

MEMORANDUM

TO: File No. S7-07-18
FROM: Division of Trading and Markets
RE: Telephone Meeting with Florida International Bankers Association
DATE: December 14, 2018

On December 12, 2018, Lourdes Gonzalez of the Division of Trading and Markets participated in a telephone meeting with representatives of the Florida International Bankers Association ("FIBA"). The FIBA representatives were David Schwartz and Sergio Alvarez-Mena (Jones Day).

The participants discussed, among other things, the issues raised in the attached article with respect to proposed Regulation Best Interest.



‘Excessive disclosure’: how an incoming SEC rule could overwhelm US offshore

10 Dec, 2018



*A new regulation proposal could have a profound effect on brokers in the offshore industry, but almost no one is talking about it, says **Sergio Alvarez-Mena** (pictured below).*

Many of you might be well aware of the Securities and Exchange Commission’s Regulation Best Interest proposal that was released earlier this year, which requires financial advisors and broker-dealers to operate in the best interest of their customers.

While it has received wide industry support in the US, little, if any, attention has been paid to how disruptive this regulation could prove for the cross-border private wealth business.

The regulation, which may be implemented by September 2019, would require wealth managers to disclose and eliminate or mitigate potential conflicts of interest – arguably a good thing, but it is how it goes about it that has raised concerns within certain corners of the offshore wealth industry.

As a legal specialist with over 25 years’ experience in cross-border regulation, one of the key things that struck me about the regulation was how difficult it might be to apply it to cross-border investments.

Considerations such as offshore clients’ geographic diversity, dollarization of their assets, heightened need for privacy and security, use of complex structures for tax and succession planning, and other highly personalized customer interests are not easily adaptable to a sanguine economic analysis.

It would also disproportionately affect products traditionally used by international customers such as structured products and offshore mutual funds. Brokers specializing in cross-border who, as statistics indicate, change employment more frequently than their US domestic counterparts will also be impacted.

The regulation also fails to recognize the difficulty of completing those duties in foreign countries with customers with a local focus, who do not do business mainly in English, and who have often have complex products and needs.

In this column, I've put together a breakdown of how the regulation could impact offshore wealth managers and investors that I hope will prove useful to you.



Unique impact

When you get down to it, the regulation's impact lies in certain key differences between the cross-border private wealth industry and the US domestic industry, among them:

- Foreign investment into US accounts is often driven by many non-economic factors
- Many international clients invest through offshore holding vehicles such as PICs, trusts, foundations or other vehicles, adding complicated tax analysis to any 'best interest' standard
- Non-US investors operate according to local practices and conduct their business in languages other than English
- Brokers who cater to and visit cross-border clients in countries may be restricted in what kind of financial documents they can provide and what information they can access while traveling
- Non-US investors often gravitate to more complex products and structures than US investors
- And cross-border brokers are more mobile than their domestic counterparts and more likely to work under benchmark-laden employment contracts

Another key consideration is that international investors' decision-making often strays from primarily economic factors. Many non-US investors are keenly concerned about home country security and the reach of international information exchange treaties.

The regulation's high demands has led many to comment that it could result in excessive disclosure that may overwhelm cross-border investors

Misunderstood duties

According to the regulation, the client's tax status must be taken into consideration before any investments are recommended. Once again, another worthwhile criteria.

However, many cross-border clients hold their investments in offshore private investment companies, offshore trusts or similar structures.

Given the complex tax structure of these holdings, the level of knowledge broker-dealers will require of their client's individual tax status before they can even make a recommendation will prove both daunting and unwieldy for many.

The broker-dealer may be obligated to extensively ferret out the foreign country tax status of their customers, requiring even more time and costs dedicated to client due diligence.

Moreover, under the regulation the definition of 'retail customer' includes corporate forms and structures. This potentially mandates a new and intrusive level of tax awareness and inquiry into institutional offshore providers which is beyond the traditional ability of a US broker-dealer.

Communication breakdown

Its additional mandated disclosures may create confusion for many who are naturally grounded in the different capital market systems of their home countries. Moreover, the 'plain English' requirement may be difficult to satisfy when disclosing to non-English-fluent clients.

Assuming the plain English standard is not a call for 'English-only' but rather a call for clarity and simplicity, the demands of providing accurate disclosures in a foreign language will become an area for even greater regulatory concern.

By definition, cross-border clients reside outside of the US and bring to the brokerage relationship a different frame of reference as to what they expect from financial services. The regulation's high demands has led many to comment that it could result in excessive disclosure that may overwhelm cross-border investors.

Local conflicts

The obligation to provide required disclosures accompanying the recommendation in real time presents foreign country regulatory conflicts unique to the cross-border business.

Cross-border representatives often travel outside of the US to meet with clients and are seldom permitted, by either local law or prudence, to access their firm's systems from abroad or to produce written materials while they are in a foreign country.

However, under the regulation they will have to ensure that any recommendation of an investment or strategy they make be compliant while they are still in said foreign country.

This means firms may lose their ability to contractually craft client terms that are compliant with local law before prospective clients are inundated with legal documents – and before firms secure customer consent. This creates an awkward exchange before a client relationship even begins and the subsequent increase in pre-account costs may well drive broker-dealers out of certain markets and limit the amount of products international investors can access.

Let's not forget that technology transfer laws, including data protection laws and cyber security considerations, often limit the information traveling brokers can access from their firm's systems while in a foreign country, and traveling with sensitive client data is often restricted on a prudential basis.

Firms that have not considered the application of Regulation Best Interest to their cross-border policies should begin immediately

Cost Concerns

Cross-border clients are traditionally well-versed in foreign exchange markets and in carrying out their business beyond their home borders. Accordingly, many on the higher end of the wealth spectrum are comfortable with structured products that have added complexity.

On the lower end, rather than pick individual equities, many invest in mutual funds or ETFs to provide them with a range of expertise and diversification not found in their local markets. Both investments may now require even more extensive and complicated disclosures, which will create disproportionate costs for international clients.

In addition, US licensed brokers may find themselves required to disclose even more information to international customers on topics such as the complexities of deferred compensation, trailers, cross-marketing fees and other common compensation conventions regularly found in these products.

Add to this that unregistered offshore products may now need to meet stringent disclosures under the regulation, which may well create a flurry of activity in the offshore fund world, as brokers look to offload their unregistered products.

Broker Compensation

Finally, we get to another significant difference between cross-border international brokers and US domestic brokers: the former switch firms and move their books more frequently than their domestic counterparts. Under the regulation, financial packages designed to help their transition, to the extent they create financial incentives, may need to be reworked, if not mitigated or eliminated, to include 'neutral factors' as a base for compensation.

Ominously, the US regulator continues to maintain certain conflicts may be difficult to mitigate and 'may be more appropriately avoided'; included among those are 'bonuses that are based on accumulation of assets under management.'

What should you do?

The resiliency of the cross-border broker-dealer business has been proven time and again. The global allure of participating in the US capital markets is simply too strong to create disinterest.

Yet, this regulation will present new, significant and unique challenges to those firms and actors active in this industry segment.

Firms that have not considered the application of Regulation Best Interest to their cross-border policies should begin immediately. You should also start examining the cyber security practices within your own regional context straight away.

And, as always, careful documentation of client particulars should be a priority in applying the standard.

Sergio Alvarez-Mena is a partner at Jones Day in Miami and regularly advises financial institutions in cross-border private wealth matters. His colleague Michael Butowsky, who has over three decades' legal experience advising financial services industry clients, also contributed to this feature.

This article was originally published in the November edition of Citywire Americas.