

September 2, 2008

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. S7-16-08 (Exemption of Certain Foreign Brokers or Dealers)

Dear Ms. Harmon:

The Financial Industry Regulatory Authority (FINRA) staff¹ submits this comment letter in response to certain provisions of the Commission's proposed amendments to Rule 15a-6 under the Securities Exchange Act of 1934 (Exchange Act).² Among other things, the proposal would significantly expand the exemption from broker-dealer registration for foreign entities that solicit transactions – including those in U.S. securities – from “qualified investors” in the United States. Indeed, in some circumstances, the proposal would allow a foreign broker-dealer to provide to these investors full brokerage services, including effecting trades and maintaining custody of funds and securities, without any intermediation by a U.S. registered broker-dealer subject to the federal securities laws and FINRA or other self-regulatory organization (SRO) rules.

FINRA recognizes the rapidly increasing globalization of markets. And, we share the proposal's stated goal to ease direct access between sophisticated U.S. investors and those entities with expertise in foreign markets and foreign securities, while maintaining a regulatory structure that protects investors and promotes confidence in the U.S. markets.

¹ As the largest non-governmental regulator for all securities firms doing business with the public in the United States, FINRA oversees nearly 5,000 brokerage firms, about 173,000 branch offices and more than 676,000 registered securities representatives.

Created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange, FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. FINRA has approximately 3,000 employees and operates from Washington, DC, and New York, NY, with 15 District Offices around the country.

The comments provided in this letter are solely those of the staff of FINRA; they have not been reviewed or endorsed by the Board of Governors of FINRA. For ease of reference, this letter may refer to “we,” “FINRA” or “FINRA staff” interchangeably, but these terms refer only to FINRA staff.

² See Exchange Act Release No. 58047 (June 27, 2008), 73 Fed. Reg. 39181 (July 8, 2008).

However, FINRA respectfully suggests that the Commission's proposal could strike a better balance between these sometimes competing interests.

In particular, FINRA urges the Commission to reevaluate three aspects of the proposal related to extending the exemption to solicited transactions by foreign broker-dealers.³ First, FINRA is concerned that certain categories of persons encompassed by the "qualified investor" standard may lack the financial acumen and experience to interact with foreign broker-dealers without the protections afforded by the federal securities laws and FINRA rules. Second, FINRA believes the exemption for solicited transactions should be limited to transactions in foreign securities, so as to maintain quote and transaction reporting transparency and minimize the fragmentation of liquidity in trading of U.S. securities. Finally, with respect to foreign broker-dealers that rely on the proposed "foreign business" exemption, FINRA believes the Commission must ensure certain minimum time, manner and form standards regarding maintenance of books and records by such foreign broker-dealers and ensure FINRA access to those materials to the extent that they relate to an examination or investigation of an affiliated FINRA member.

Qualified Investors

The proposal would at once both expand the category of U.S. investors with which a foreign broker-dealer may directly interact and lessen the role that a U.S. broker-dealer must play in intermediating such transactions. With few exceptions, the current exemption only permits foreign broker-dealers to interact with "major U.S. institutional investors" or "U.S. institutional investors." The former comprises investors who own or manage total assets in excess of \$100 million and registered investment advisers with total assets under management in excess of \$100 million. The latter includes, among other entities, registered investment companies, banks, savings and loan associations, insurance companies, certain business development companies and certain employee benefit plans and trusts with assets of least \$5 million. The current exemption prohibits contacts with natural persons, irrespective of the assets or investments owned by such persons.

The current exemption further requires a U.S. registered broker-dealer to effect all aspects of the transaction, including "chaperoning" contacts between the foreign broker-dealer and the U.S. institutional investors covered by the exemption.⁴ Part and parcel of the responsibility of the U.S. broker-dealer is to review such transactions for indications of possible violations of the federal securities laws.

The Commission's proposal would replace the categories of "major U.S. institutional investor" and "U.S. institutional investor" with the "qualified investor" standard set forth in

³ We limit our comments in this letter to the proposed changes regarding solicited transactions.

⁴ The U.S. registered broker-dealer also is responsible for issuing confirmations and account statements; extending credit; maintaining books and records; and receiving, delivering and safeguarding funds and securities related to the transaction.

Section 3(a)(54) of the Exchange Act. The definition of “qualified investor” includes several additional classes of persons, including most notably the following: (1) any natural person, corporation, company or partnership who owns and invests on a discretionary basis at least \$25 million in investments; (2) any government or political subdivision, agency, or instrumentality of a government that owns and invests on a discretionary basis at least \$50 million in investments; (3) certain employee benefit plans, regardless of assets, if the investment decisions are made by a plan fiduciary; and (4) any trust, regardless of assets, whose purchases of securities are directed by certain persons that otherwise qualify for one of several qualified investor classes.

In explaining its rationale for dropping the asset thresholds for major institutional investors and adding natural persons and other classes of entities, the Commission first recalls its intention in adopting the \$100 million asset threshold under the current rule: “to increase the likelihood that [the investor has] prior experience in foreign markets that provides insight into the reliability and reputation of various foreign broker-dealers.” The Commission then concludes that “increased access to information about foreign securities markets due to advancements in communication technology suggest that a broader spectrum of investors are likely to have this type of sophistication” and that the qualified investor definition would “more accurately encompass persons that have prior experience in foreign markets *and* an appropriate level of investment experience and sophistication overall.” (emphasis added)

FINRA questions whether increased access to information is a fair proxy for actual experience in dealing with foreign broker-dealers – or for sophistication more generally. And we are skeptical that direct investment in foreign markets and foreign securities is already so commonplace as to assume that the expanded classes of persons under the “qualified investor” standard have engaged in such activity. FINRA is therefore concerned that the “qualified investor” standard is too broad, particularly in this context where the expanded scope of the exemption is coupled with a corresponding reduction – and in some cases, elimination – of the prophylactic role of a U.S. registered broker-dealer in connection with solicited transactions. And unlike the Commission’s mutual recognition effort, the proposed amendments to Rule 15a-6 would not ensure any minimum standards of regulation by the foreign securities authority charged with overseeing a foreign broker-dealer. Indeed, the proposal seems to carry no assurances that the foreign securities authority’s regulations will even reach the conduct of its broker-dealers’ activities outside of the country or with non-citizens.

FINRA supports eliminating the “chaperoning” requirement as a condition for the current exemption as it pertains to the trading of foreign securities and appropriate classes of sophisticated investors. But we would ask the Commission to rethink whether it is reasonable to conclude that essentially all employee benefit plan fiduciaries and trust directors, as well as natural persons and municipalities and governmental authorities with relatively modest investment thresholds, possess sufficient levels of investment experience in foreign markets such that they can effectively be treated as counterparties that need none of the protections of the federal securities laws and FINRA rules. We note that the Commission asks whether the qualified investor definition should further be tailored to encompass only

investors with demonstrable experience in foreign securities transactions. FINRA believes the posing of the question itself indicates that the qualified investor definition is an imperfect proxy for assuring the experience needed to navigate investment decisions without the protection of the U.S. regulatory scheme.

Transactions in U.S. Securities

The proposal would create two exemptive options for solicited transactions by a foreign broker-dealer, each implicating differing obligations on the part of a U.S. broker-dealer. Under one option, a foreign broker-dealer that conducts a “foreign business”⁵ could effect essentially all aspects of securities transaction with a “qualified investor” without any intermediation by a U.S. registered broker-dealer subject to the federal securities laws or FINRA rules. Where a foreign broker-dealer relies on this option, a U.S. registered broker-dealer only would be required to maintain copies of all books and records, including confirmations and account statements, in the form, manner and for the periods prescribed by the foreign securities authority that regulates the foreign broker-dealer. Those books and records could be maintained with the foreign broker-dealer, provided that the U.S. registered broker-dealer makes a reasonable determination that copies could promptly be furnished to the Commission. The other exemptive option would be available to all foreign broker-dealers, regardless of the percentage of their business in foreign securities. Notably, it still would permit those entities to effect solicited transactions, but it would require a U.S. broker-dealer to custody the funds and securities of the qualified investors and maintain books and records in accordance with SEC rules.

Under either option – and of considerable concern to FINRA – a foreign-broker dealer could solicit and effect transactions in *U.S.* securities without the involvement of a U.S. registered broker-dealer subject to the federal securities laws and FINRA rules. FINRA believes this aspect of the proposal goes too far. To the extent the Commission exempts a foreign broker-dealer from registration – and by extension, SRO membership – such exemption should apply only to the trading of foreign securities. In addition to the serious regulatory and transparency concerns set forth below, this aspect of the proposal further would fragment the liquidity in U.S. securities to the detriment of the U.S. markets and all U.S. investors, including retail investors.

The Commission notes that transactions in U.S. securities effected on a U.S. national securities exchange, through a U.S. alternative trading system or with a registered market maker or an over-the-counter dealer in the United States necessarily would require a U.S. registered broker-dealer to effect the transaction. However, those broker-dealers that “effect” a transaction – market makers or specialists, for example – still would not be subject to the panoply of sales practice rules that protect U.S. investors, such as suitability and advertising

⁵ The proposal would define “foreign business” to mean the business of a foreign broker-dealer with qualified investors and foreign resident clients where at least 85% of the aggregate value of securities purchased or sold in reliance on the exemption is derived from sales of foreign securities, as calculated on a rolling two-year basis.

rules. Moreover, the proposed rule change would further provide the opportunity for a substantial number of transactions in U.S. securities to be effected by foreign broker-dealers away from the U.S. markets – for example, transactions internalized by foreign broker-dealers and those accessing foreign over-the-counter liquidity pools – unsusceptible to the federal securities laws and regulations imposed by the Commission, FINRA and SROs and without the attendant transparency and access that U.S. investors have come to expect when trading U.S. securities. While this may be a relatively small universe of transactions today, as discussed below, the proposed easing of U.S. regulatory constraints on these transactions will likely result in an increase in this type of trading.

Thus, a significant universe of transactions in U.S. securities would evade surveillance for insider trading, market manipulation and other types of securities fraud. Those transactions similarly may not be captured by various quality of markets regulations, such as Regulation SHO. Indeed, the proposal would seemingly frustrate the purposes of Regulation SHO and FINRA’s accompanying Rule 3210 (Short Sale Delivery Requirements) and exacerbate failures to deliver. The exempt foreign broker-dealers would not be subject to the Regulation SHO locate requirements and their failures to deliver in U.S. securities may not be reflected at the National Securities Clearing Corporation and therefore might not be counted as part of the threshold determination that triggers the important remedial measures with respect to those fails. Essentially, an entire segment of the market in U.S. securities would be opaque to both U.S. regulators and investors and therefore vulnerable to conduct that could compromise the integrity of the U.S. markets.

FINRA further doubts that the “foreign business” exemption’s 85% threshold, which is a constraint only in the case of the first exemptive option, will meaningfully mitigate the exposure of a substantial volume of transactions in U.S. securities to regulatory arbitrage in foreign jurisdictions with uncertain investor protection schemes. The Commission asserts that the 85% threshold is intended to “accommodate existing business models and allow foreign broker-dealers to continue to do a limited amount of business in U.S. securities, whether as an accommodation to their clients or as part of program trading . . . without causing those foreign broker-dealers to lose the benefit of the exemption.” Yet, the threshold proposed by the Commission opens the door to conducting a business in U.S. securities well beyond such narrow “accommodations.” For a large foreign broker-dealer, up to 15% of transactions in U.S. securities with qualified investors could alone easily amount to a sizeable market, and certainly would in combination with other foreign broker-dealers.

The Commission further states that it understands that foreign broker-dealers currently only do a small percentage of their business in U.S. securities and that it “has not been given any indication that foreign broker-dealers would seek to use an expanded exemption to increase their business in U.S. securities.” Given that the proposed exemption would ease the ability of foreign broker-dealers to do business in U.S. securities at a lower cost with an expanded universe of asset-rich investors, FINRA suggests that past intentions are misaligned with the future incentives created by this proposed rule: capital and investment often follow the path created by regulatory arbitrage incentives. Consequently, FINRA believes the more appropriate question to ask is: what are the implications if those foreign broker-dealers do

choose to increase such business in U.S. securities, as the exemption would permit? Because the implications are potentially far reaching and could undermine confidence in the U.S. market, FINRA implores the Commission to limit any exemption to trading in foreign securities.⁶

Books and Records

As referenced above, the proposal would require a U.S. registered broker-dealer to maintain books and records relating to transactions effected by a foreign broker-dealer that relies on the “foreign business” exemption. The proposal would permit these records to be maintained with the foreign broker-dealer in the form, manner and for the periods prescribed by the foreign securities authority that regulates the foreign broker-dealer, provided that the U.S. broker-dealer makes a reasonable determination that copies of all books and records can be furnished promptly to the Commission, and promptly provides such books and records to the Commission upon request.

First, we believe it essential to FINRA’s regulatory mission to have the same access as the Commission to a foreign broker-dealer’s records to the extent that they relate to an examination or investigation of a FINRA member. For example, situations may arise in which FINRA is unable to determine the details of a transaction involving a FINRA member pursuant to the exemption without access to a foreign broker-dealer’s records. Accordingly, FINRA urges the Commission to revise the proposed rule to require U.S. registered broker-dealers to furnish promptly to an SRO upon request a foreign broker-dealer’s books and records that relate to the role of U.S. broker-dealers in transactions covered by the proposed exemption.

Second, FINRA is concerned that this proposed provision imposes no adequacy standard on the books and recordkeeping requirements to which the foreign broker-dealer is subject. As such, FINRA believes this aspect of the proposal could frustrate the ability of the Commission and SROs to monitor and enforce compliance with not only the exemption, but also more broadly the federal securities laws and SRO rules. A foreign securities authority may simply choose not to require maintenance of certain records critical to the oversight responsibilities of U.S. regulators, or to allow disposal of such records after unreasonably short periods of time. FINRA strongly suggests that the Commission amend the proposal to incorporate certain minimum time, manner and form requirements consistent with those prescribed by Rules 17a-3 and 17a-4 under the Exchange Act.

⁶ FINRA notes that such a result would be consistent with the views expressed by the Commission staff in its guidance regarding its Emergency Order Concerning Short Selling. In response to Question 6 as to how the Order applies to overseas transactions, the staff opined that the Order would apply even to short sale transactions in the specified publicly traded securities involving exempt or unregistered foreign broker-dealers where such entities use the means or instrumentalities of interstate commerce in the United States to effect such short sales. FINRA similarly believes that a foreign broker-dealer should be required to register with the Commission and become an SRO member subject to all of the U.S. securities laws once it trips federal jurisdiction by soliciting U.S. securities to customers in the United States.

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Thank you for the opportunity to express our views on these important issues. Please contact me at (202) 728-8410 or Philip Shaikun at (202) 728-8451 if you have any questions.

Very truly yours,

A handwritten signature in black ink, appearing to read "Marc Menchel". The signature is fluid and cursive, with the first name "Marc" and last name "Menchel" clearly distinguishable.

Marc Menchel