

## CHAPTER TWO

# Regulation of Broker-Dealers and Agents

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*(18 questions on the exam)*

### 2.1. BROKER-DEALERS

So far, everything discussed in this study guide has pertained to investment advisers and their representatives. These are people and firms who, for a fee, provide investment advice. It's very important to note though, that they receive their fee for providing advice, regardless of whether or not the advice actually leads to the purchase or sale of securities (investments). In other words, sometimes they get paid for simply telling people to stay put and not move their money from one investment to another.

By contrast, broker-dealers and their agents get paid when their customers complete a transaction (either buy or sell securities). If no buying or selling takes place in an account, no fees or commissions are generated. Any investment advice a broker-dealer or its agent gives is considered incidental to the transaction itself, unless a separate agreement is in place to provide investment advice.

While that may seem like a pretty cloudy line between being an investment adviser and a broker-dealer, it's one that regulators take very seriously. To operate in either capacity, a firm or an individual must be properly registered. Interestingly enough, regulators have no problem with the same person or firm acting in both capacities, even for the same client, as long as it is done in an ethical manner. But again, the professional or firm must be properly registered in each capacity. Always keep in mind that those giving investment advice for a fee must be registered as investment advisers or investment adviser representatives, while those effecting transactions must be registered as broker-dealers (or, as we will see later, as agents).

#### 2.1.1. BROKER-DEALER—DEFINITION

While the term investment adviser from Chapter One is fairly self-explanatory, the term **broker-dealer** is often much more confusing for test takers. Take a look at the definition from the Uniform Securities Act and see if the picture comes any more into focus.

“Broker-dealer” means any person engaged in the business of effecting transactions in securities for the account of others or for [the person’s] own account.

Before we go any further, let’s stop and address the definition of ‘person’ as it applies to broker-dealers. The USA defines a person as “an individual, a corporation, a partnership, an association, a joint-stock company, a trust where the interests of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government.” As is the case with investment advisers, it is important to understand what is meant by the word “person.” In reality, broker-dealers are rarely persons in the living, breathing sense of the word. Instead, they are almost always the firm or business that employs actual living, breathing people to effect securities transactions. Those people, as we will soon learn, are called agents.

So what about the rest of the definition of broker-dealer? One thing that you might notice about it is that it does not specify exactly what a broker-dealer is.

The easiest way to understand the term broker-dealer is to start with the heart of the definition above. Brokers and dealers help people *effect transactions in securities* (buy or sell stocks, bonds, etc.). That means they are involved in the mechanics of money and securities changing hands on behalf of their customers.

While the words broker and dealer are often combined, each actually represents a different entity. The difference between operating as a broker or a dealer comes in the second part of that definition, where it says they do it “for the account of others or for [their] own account.” In short, **brokers** act as the go-between for two parties interested in making a transaction, whereas **dealers** are either buying securities from a customer to add to their inventory of securities or selling securities to a customer from that same inventory of securities.

An easy way to visualize the difference between a broker and a dealer is by thinking about the sale of real estate. A real estate broker helps a buyer find a seller, or a seller find a buyer. It is a financial matchmaker, if you will. Someone who decides to skip the middleman and list his home “For Sale by Owner” essentially handles the deal himself. The seller’s home is his inventory that he’s selling directly to the public.

In the most basic sense, a broker makes money by charging a commission on the transactions they help effect; a dealer makes money by charging a client a markup on securities sold out of its own account or by purchasing securities for its account at a markdown.


In addition to effecting trades between investors, broker-dealers also help to bring securities to the market for the first time, for instance in an IPO (initial public offering). In these instances, broker-dealers act as investment bankers and underwriters for an offering. They assist a private company in selling its securities to the public in order to raise capital. When acting in this capacity, a broker-dealer also profits from the sale of shares by receiving an agreed-upon percentage of each sale.

When investors trade securities with other investors, they do so on the secondary market, while when issuers sell securities to the public for the first time, they do so on the primary market. Broker-dealers assist their customers in both the primary and secondary markets. In each case, a broker-dealer receives money for assisting someone to buy and/


or sell securities. But does that mean that any entity that helps two people complete a transaction, or buys and sells for its own account, is a broker-dealer? As always, there's a list of exceptions that will very likely be tested on the Series 63.

Exceptions to the definition of a broker-dealer at the state level:


(1) an agent

 **Explanation:** In the same way that an employee of an investment adviser is called an investment adviser representative, the proper term for a registered employee of a broker-dealer is agent. Since there is a separate type of registration for agents of broker-dealers, they don't have to register as broker-dealers.

(2) an issuer

 **Explanation:** Issuers (creators) of securities, as well as the securities they issue, are subject to registration requirements that are different from those for broker-dealers when they conduct these activities.

(3) a bank, savings institution, or trust company

 **Explanation:** Under the Uniform Securities Act of 1956, banks, savings institutions, and trust companies are exempt from broker-dealer registration requirements.



## EXERCISE

### CHOOSE BROKER-DEALER OR NOT A BROKER-DEALER

1. \_\_\_\_ James is an employee of Securities-R-U's, a broker-dealer firm. He helps clients effect transactions.
2. \_\_\_\_ The city of Raleigh, North Carolina, issues municipal securities, which it sells to the general public.
3. \_\_\_\_ ABC is a firm that specializes in selling securities from its own account to retail clients.
4. \_\_\_\_ ABC Mutual Funds is a firm that specializes in sponsoring mutual funds and selling the fund shares to investors.

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**Answers:** 1. Not a broker-dealer; 2. Not a broker-dealer; 3. Broker-dealer; 4. Broker-dealer

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## 2.1.2. REGISTRATION OF BROKER-DEALERS

The persons and entities listed above that do not meet the definition of a broker-dealer do not have to register as broker-dealers. In addition, broker-dealers (persons or firms) that do not have a physical office in a state do not have to register in the state if their only clients are:


(i) the issuers of the securities involved in the transactions

 **Explanation:** In other words, if the only transactions someone does in the state are with the company that created the securities being bought or sold, registration is not required. So, if ABC Brokerage has no office in New York and the only activity it performs in the state involves purchasing securities issued by a New York-based company directly from that company, ABC does not need to register in New York..

(ii) other broker-dealers

 **Explanation:** Similar to not being required to register when dealing with a security's issuer, a firm that deals only with another broker-dealer is not required to register in that broker-dealer's state. In essence, the law does not require a person or firm to jump through the hoops of registration if it is dealing only with individuals or firms who are industry professionals and don't need the same level of regulatory protection as retail clients.

(iii) [institutional investors]

 **Explanation:** As when dealing with the actual issuers of securities and other broker-dealers, individuals and firms dealing only with *institutional* investors don't need to register in the institutional investors' state or states. These institutional investors, who handle very large amounts of money, are viewed as having enough sophistication to watch their own backs without as much help from regulators.

Since it'll come up again and again, you should memorize the fact that an institutional investor is someone or something that fits into one of the following categories:

- A bank or savings and loan association
- An insurance company
- An investment company (mutual fund)
- A broker-dealer
- An investment adviser registered either with the SEC or with a state securities commission
- Any other person with total assets of at least \$50 million
- A governmental entity or subdivision thereof
- An employee benefit plan or qualified plan that meets Section 403(b) or 457 requirements of the Internal Revenue Code, or under the Exchange Act, and has at least 100 participants (excluding the participants of such plans)
- A pension or profit-sharing trust
- A member firm or the registered person of a member firm
- A person acting solely on behalf of an institutional investor



**Test Note:** A person or firm acting as a broker-dealer with an office in a state must register in that state. A person or firm without an office in a state does not have to register in a state if it has only institutional clients in the state. A person or firm without an office in a state must register in the state if it has even one noninstitutional client

A person is also not considered to meet the definition of a broker-dealer in a given state if:

the person is licensed under the securities act of a state in which the person maintains a place of business and the person offers and sells in that state to a person who is an existing customer of the person and whose residence is not in that state.



**Explanation:** In other words, a broker-dealer that has an office only in State A and sells in State A to an existing client who resides in State B is not required to register in State B.



**Test Note:** Subsidiaries of bank holding companies that effect securities transactions with the public must register as broker-dealers. Commercial banks are exempt.

To summarize, if a broker-dealer has an office in State A, it must register in State A. If it has an office in State A and sells securities in State B, it must register in State B unless it meets one of the above conditions. If it only has an office in State A and sells securities from that office to an existing client from State B, it does not have to register in State B.

### 2.1.2.1. Exceptions for Canadian Broker-Dealers

While a broker-dealer from Canada may not come and set up shop in any state without jumping through the required regulatory and registration hoops, there are some exceptions that permit them to operate within a state using a limited registration.

These exceptions are built around the basic premise that the Canadian firm *does not* have offices in that state, in which case it can transact securities with a client located in that state if any of the following conditions apply:

- The client is from Canada, is temporarily in that state, and had a relationship with the Canadian broker-dealer prior to entering the state.
- The client is engaging in transactions for a self-directed, tax-advantaged retirement plan held in Canada, for which she is the holder or contributor.
- The client is an institutional investor.

Agents working for a broker-dealer whose only clients in a state meet any of the above characteristics may also use a limited registration.

To obtain this limited registration, the agent's broker-dealer would have to:

- File an application in the form required by the jurisdiction in which it has its principal office
- File a consent to service of process
- Provide evidence of good standing in the jurisdiction where the broker-dealer is registered
- File proof of membership in a Canadian self-regulatory organization (SRO) or Canadian stock exchange
- Make records of all business done in that state available to the state administrator
- Inform the administrator of any criminal action taken against the broker-dealer
- Disclose to clients in the state that the Canadian broker-dealer is not subject to the state's full regulatory requirements
- Pay a filing fee

#### 2.1.2.2. **Exceptions for Certain Foreign Broker-Dealers**

The Securities Exchange Act of 1934 also provides conditional exemptions from registration for foreign broker-dealers that engage in certain specified activities involving U.S. investors. A foreign broker-dealer is defined by the SEC as any non-U.S. resident 'person' that is not an office or branch of or a natural person associated with a registered broker-dealer and whose securities activities would otherwise qualify the 'person' as a broker or a dealer. Basically, if they are outside the U.S., not affiliated with registered broker-dealers, and engaged in the business of effecting securities transactions, foreign broker-dealers may be eligible for this exemption.

However, these foreign broker-dealers are only allowed to participate in a handful of specific activities while avoiding registration requirements. These activities include:

- Effecting unsolicited securities transactions, meaning transactions that are initiated by the customer
- Providing research reports to American institutional investors
- Soliciting and effecting transactions with or for most American institutional investors through a registered broker-dealer
- Soliciting and effecting transactions directly with or for registered broker-dealers, banks serving as broker-dealers, certain international organizations, foreign persons temporarily present in the U.S., American citizens resident outside the U.S., and agencies or branches of U.S. persons permanently located outside of the U.S.

**ENTITIES THAT DO NOT NEED TO REGISTER WITH THE STATE AS BROKER-DEALERS**

<b>Is Not a Broker-Dealer</b>	<b>Broker-Dealer Exempt from State Registration</b>
Agent	BD without office in state whose only clients are: <ul style="list-style-type: none"> <li>• Issuers of securities</li> <li>• Other broker-dealers</li> <li>• Institutional investors</li> </ul>
Issuer of securities	BD with office in state who sells to existing client from a different state while at that office
Bank, savings institution, or trust company	Canadian broker-dealer that: <ul style="list-style-type: none"> <li>• Sells to existing client temporarily in a state,</li> <li>• Has a client in the state engaged in Canadian self-directed tax-advantaged retirement plan, or</li> <li>• Sells only to institutional investors</li> </ul> (in each case, however, broker-dealer needs to obtain a limited registration)
	Foreign broker-dealer involved in limited activities

**EXERCISE****ANSWER YES OR NO**

1. \_\_\_\_ A BD has an office in State A and three non-institutional clients in State B. Does the firm need to be registered in State B?
2. \_\_\_\_ A BD has an office in State C, but its only client is a corporation located in state D. The corporation issued the securities being bought and sold. Does the firm need to be registered in State D?
3. \_\_\_\_ A BD has an office in State E and has three clients in State F. Those clients are a mutual fund, a savings institution, and a retail investor. Does the firm need to be registered in State F?
4. \_\_\_\_ On January 15, North Star Investment, a Canadian broker-dealer, reaches an agreement to effect trades for Jim Maple, who is vacationing in Florida at the time. Two days later, a North Star agent makes a transaction for Jim, who is still in Florida. Does North Star need to be registered in Florida?
5. \_\_\_\_ Lira Financial, an Italian-based brokerage firm with no office in the United States, regularly trades securities with International Intentions, a broker-dealer located in North Carolina. Does Lira need to be registered in North Carolina?



### ANSWERS

1. **Yes.** For broker-dealers, having even one non-institutional client in a state requires registration in that state.
2. **No.** If the only client that a broker-dealer has in a state is an issuer of the securities involved in a transaction, the broker-dealer does not need to register in that state (as long as it does not have an office in the state).
3. **Yes.** The firm would not need to register if the only clients it had in State F were the mutual fund and savings institution; however, having even one retail (i.e., non-institutional) investor means it must register in that state.
4. **Yes.** For a Canadian broker-dealer to be exempt from regular state registration, it must have a pre-existing relationship with a vacationing client for whom it effects a transaction.
5. **No.** Since International Intentions is a broker-dealer, the foreign-based Lira Financial does not have to register in North Carolina.

### 2.1.2.3. The Registration Process

Broker-dealers must almost always register at the federal level, in addition to meeting state registration requirements. Registration is permitted *only* at the state level if all transactions and all aspects of the transactions are conducted or expected to be conducted within state boundaries. Additionally, broker-dealers that only transact in certain exempt securities are exempt from federal registration. All other broker-dealers, meaning the vast majority of firms, must register at both the federal and the state level.

To register federally, a broker-dealer must complete a two-step process. First, the BD must register with the SEC using the Central Depository Registration system to file a **Form BD**. This form requires important background information about the broker-dealer, including key personnel, contact information, and disclosures of any previous regulatory violations. The second step is to register with FINRA, which is done by filing Form NMA (New Member Application form). Additionally, the broker-dealer must join the Securities Investor Protection Corporation (SIPC). The SEC must then review the application and approve it within *45 days* or initiate proceedings to determine whether or not the registration should be denied.

A broker-dealer's application for registration at the state level becomes effective at noon on the *30th day* after it is initially filed, unless the state requires additional information or denies the application. If a state's administrator wishes to initiate a hearing based on an applicant's admission of a final judicial or administrative order made against the firm prior to its registration, it has 90 days to do so following registration. If the administrator fails to initiate a hearing during that time period, it may no longer use that information to challenge the broker-dealer's registration.

A broker-dealer's registration remains in effect *until midnight of December 31* of the year for which the registration is filed. If a renewal was not filed, the registration is considered revoked. This means that a broker-dealer who initially registers on November 15 must renew its registration less than two months later.



When a broker-dealer files an application for a successor firm for the unexpired portion of the year (from the time of filing to December 31), the firm does not need to pay a filing fee.



**Test Note:** As is true of an investment adviser, a broker-dealer must file a consent to service of process as part of its state registration process. Once the consent to service of process has been filed, it does not need to be renewed.

### 2.1.2.4. Net Capital Requirements

As with investment advisers, broker-dealers are required by states to meet net capital requirements both prior to registration and at all times while their registration remains active. Unlike the simpler investment adviser's requirements, however, the broker-dealer capital requirements use complex formulas that go beyond the scope of the Series 63 exam. It's sufficient to know that broker-dealers are subject to substantial net capital requirements.

You will also need to know that the state cannot require broker-dealers to meet net capital requirements that exceed SEC net capital requirements.



**Test Note:** The administrator may require registered broker-dealers, agents, and investment advisers who have custody of or discretionary authority over client funds or securities to post bonds in amounts that the administrator prescribes. These amounts are subject to the limitations and conditions of the Securities Exchange Act of 1934 for broker-dealers and the Investment Advisers Act of 1940 for investment advisers. Any appropriate deposit of cash or securities shall be accepted in lieu of any bond so required. No bond may be required of any registrant whose net capital, or, in the case of an investment adviser whose minimum financial requirements exceed the amounts required by the administrator.

### 2.1.2.5. Post-Registration Requirements

In addition to the ongoing requirement to file the appropriate renewal forms on an annual basis, broker-dealers must meet ongoing requirements known as **post-registration requirements**. These requirements include:

- **Financial reports.** Broker-dealers are required to file regular reports regarding their firm's financial condition. If the information filed on these forms or on a firm's Form BD becomes inaccurate at any point, updated reports must be filed as soon as possible.
- **Recordkeeping.** Broker-dealers must keep most forms of client records and marketing literature on file for three years, the first two years in an easily accessible place, even if the broker-dealer goes out of business. Some records must be kept for six years.
- **Audits.** All broker-dealers are subject to audits by the states in which they are licensed as well as by federal regulators *at any time*. As part of the audit, the state administrator may examine any records it deems useful. Additionally, some states may require the broker-dealer to pay a reasonable fee to conduct the audit.

- **Bond or insurance required for broker-dealers with custody or authority.** States may require the broker-dealer to post a bond or provide an appropriate deposit of cash or securities.
- **Form CRS.** Like investment advisers, broker-dealers are required to deliver this form, which summarizes the relationship between the firm and a client, when they on-board a new client.



**Test Note:** The National Securities Markets Improvement Act (NSMIA) prohibits a state from making any capital, bonding, custody, reporting or record keeping requirements that are different from or greater than the SEC requirements. This law requires the state requirements on these topics to be consistent with the SEC requirements.

### 2.1.3. **BROKER-DEALER SUPERVISION OF AGENTS**

The supervision of agents is one of the key responsibilities of a broker-dealer. The Securities Exchange Act of 1934 notes that the SEC can take punitive action against any broker-dealer that has willfully violated, enabled the violation, or failed to supervise a violator of applicable securities law and regulations who is employed by the firm. This means that if a broker-dealer does not adequately supervise one of its employees, the Feds can get involved. The Act goes on to say, however, that no supervisor will have failed in his duties if a supervisory system and procedures have been established and dutifully applied to detect and prevent such violations.

An acceptable supervisory system must include a written description of the member firm's supervisory responsibilities and a set of written supervisory procedures that will govern the activities of its registered employees. The firm must make sure that it has supervisory controls in place. The broker-dealer also must conduct periodic inspections to help ensure proper compliance with those procedures.

FINRA has similar rules on the books, and it has outlined a procedural framework by which a supervisor's responsibilities will be known and procedures set in place for their execution. Each member firm is required to establish in writing a clear delineation of supervisory responsibilities and a set of written supervisory procedures (WSPs) to govern the activities of its registered employees. Compliance with these procedures is accomplished through supervisory controls, periodic inspections, and reviews. Each firm must also maintain an **Office of Supervisory Jurisdiction (OSJ)**, which is an office where supervisory activities take place. These activities include:

- Final approval of new customer accounts
- Review and endorsement of customer orders
- Final approval of retail communications used by agents
- Supervision of activities of persons at one or more of the member firm's branch offices (a **branch office** is any location where one or more associated employees is involved in soliciting or effecting the purchase or sale of any security)

Additionally, each branch office is required to designate one representative or principal to have supervisory authority and responsibility for the activities of that office and

any non-branch offices in its jurisdiction. Each associate of the firm must participate in an annual compliance meeting, whose purpose is to assure that all employees remain current on changes in compliance requirements. Written procedures should describe how this mandatory meeting will take shape and who must attend. The firm must also establish, in writing, procedures for the review and approval of all agent-initiated transactions.

Failure to meet any of these requirements may result in administrative action as described in the USA.



## EXERCISE

### ANSWER YES OR NO—HAS PROPER SUPERVISION TAKEN PLACE?

1. \_\_\_\_ **An agent of a broker-dealer commits securities fraud; however, the broker-dealer has an appropriate supervisory system in place.**
2. \_\_\_\_ **An agent of a broker-dealer has a spotless record on all transactions she has effected, but she has not attended a compliance meeting in the past 18 months.**
3. \_\_\_\_ **A firm has a set of procedures, each of which follows FINRA and SEC guidelines, yet those procedures have not been put in writing.**

### ANSWERS

1. **Yes.** As long as an appropriate supervisory system and procedures have been put in place, the actions of this agent do not make the firm liable to penalty for a failure to supervise. Note, however, the agent is still subject to administrative penalties.
2. **No.** Agents of broker-dealers are required to attend an annual compliance meeting. So, despite her otherwise spotless conduct, this agent's failure to attend an annual meeting represents a failure on behalf of her firm to comply with FINRA regulations.
3. **No.** Supervisory procedures must be in writing to comply with FINRA requirements.

## 2.1.4. TERMINATION OF A BROKER-DEALER'S REGISTRATION

Recall that registration as a broker-dealer is by no means permanent. At bare minimum, state and federal approval to operate can terminate on December 31 of any year simply because a broker-dealer forgets to submit its renewal paperwork. For a full list of reasons registration can be terminated, please see "Termination of an Investment Adviser Registration" on page 13. However, for broker-dealers, there is one exception: a broker-dealer may choose to terminate its registration at any time by filing a Form BDW. The withdrawal