of interest in loans or real estate may or may not trade securities, depending on the exact characteristics of each instrument.

The newest frontier of this analysis deals with whether digital coins and tokens are defined as securities. The SEC has determined that at least some instruments sold in Initial Coin Offerings (ICOs) and Token Sales are securities, while the US Commodities Futures Trading Commission has stated that some may be commodities.

Until US regulators provide additional clarity regarding the regulatory treatment of different types of coins and tokens, operators of platforms that accept US customers and facilitate the purchase and sale of virtual coins and tokens that are similar to those that have already been classified as "securities" should consider whether they are required to register as brokers (and register their platforms as "alternative trading systems").

US$25m
Threshold for US assets under management that triggers the need for non-US private fund advisers to register with the SEC

Approaching US investors through third parties

Non-US securities firms often seek to approach US investors through third parties to avoid triggering broker registration obligations. This strategy may be implemented successfully by complying with SEC Rule 15a-6, which generally requires that transactions be "chaperoned" by a US-registered broker-dealer. However, some non-US securities firms may wish to dispense with the chaperoning requirement and hire a so-called "finder" to introduce US customers.

If a firm decides to appoint a finder, it must ensure the finder is properly registered in the US or run the risk of regulatory enforcement and sanctions. This was the case for a private equity firm and one of its senior executives when they were charged by the SEC with hiring an unregistered finder. The firm and its executive paid civil penalties, and the executive was barred from the securities industry for their roles in aiding and abetting the unregistered broker's violation of the US securities laws.

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