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# U.S. SEC Settlement With Portuguese Bank Highlights Reach Of U.S. Securities Laws To Broker-Dealers And Advisers Outside The United States

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On October 24, 2011, the U.S. Securities and Exchange Commission ("SEC") announced it had charged Banco Espírito Santo S.A. ("BES"), a commercial bank headquartered in Portugal, with violating provisions of the U.S. federal securities laws that govern the activities of intermediaries acting as broker-dealers, the activities of investment advisers, and the offering of securities. The action was settled concurrently with the announcement.

We set forth below the key elements of the claims against BES and the context in which the claims arose. This enforcement action serves as a useful reminder of the applicability of U.S. regulatory requirements to securities intermediaries and advisers based outside the United States in respect of activities that target clients in the United States and the potential consequences of failing to comply with such requirements.

## Claims against BES

According to the SEC's order, BES maintained relationships with approximately 3,800 U.S. residents who held products deemed securities under U.S. law in their brokerage accounts ("U.S. Customers") and advisory accounts ("U.S. Clients") with BES. According to the order, BES provided brokerage services to U.S. Customers and provided investment advice to U.S. Clients. Among other activities, BES:

- used its Portugal-based department of marketing, communications and consumer research to mail marketing materials to BES customers, including U.S. Customers;
- offered financial products — including securities — to U.S. Customers over the telephone, through a customer service call center located in Portugal operated by a third party (which had employees dedicated to servicing U.S. Customers);
- offered brokerage services to U.S. Customers through its money transmitter business, which also served as a point of contact for U.S. Customers' banking and investment activities; and
- serviced, through its U.S.-dedicated International Private Banking relationship managers, U.S. Clients by way of visits in person (twice a year) and communications via telephone, facsimile and e-mail. As part of these visits and communications, BES discussed U.S. Clients' accounts and financial products, including securities; helped to effect transactions in financial products; and encouraged U.S. Clients to buy, sell or hold certain financial products.

During this time:

- BES was not registered with the SEC as a broker-dealer or as an investment adviser;
- BES employees dedicated to servicing U.S. Customers in the customer service call center were not registered as representatives of a broker-dealer or associated with an SEC-registered broker-dealer; and
- the persons who worked in the BES money transmitter business and the U.S.-dedicated International Private Banking relationship managers were not registered as representatives of a broker-dealer or an investment adviser, were not associated with an SEC-registered broker-dealer or an SEC-registered investment adviser, and did not hold any U.S. securities licenses.

As a result, the SEC found that BES had violated Section 15(a) of the U.S. Securities Exchange Act of 1934 (the "Exchange Act"), which governs the activities of broker-dealers, and Section 203(a) of the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), which governs the activities of investment advisers.

In addition, according to the SEC's order, BES offered and sold in the United States a variety of securities to U.S. Customers and U.S. Clients without registration and without an applicable exemption from registration. As a result, the SEC found that BES had violated Sections 5(a) and 5(c) of the U.S. Securities Act of 1933 (the "Securities Act").

## Applicable Requirements

### Broker-Dealer Activities in the United States

Section 15(a) of the Exchange Act requires, with certain exceptions, any "broker" or "dealer" using the mails or any means or instrumentality of U.S. interstate commerce to induce or effect transactions in securities to register as a broker-dealer with the SEC.

The definition of "broker" under the Exchange Act focuses on three elements. A broker must: be "engaged in the business" of "effecting transactions in securities" "for the account of others." These concepts are broadly drawn to encompass a wide range of activities, and the courts and the SEC have taken an expansive view of their scope.

To determine whether a person or an entity is a broker, the SEC looks at the activities that the person or business actually performs, rather than the name under which it performs such activities (*e.g.*, a person who refers to himself as a "finder" may well be required to register as a broker). To determine whether someone is acting as a broker, the SEC will consider, among other things, the following factors:

- Does the person or entity participate in important parts of a securities transaction, including solicitation, negotiation or execution of the transaction?

Participation may include assisting an issuer to identify potential purchasers of securities, screening potential participants in a transaction for creditworthiness, soliciting securities transactions, negotiating between the issuer and the investor, giving advice, taking, routing or matching orders, or facilitating the execution of a securities transaction, among other things. While some of these activities are not themselves sufficient to trigger registration, they may indicate broker activity in conjunction with other facts, in particular transaction-based compensation.

- Does compensation for participation of the person or entity in the transaction depend upon, or is it related to, the size, value or completion of the transaction? Does the person or entity receive trailing commissions? Does it receive any other transaction-related compensation?

The SEC has identified the receipt of transaction-related compensation as a critical factor in its decisions to deny no-action relief and in enforcement actions relating to broker-dealer activities. Compensation becomes a particularly important factor in determining whether so-called "finders" or "M&A advisers," who typically bring buyers and sellers together, are required to register.

- Is the person or entity otherwise engaged in the business of effecting or facilitating securities transactions?

Regularity of business is not the only factor to determine whether a person or entity is engaged in the business. Soliciting securities transactions and receiving transaction-related compensation have also been identified by the SEC and courts as relevant factors.

- Does the person or entity handle the securities or funds of others in connection with securities transactions?

#### Associated Persons

Persons who work for a registered broker-dealer ("associated persons" or "registered representatives") do not have to register separately with the SEC, but they must be supervised by an SEC-registered broker-dealer. With certain exceptions, associated persons need to register with the Financial Industry Regulatory Authority ("FINRA").

#### Territorial Approach

The SEC takes a territorial approach in applying U.S. broker-dealer registration requirements to the international operations of broker-dealers. Under this approach, any broker-dealer operating within the United States that solicits securities transactions is required to register with the SEC, even if the activities are directed only outside the United States.

Rule 15a-6 of the Exchange Act provides exemptions from registration for non-U.S. broker-dealers not registered with the SEC ("Unregistered Non-U.S. Broker-Dealers") undertaking activities in the United States in certain limited circumstances. Rule 15a-6 permits Unregistered Non-U.S. Broker-Dealers to undertake the following activities:

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- Effecting trades by any type of U.S. customer that are unsolicited by the Unregistered Non-U.S. Broker-Dealer, which is based on the theory that registration can be triggered only if the broker-dealer "solicits" securities transactions. "Solicitation" is broadly interpreted so as to include any form of communication (written or oral) regarding the purchase or sale of securities. As a result, this exemption may have little value for Unregistered Non-U.S. Broker-Dealers seeking to conduct any ongoing business in the United States. Also, the widespread use of websites makes it very difficult to rely on this exemption. In short, there can be no affirmative effort to induce any transaction.

- Providing research reports to "major U.S. institutional investors," following which the Unregistered Non-U.S. Broker-Dealer can effect transactions in reliance on other elements of the Rule.

- Soliciting transactions in securities with a "U.S. institutional investor" or a "major U.S. institutional investor" that are effected through a U.S. registered broker-dealer and subject to certain conditions. This exemption is available where the Unregistered Non-U.S. Broker-Dealer seeks to deal with U.S. investors from its overseas trading desk or where U.S. institutions seek direct contact with overseas traders. Generally, in these situations, the U.S. registered broker-dealer intermediating trades must handle most aspects of the transaction (other than negotiating the terms of the trade), which would include issuing confirmations and account statements, being responsible for extending credit, maintaining books and records, receiving, delivering and safeguarding funds and securities and handling key sales activities through "chaperoning" the contacts of persons associated with the Unregistered Non-U.S. Broker-Dealer with certain institutional investors.

- Soliciting or effecting transactions for certain categories of investors, including U.S. registered broker-dealers.

## Providing Investment Advice to U.S. Persons

Under Section 203(a) of the Advisers Act, except as provided in the Advisers Act, it is unlawful for any investment adviser to make use of the mails or any means or instrumentality of U.S. interstate commerce in connection with its business as an investment adviser, unless it registers with the SEC.

The Advisers Act generally defines an "investment adviser" as any person or firm that, for compensation, is engaged in the business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. Similarly to the definition of a broker, each of the elements of the definition of investment adviser has been broadly interpreted by the SEC.

With respect to "for compensation," receiving any economic benefit is sufficient; also, a fee does not need to be identified as an advisory fee or to be received directly from a client.

In addition, a person or entity may be "engaged in the business" if it holds itself out as giving investment advice, receives separate or additional compensation for providing advice about securities, or typically provides advice about specific securities or specific category of securities.

With respect to "providing advice," a person or entity provides advice in respect of securities if the advice or reports relate to securities. According to the SEC, providing one or more of the following could be deemed "providing advice" for purposes of the Advisers Act:

- advice about market trends;

- advice in the form of statistical or historical data (with certain exceptions);

- advice about the selection of an investment adviser;

- advice in respect of advantages of investing in securities instead of other types of investments; and

- a list of securities from which a client can choose, even if the adviser does not make specific recommendations from the list.

### Associated Persons

An employee of an SEC-registered investment adviser does not need to register separately, provided the employee's investment advisory activities are within the scope of its employment.

### Territorial Approach

The Advisers Act does not contain territorial limits and may apply to investment advisers located outside the United States. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 203(b)(3) of the Advisers Act to provide a new exemption from SEC registration for "foreign private advisers" (the "Foreign Private Adviser Exemption"). Under the Foreign Private Adviser Exemption, an adviser is not required to register with the SEC if it:

- has no place of business in the United States;

- has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;

- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by such investment adviser of less than $25 million; and

- neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 or any business development company.

There are also other exemptions available to non-U.S. investment advisers that advise solely venture capital funds or that advise solely private funds and have aggregate assets under management in the United States of less than $150 million.

## Offering Securities in the United States

Section 5 of the Securities Act — the heart of the public offering regime in the United States — provides that all securities offered[1] or sold in the United States must be registered with the SEC, unless an exemption from registration applies.

Private placements to certain wealthy or sophisticated investors in the United States are exempt from registration if certain conditions are met (*e.g.*, there is no general solicitation or general advertising of the offering in the United States).[2] In addition, Regulation S allows companies to sell securities outside the United States (in certain cases, including to U.S. persons), provided certain conditions are met (*e.g.*, there are no directed selling efforts made in the United States and the transaction is "offshore").

State securities laws may also apply to the offering of securities that are not listed in the United States.

## Implications

The SEC's enforcement efforts have increased dramatically. The agency filed a record 735 enforcement actions in the 12 months ended September 30, 2011. Among other areas, the SEC has increased its number of enforcement actions relating to investment advisers (a 30 percent increase compared to 2010) and broker-dealers (a 60 percent increase compared to 2010) in 2011.

From an enforcement perspective, the reach of U.S. regulators does not stop at the water's edge. Although the cases involving non-U.S. persons ensnared by the extraterritorial application of the U.S. securities laws tend to involve bribery and insider trading,[3] there have been a few enforcement actions involving broker-dealer and investment adviser activities.

The BES enforcement action thus serves as a useful reminder that activities conducted purely offshore may nonetheless trigger U.S. enforcement action.

That having been said, there are well-defined ways in which non-U.S. financial intermediaries can undertake activities in the United States (often, but not exclusively, through U.S. affiliates). However, financial intermediaries outside the United States, whether or not they have U.S. affiliates that are registered with the SEC as broker-dealers or investment advisers, need to ensure that activities directed at U.S. resident clients or potential U.S. clients comply with applicable requirements.

### NOTES

[1] The term "offer" (defined in the Securities Act) is broadly interpreted by the SEC and includes any publicity that may "contribute to conditioning the public mind or arousing public interest" in an offering.

[2] An intermediary who sells securities offered in a transaction exempt from the registration requirements must still comply with the broker-dealer registration regime.

[3] Most recently, in December 2011, U.S. authorities brought criminal and civil charges against a group of former executives of Siemens AG and its Argentine subsidiary for violations of the Foreign Corrupt Practices Act of 1977 ("FCPA"). According to allegations, the executives paid bribes to various Argentine officials (*see WSLR, January 2012, page 3*). In addition, also in December 2011, the U.S. authorities charged Magyar Telekom Plc, the largest telecommunications provider in Hungary, and three of its former top executives with bribing government and political party officials in Macedonia and Montenegro to win business and shut out competition in the telecommunications industry. Magyar Telekom's parent company, Deutsche Telekom AG, was also charged with books and records and internal controls violations of the FCPA (*see WSLR, January 2012, page 5*).

*The SEC's order involving BES can be accessed on its website at http://www.sec.gov/litigation/admin/2011/33-9270.pdf.*

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