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Broker-Dealer Compliance I

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FUTURES INDUSTRY ASSOCIATION
LAW & COMPLIANCE DIVISION 25TH ANNUAL WORKSHOP

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BROKER-DEALER COMPLIANCE I

I. Introduction

The purpose of this panel and the accompanying outline is to focus on various areas of advanced broker-dealer compliance, including the following:

1. supervisory responsibilities;
2. new books and records rules;
3. key supervisory issues for remote branches;
4. marketing;
5. mandatory disclosure of order execution and routing practices;
6. prime brokerage issues and compliance;
7. asset-based brokerage and unbundled brokerage fees.

There are several other areas of advanced broker-dealer compliance which will be the focus of the Broker-Dealer Regulation Panel Part II, the Anti-Money Laundering Panel and the Security Futures Panel and they are not covered in this outline.

II. Supervisory Responsibilities

A. In General

The supervisory responsibility of broker-dealers and persons who may be supervisors is spelled out in the Securities Exchange Act of 1934 ("'34 Act")[2] in Sections 15(b)(4)(E) and 15(b)(6), New York Stock Exchange ("NYSE") Rule 342 and National Association of Securities Dealers Regulation, Inc. ("NASDR") Conduct Rule 3010.

The '34 Act indirectly mandates a supervisory requirement. Under the '34 Act, a broker-dealer and its supervisory personnel are at absolute liability for a violation by a subordinate that they supervise unless the broker-dealer has adequate written supervisory procedures that have

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[2] 15 U.S.C. §78a *et seq.*

been reasonably implemented. Section 15(b)(4)(E) of the '34 Act provides for liability of a broker-dealer or an associated person who has violated the securities or commodities laws or who "has failed reasonably to supervise, with a view to preventing violations of the provision of such statutes, rules and regulations, another person who commits such a violation if such person is subject to his supervision." Subsection (E) further provides that

> "no person shall be deemed to have failed reasonably to supervise any other person <u>if</u>:
>
> (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such person, and
>
> (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe that such procedures and systems were not being complied with." (emphasis added)

NASDR Rule 3010 is similar to Section 15 of the '34 Act in structuring its requirements around the concept of reasonable supervision. Rule 3010 requires that

> "Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association. Final responsibility for proper supervision shall rest with the member."

In particular, each member firm shall establish, maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of its registered representatives and associated persons in a manner reasonably designed to achieve compliance with the securities laws and regulations and with the applicable rules of the NASDR. Rule 3010 establishes a number of requirements including, but not limited to, the following:

1. Written supervisory procedures.

2. Designation of registered principals with authority to carry out the supervisory responsibilities.

3. Designation of an OSJ for each location that meets the requirements. Each OSJ must supervise branches and other sites where business is conducted.

4. Designation of one or more registered principals at each OSJ, including the main office, and one or more registered representatives or principals at each non-OSJ branch office, with authority to carry out supervisory responsibilities assigned to that office.

5. The assignment of each registered person to an appropriately registered representative or principal.

6. Qualified supervisory personnel.

7. Annual compliance review.

8. Annual review of supervisory procedures.

Rule 3010(b) requires that the written supervisory procedures set forth the titles, registration status and location of the supervisory personnel and the specific responsibilities of each supervisory person. A member must maintain internal records regarding all such persons and the date when their responsibilities become effective. Last, but not least, each member must maintain written supervisory procedures at each OSJ and each location where supervisory activities are conducted. In addition to the annual review of supervisory procedures required by Rule 3010(a), Rule 3010(b) requires further that these procedures be changed any time there is a material change in the business of the member. This in essence means that a broker-dealer should review its procedures whenever it offers new products or acquires new offices. Since such changes in business are frequent, most broker-dealers should review procedures more frequently than annually. At many firms, review of procedures is conducted on a quarterly basis.

Rule 3010(c) requires that each member conduct an internal inspection of all of its operations on an annual basis. This includes all offices, including branch offices. Rule 3010(d) sets forth certain on-going requirements which may be paraphrased as follows:

1. A registered principal must be responsible for the review and endorsement of all transactions and incoming and outgoing correspondence and electronic correspondence. Not all correspondence need be reviewed, but there must be a reasonable supervisory procedure.

2. Each member must develop written procedures for the review of incoming and outgoing electronic correspondence with the public relating to its securities business.

3. Each member must provide for the review and retention of correspondence.

See Sections III and V.D. below for a further discussion.

Rule 3010(e) requires the investigation of the background business qualifications and experience of each registered person. The SEC Books and Records Rule 17a-3(a)(12) also requires a full history of each person who is employed by a firm or associated with handling funds, securities or soliciting customers. Rule 3010(f) also provides as follows:

> Any applicant for registration who receives a request for a copy of his or her Form U-5 from a member pursuant to this Rule shall provide such copy to the member within two (2) business days of the request if the Form U-5 has been provided to such person by his or her former employer. If a former employer has failed to provide the Form U-5 to the

> applicant for registration, such person shall promptly request the Form U-5, and shall provide it to the requesting member within two (2) business days of receipt thereof. The applicant shall promptly provide any subsequent amendments to a Form U-5 he or she receives to the requesting member.

Rule 3010(g) defines Office of Supervisory Jurisdiction and Branch Office, which is discussed further below in Section II.B.

Establishment of written supervisory procedures is a complex and continuing task. Appropriate procedures cannot be taken from a book or downloaded from the internet. Boilerplate alone is not adequate. While "canned" procedures may provide a useful starting point, supervisory procedures have to be tailored to each broker-dealer and its business. NASD Notice to Members ("NTM") 99-45 and NTM 98-96 provide an excellent statement of what the NASDR expects in this regard. One needs to consider the customer base, product lines, and geographic locations of offices and personnel. Further, the broker-dealer's current systems, operating units and organizational structures need to be considered. Likewise, experience of personnel and their background is important in developing procedures. The applicable regulatory requirements are constantly changing and business is constantly changing, so it is a never-ending chase to keep written supervisory procedures current. Most important, supervisory procedures must be practical and tailored to the business. Supervisory procedures that are too complex are generally not followed. If they are not followed, there is almost automatic liability. Complex procedures that are not followed are, in many cases, worse than no procedures at all.

B. <u>OSJs and Branch Offices</u>

1. <u>NASDR Rule 3010</u>

NASDR Rule 3010(g)(1) defines an Office of Supervisory Jurisdiction as follows:

> "Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place:
>
> (A) order execution and/or market making;
>
> (B) structuring of public offerings or private placements;
>
> (C) maintaining custody of customers' funds and/or securities;
>
> (D) final acceptance (approval) of new accounts on behalf of the member;
>
> (E) review and endorsement of customer orders, pursuant to paragraph (d) above;
>
> (F) final approval of advertising or sales literature for use by persons associated with the member, pursuant to Rule 2210(b)(1); or
>
> (G) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

The NASDR is reviewing the definition of OSJ in light of the recent changes in the business, particularly with respect to trading firms. The NASDR has granted limited relief in this area for offsite proprietary trading locations where the trading system has real time monitoring capability at

an office of an OSJ or the electronic trading system at the OSJ has approval control or limits on executions. This relief has been granted only in connection with proprietary trading transactions. The NASDR has not permitted such relief in the case of any type of customer transactions where the office is held out to the public as an office of the firm.

Rule 3010(g)(2) defines the term Branch Office as "any location identified by any means to the public or customers at a location at which the member conducts an investment banking or securities business", excluding the following:

> (A) any location identified in a telephone director line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised;
> (B) any location referred to in a member advertisement, as this term is defined in Rule 2210, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised; or
> (C) any location identified by address in a member's sales literature, as this term is defined in Rule 2210, provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised.
> (D) any location where a person conducts business on behalf of the member occasionally and exclusively by appointment for the convenience of customers, so long as each customer is provided with the address and telephone number of the branch office or OSJ of the firm from which the person conducting business at the non-branch location is directly supervised.

It is important to remember that the terms "Branch Office" and "OSJ" are not synonymous. Because the differences in supervisory requirements between Branch Office and OSJ can be confusing, the terms need to be reviewed carefully when, for example, determining whether an office really is an OSJ or whether a Branch Office falls within the subparagraph (g)(2) definition. Further, one needs to consider the branch office exclusions of Rule 3010(g)(2). These exclusions offer a variety of helpful relief for remote offices and representatives. Further relief may be found in subsection (g)(3) of Rule 3010, which permits a member to substitute a central office address and telephone number for the supervisory branch office or OSJ under certain conditions, the most important of which is that a supervisory program exists to review complaints and to see that they are followed up with the local office.

C. New York Stock Exchange Rule 342

NYSE Rule 342 is applicable to New York Stock Exchange member firms and is quite different than NASDR Rule 3010. Rule 342 of the New York Stock Exchange is not as far-reaching or as particularized as Rule 3010. While Rule 342 does not define a branch office, it does

require prior NYSE consent for each office "other than a main office." Thus, under the literal wording of the rule, when a registered representative operates from home or remote location, each such location is considered an office. However, the NYSE has supplemented Rule 342 so that the rule similar in concept, if not wording, to the NASDR Rule. For that reason, NYSE Rule 342 is not discussed at length in this paper.

D. Anti-Money Laundering Compliance

Each broker-dealer as a member of the New York Stock Exchange or the NASD is required to develop and implement a written anti-money laundering program. The NASD and the New York Stock Exchange provisions[3] are similar and require the following:

1. Establish and implement policies and procedures that can be reasonably expected to detect and cause reporting the transactions required under the Bank Secrecy Act[4] and implementing regulations.

2. Establish and implement polices, procedures and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementation regulations thereunder.

3. Provide for independent testing for compliance to be conducted.

4. Designate and identify to the NASD the compliance person responsible for implementing and monitoring day-to-day operations and internal controls of the program and to provide notification to the NASD regarding any change in such designations.

This outline does not discuss anti-money laundering further since it is the subject of a separate program at the 25th Annual Futures Industry Association Law & Compliance meeting.

E. Compliance Officers

Over the past 10 years, the SEC enforcement staff and various self-regulatory organizations have brought proceedings against compliance officers for failure to supervise. The SEC has clearly stated that legal and compliance personnel are not automatically supervisors for purposes of the '34 Act. The SEC and other regulators, when determining whether a compliance officer has supervisory responsibility, will focus on the degree of responsibility, ability, or authority to affect the conduct of the broker whose behavior is at issue. *See In re Gutfreund*, 52 S.E.C. 2849, 1992 SEC Lexis 293 (Dec. 3, 1992). A more basic test is whether the compliance officer has the ability to hire or fire an employee. *See In re Arthur James Huff*, 50 S.E.C. 524, 1991 WL 296561 (Mar. 28, 1991). However, since *Gutfreund*, this later test is not definitive. Under *Gutfreund*, a compliance officer will be deemed to be a supervisor if it is shown that he or she was in a unique position in relationship to the wrongful conduct such that he or she has the ability to stop it and that the employer has authorized the particular compliance personnel to go beyond his usual compliance and legal duties to supervise a particular employee or operation.

[3] NASD Rule 3011; NYSE Rule 445.
[4] 31 U.S.C. 5318(g).

In the 21(a) Report accompanying the *Gutfreund* consent order, then-Commissioner Mary L. Schapiro (now President of the NASDR) stated as follows:

> There are three critical messages in this report concerning who may be deemed to be a 'supervisor.' First, employees who have legal or compliance responsibilities do not become 'supervisors' solely because of their positions. In other words, the Commission will analyze each case on the basis of its unique facts and circumstances, taking into account the managerial structure of the particular firm and the devolution of responsibility within the firm. Second, the determination of whether a particular person is a supervisor depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employees whose behavior is at issue. Again, the facts and circumstances are crucial, as is an analysis of responsibility and control, to making the determination. And third, it is possible, to <u>become</u> a supervisor under a particular set of facts and circumstances, even if formerly you did not have 'direct supervisory responsibility for <u>any</u> of the activities of the employee.'
>
> *   *   *   *   *
>
> In my view, the facts and circumstances which may make you 'become' a supervisor vis-à-vis a particular employee, when formerly you were not, are (1) your knowledge and awareness of allegedly improper conduct, and (2) being so situated within a firm that you have some ability to affect the conduct at issue.

Remarks of Commissioner Mary L. Schapiro, *Broker-Dealer Failure to Supervise: Determining Who is a "Supervisor,"* at 14-15, SIA Compliance and Legal Seminar (Mar. 24, 1993).

Most large wirehouses consider their compliance officers to be staff personnel, not line supervisors, and their procedures make it clear that the compliance officers do not supervise specific registered representatives or principals. Compliance staff provide compliance advice to line supervisors but the decision as to whether to hire, fire, discipline or carry out the advice remains with the line supervisors. However, if the written supervisory procedures, particularly the designations of supervisors, are not clear regarding who has responsibility for supervision of a particular person, the compliance officer may be charged as supervisors. <u>The SEC and the self-regulatory organizations' basic principle seems to be that if the written supervisory procedures do not clearly delineate the line of supervision, all persons dealing with a violator will be charged for failure to supervise</u>. It appears that the SEC is reaching in some cases beyond its past acknowledged standard to name compliance personnel if (1) they are very senior persons; (2) they can, by reason of their influence within the firm, cause a person to be terminated or stop the violative conduct. This could create troublesome precedent due to its fact-intensive nature and the difficulty of application. If continued, ultimately, the courts and the SEC are going to have a difficult time dealing with the potentially arbitrary nature of this standard.

It is critically important that compliance officers establish a supervisory chain of command which does <u>not</u> include compliance personnel. Furthermore, supervisory procedures should not specifically assign supervisory responsibilities to compliance professionals. If they do, then the compliance personnel may have supervisory responsibilities. Of course, the fact that

compliance personnel review actions or activities of others will not necessarily amount to direct supervision.

III. New Customer and Other Books and Records Requirements Effective May 3, 2003

A. Introduction

On November 2, 2001, the SEC published "New Books and Records Requirements for Broker-Dealers" under SEC Rules 17a-3 and 17a-4.[5] The effective date of the new rules is May 2, 2003. The rule amendments to SEC Rules 17a-3 and 17a-4 were very controversial. The state securities commissioners pushed for maintaining substantial records at each office within their respective states so that they could easily access them. Because of the cost, the industry strongly opposed the change. The SEC compromised by providing that only certain records, mostly dealing with customer sales practices, would be maintained at each office or alternatively made available electronically. The purpose of this section is to outline some of the key changes that effect broker-dealer operations, particularly branch offices and sales practices. The key changed areas in SEC Rules 17a-3 and 17a-4 are described below.

B. Order Tickets

Order tickets whether executed or unexecuted must show:

1. The terms and conditions of the order and instructions and any modification or cancellation thereof;

2. The account number;

3. Time of entry;

4. Execution price;

5. Time of execution or cancellation;

6. Discretion;

7. Order receipt time;

8. Identity of associated person, if any, responsible for the account;

9. Identity of person who entered or accepted the order on behalf of the customer (or if the order was entered on an electronic system, a notation regarding such).

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[5] SEC Rule 17a-3, 17 C.F.R. 240.17a-3; SEC Rule 17a-4, 17 C.F.R. 240.17a-4; SEC Release 34-44992 66 F.R. 55818 (November 2, 2001).

C. Memorandum of Each Purchase or Sale

1. Memorandum of each purchase or sale of securities for the broker-dealer's own account showing:

   a. the price; and

   b. time of execution to the extent feasible;

2. Where such purchase or sale is with a customer other than a broker or dealer, the time and receipt, the terms and conditions of the order and the account for which it was entered;

3. The terms and conditions of the order, any modification or cancellation;

4. The identity of each associated person, if any, responsible for the account.

5. The identity of any other person who entered or accepted the order on behalf of the customer or where it is entered by an electronic system, a notation that the customer entered the order by himself or herself.

6. For orders by customer (other than a BD), a designation that the order was entered pursuant to discretionary authority.

D. Account Information for Individual Customers or Owners of an Account

Account records must include:

1. Customer or owner's name;

2. Identification number;

3. Address, telephone number and date of birth;

4. Employment status, including occupation and affiliation, if any, with another member, broker-dealer or FCM;

5. Annual income and net worth (excluding primary residence);

6. Account's investment objectives;

7. In the case of a joint account, all of the above information for each joint account owner that is a natural person, provided that financial information may be combined;

8. Signature of associated person, if any, responsible for the account and approval by a principal.

For accounts in existence on May 2, 2003, a broker-dealer must obtain this information within three years of such date. If a customer refuses to provide information, the record must include the refusal.

E. Confirmation of Customer Account Information by Customer

1. Within thirty days of the opening of an account and at intervals of thirty-six months thereafter, the broker-dealer must furnish to each customer or owner a copy of the account record or a similar document containing all of the information set forth above in D. If the account was open on May 2, 2003, the information must be sent within a three year period.

2. The broker-dealer must, in connection with the investment objectives, include an explanation of the meaning of any terms used by the broker-dealer regarding investment objectives.

3. The document furnished to the customer must prominently indicate that the customer should make any corrections and return to the broker-dealer and that the customer should notify the broker-dealer of any future changes to the information in the account record.

F. Change in Name or Address of Customer or Owner or Account Investment Objectives

1. Broker-dealer must furnish notification of the change of the customer's address to the former address and to each joint owner and the associated person, if any, responsible for the account within thirty days notice of receipt of such change.

2. Within thirty days after the date the broker-dealer receives notice of any change of investment objective or other change, the broker-dealer must furnish to each customer or owner and the associated person, if any, responsible for the account, a copy of an updated record of information.

G. Discretionary Accounts

A record containing a signature of customer or owner on each power and the signature of the natural person to whom discretionary authority is granted must be maintained.

H. Customer Agreement

A record for each account that each customer or owner was furnished with a copy of any written agreement entered into on or after May 3, 2003 regarding the account and if requested by the customer evidence that the customer or owner was furnished with a fully executed copy of each agreement.

I. Complaints

A broker-dealer must maintain:

1. A copy of each written customer complaint concerning an associated person and its disposition, or alternatively a record of the complainant's name, address, account number, date the complaint was received, the name of all associated persons identified in the complaint, a brief description of the nature of the complaint and the disposition of the complaint.

2. A record showing that each customer has been provided with notice of the address and telephone number of the department to which complaints may be directed.

J. Account Person Compensation

1. A list of each purchase and sale of a security for which an associated person receives compensation, including monetary or non-monetary compensation. (Alternatively, this information could be produced from the firm's record if it can be produced promptly to a securities regulatory authority.)

2. A record of all agreements pertaining to the associated person, including a summary of each associated person's compensation agreement or plan and to the extent the compensation is based on factors other than remuneration, a description of the method of granting compensation.

K. Unusual Account Activity

Copies of all reports of unusual account activity must be maintained.

L. Advertising, Sales Literature and Communications Compliance

Records indicating broker-dealers have complied with and adopted policies and procedures reasonably designed to establish compliance with the applicable requirements regarding advertising, sales literature or other communications with the public be approved by a principal.

M. Communications

Originals of all communications received and copies of communications sent by the broker-dealer, including interoffice memoranda and communication relating to the broker-dealer's business and to the extent required any approvals thereof.

N. Regulatory Orders, Settlements and Examination Reports

Records must be maintained of all regulatory orders, settlements and examination reports and they all need to be available.

O. Supervisory Procedures and Policies

Copies of all procedures and policies within the last three years must be maintained.

P. Branch Office Listings of Certain Persons

1. Record Explicator

For each office, a listing by name and title of each person who can explain without delay the types of records the firm maintains at a particular office and the information contained in those records.

2. Responsible Compliance Personnel

The rules require a listing of each principal responsible for establishing policies and procedures to ensure compliance with the applicable rules that require acceptance or approval of a record by a principal.

Q. Associated Person CRD Number and Identification

Each office where an associated person conducts business or handles funds or securities is required to maintain copies of the associated person's CRD number and all internal identification numbers or code assigned to each associated person dealing from that office.

R. Organization and Registration Documentation

1. All Form BDs and amendments.
2. All Form BDWs and amendments.
3. All licenses or other documentation showing the broker-dealer's registration with regulatory authorities.

S. Record Retention

Rule 17a-4 provides that certain records must be kept for not less than six years, the first two years in an easily accessible place. This includes certain records required by Rule 17a-3 such as:

1. Blotters of all transactions;
2. All assets, liabilities, income expense in capital accounts;
3. Ledgers;
4. Ledger accounts;
5. Securities record;

6. The records required by Rule 17a-3(a)(21) and (22) (i.e., P above).

In addition, because the SEC made an error in amending SEC Rule 17a-3 (it has two subsection (f)s), all of the records required by the new additions discussed in A though Q above appear to be required to be maintained for six years at a minimum. Rule 17a-4 also requires that the broker-dealer preserve for a period not less than six years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account. This means that almost all of the records in the new record provisions described in A through Q above shall be preserved for six years after closing an account.

Rule 17a-4 also requires that other records be maintained for not less than three years, the first two years in a readily accessible place. These other records include a variety of records dealing with accounts, accounting, books and other similar records. The provision for three years includes the new provisions but because of the error noted above it is unclear whether they are subject to the six year period described above or the three year period. However, it appears that order tickets and memorandum of purchase and sale, confirmations, margin documents and option documents would need to only be maintained for the three year period. Other documents, including internal broker-dealer systems of which the broker-dealer is a sponsor (relating primarily to trading systems), complaints, account executive compensation and communications, advertisements and sales literature would appear to be subject to the three year requirement were it not for the SEC error.

Rule 17a-4(e) requires that broker-dealers maintain and preserve in an easily accessible place for at least three years after an associated person's employment and any other connection with the broker-dealer has been terminated, all of the records with respect to such associated person. Also included within the three year requirement is every regulatory authority request and the response pursuant to any order, settlement and regulatory examination. Supervisory, compliance and similar manuals and policies and procedures must be maintained for three years after termination of the manual or the procedure. Unusual activity reports must be maintained for eighteen months.

Rule 17a-4(d) requires that all organizational documents (articles, by-laws, minutes and similar type documents and all registrations and licenses) be maintained for the life of the enterprise. Likewise, all fingerprint cards must be maintained for the life of the enterprise and all records with respect to lost and stolen securities must be maintained indefinitely.

T. Branch and Local Office Availability of Certain Records

Certain records must be maintained at an "office" to which they relate. Rule 17a-3(g) defines "office" to mean "any location where one or more associated person regularly conducts the business of handling funds or securities or effecting any transactions and inducing or attempting to induce the purchase or sale of any security." "Office" includes a private residence. If an "office" is a private residence and is not held out to the public as an office and funds and securities of customers are not received there, broker-dealer need not maintain records at that office but must maintain them at another location with the state as selected by the broker-dealer. Further, where records are required to be maintained at an office, the broker-dealer may choose to produce records promptly at the request of the representative of a securities regulatory authority at the

office to which they relate or at another location agreed to by the representative. Records covered by the above include all the records required by 17a-3(f). The records that need to be preserved include order tickets, memorandum of purchase and sale, employment questionnaires, applications and other information regarding associated persons, customer account information and other items mentioned above in A through Q, and the records required by Rule 17a-3(a)(1) and (12) relating to all transactions (securities or cash) and associated persons at the "office".

U. Electronic Storage and Media Requirements

This outline does not deal extensively with electronic storage and media requirements because it will be the subject of another outline at this conference. Rule 17a-4(f) provides that records may be stored in "micrographic media" or "electronic storage media" ("Media") if the strict provisions of those sections are met. The requirements of Rule 17a-4(f) are quite complex but are summarized as follows:

1. The broker-dealer must notify its examining authority ninety days prior to employing such Media.

2. The Media must meet the following requirements:

   a. Be in non-write, non-erasable format;

   b. Verify automatically the quality and accuracy of storage media recording process;

   c. Serialize the original and, if applicable, duplicate units of the storage media and time date for required period of retention the information;

   d. Have capacity to readily download index and records to be preserved to any medium acceptable to the regulators.

3. The broker-dealer must have available at all times for regulators:

   a. Easily readable projection or reproduction media for producing images.

   b. Immediate facsimile enlargement.

4. The broker-dealer must:

   a. Store separately the original and duplicate copy of the record stored on any medium for the times required.

   b. Organize and index accurately all information maintained for both original and duplicate storage media and make them available to the staff.

c. Copies of the index must be duplicated and must be stored separately from the original and preserved for the required time for the records.

5. The broker-dealer must have an audit system providing for accountability regarding inputting documents and the duplicate records that must be maintained. The audit materials must be available to the regulators and preserved for the times the records are required.

6. The broker-dealer must maintain, keep current and provide to the regulators all information necessary to access records and indices stored on electronic media or place in escrow and keep a copy of the physical and logical file format of the electronic storage media, the field format of all different information, types written on the electronic storage media and the source code, together with appropriate documentation and information necessary to access records and indices.

V. Summary and Commentary

The new rules require a significant amount of additional account documentation and record maintenance by broker-dealers, particularly in "offices". If a broker-dealer has an electronic retrieval system that can readily access all of these documents it will be much easier for the broker-dealer to comply with the rules. The long lead time for effectiveness of the rule changes was required to allow broker-dealers time to prepare their systems for the introduction of the new recordkeeping requirements. The contacts with customers with respect to their information and verification of the same require a number of new procedures, whether it is done manually or in electronic format.

In any event, for all "offices" as defined in Rule 17a3-(g)(1), broker-dealers are required to maintain for the most recent two year period the documents required with respect to items in A through Q above. In addition, originals of all communication received and copies of all communication sent and approvals thereof by the member broker-dealer (including interoffice communications) relating to its business as such must be maintained at the "office" to which they relate. Importantly, the amendment to Rule 17a-4(b)(4) relating to communications presents an enormous problem for retention of e-mail since if it's retained electronically it must meet all of the requirements of the SEC's electronic media requirements in 17a-4(f). These requirements are almost impossible to meet for e-mail, particularly indexing and retrieval. It should be noted that the Securities Industry Association has been working diligently with the SEC to reach some practical solutions regarding communications, particularly those in electronic format. However, as of the present time, the negotiations seem to be stalled. In any event, the new books and records requirements present many challenges to broker-dealers.

IV. Key Supervisory Issues for Remote Branches

A. Areas of Supervision that are Critical and Where Weakness Can Result in Regulatory Action

1. Hiring and Training – Investigation and Background

a. General Records and Investigation

NASDR Rule 3010(e) specifically requires an investigation into the background of any registered representative. A similar investigation of other employees or persons associated with broker-dealers is required indirectly by SEC Rule 17a-3(12), which requires a written record of the background of registered personnel and all other employees with access to funds or securities.

b. Questionnaires

In addition, the registered representative should be required to complete a detailed questionnaire with his background, financial positions, investments and specific, detailed description of outside activities. There should be a background and credit check and some third party contacts regarding his outside business activities. The background check should be extensive for registered representatives in remote locations. Telephone calls should be made not only to the references and employers required to complete the U-4, but also to other prior employers and other persons in the community who may have knowledge of the individual and his actions. Records of these calls and information obtained should be maintained. It is also important to do a credit check on any registered representative to determine if he or she has financial difficulties. There is a high correlation between registered representatives with financial difficulties and those who engage in illegal sales activities, Ponzi schemes and the like.

In hiring a representative who has prior complaints, even those resolved favorably, the firm is in fact on notice in the eyes of the NASDR and the SEC that there may be compliance problems. The account executive's background, and each prior complaint, should be thoroughly investigated as well as each complaint. It may be necessary and prudent to tailor specific supervisory procedures to monitor the account executive in such cases. New complaints of the same type as previous complaints are a red flag that must be carefully investigated.

c. Education

In addition to passing the regulatory exams, as part of the hiring process an account executive should be put through an extensive training program as to what is involved with the products that are offered by a broker-dealer. Another important area that is often overlooked is training registered representatives regarding what is securities activities. Registered representatives often do not understand how many different business activities may be deemed to involve securities. For example, most do not understand that a promissory note alone may, under certain circumstances, be deemed to be a security. Likewise, an interest in an LLC or an interest in a common investment scheme, including a partnership or limited partnership, may be a security. Few training programs do a good job providing information in all the possible ways an account

executive might be deemed to be selling away. There should be detailed education regarding this area because it is the single most vulnerable spot for branch offices. It is the area that has caused the most civil liability and enforcement penalties. Many registered representatives naively believe that they can assist a local contractor in selling notes or interests in the development of a shopping center or an apartment building or similar activities without knowing that they may involve securities.

Of particular importance today is anti-money laundering education of account executives and operations personnel, particularly in remote branches. Further, security with respect to customer information required to be secure by regulation SP is often overlooked and should be emphasized in training of account executives.

d. Registered Representative Agreements

Most firms have agreements with their registered representatives. The agreements should specifically delineate key areas of prohibited conduct, such as third party check endorsements, outside business activities and a variety of other conduct. The contract should specifically state that the employee has read and will abide by the compliance and operational manual. The contract should also specifically affirm that the information furnished to the firm in the representative's employment application is true and correct.

e. Compliance and Operations Manual

All firms should have a compliance manual and operations manual for the registered representatives. This should not be confused with a supervisory manual which is designed for supervisory personnel or supervisory procedures for supervisors. The compliance manual for registered representatives should be a list of "dos and don'ts" and should be in plain English. Such a compliance manual is an important part of the supervisory system because providing a copy of the supervisory procedures alone does not necessarily provide the registered representative with details as to what he needs to know both from an operational and compliance standpoint.

f. Insurance Agency Representatives

If the registered representative has another business, such as selling insurance, and the other business is through a different company, compliance personnel should verify essential details with that company. If the registered representative has an established business, there should also be a visit to the business, including a physical inspection, and a review of its advertising and other activities.

g. Bank Networking Arrangements

The same procedures discussed above should be employed for bank employees who are registered representatives of a broker-dealer. Furthermore, there should be particular training with respect to NASDR Rule 2350, "Broker-Dealer Conduct on Premises of Financial Institutions." Likewise, the rules of financial institutions regulators with respect to securities activities on financial institution premises should be carefully reviewed and incorporated into registered representative agreements. Investigation of bank employees and their backgrounds

should include all of the above steps, but may not need to be as intensive because bank employees are generally closely supervised and examined by the bank regulators where the representative is a full-time bank employee. Because of the higher level of supervision which bank employees receive, as a general matter, bank networking relationships with a bank employee as a registered representative do not pose the same risk as do insurance agents who are registered representatives or other remote registered representatives.

2. On-Going Compliance

a. In General

On-going compliance includes supervision of all areas of the activities and is beyond the scope of this outline. However, there are some key supervisory responsibilities that should be emphasized. In Section V, specific marketing supervision is discussed.

b. Outside Activities

The registered representative's contract and the firm's supervisory procedures should provide that the registered representative can engage in any new business activities only with the written approval of the central office. Some firms do provide that branch managers or OSJ principals may approve outside activities, but this is not recommended because they may not understand the nature of the activities and possibility of selling away.

c. Assignment of Supervision

As discussed above in Section II.A., under NASDR Rule 3010(b), it is critically important that all associated persons have a designated line supervisor. If there is dual supervision, each supervisor is potentially liable for supervision. Furthermore, principals also need to be supervised, particularly where they have their own sales activities, and in a large organization there will be supervisors of supervisors. Generally, the SEC and the NASDR do not pursue sanctions all the way up the chain of supervision unless supervisors up the chain are directly involved in the violative activity or know of red flags indicating violations.

d. Inspections of Branches

Rule 3010(c) requires an annual inspection of each office and each OSJ. This inspection mandate requires inspection of each branch office, OSJ or other location held out to the public as a place of business. Since the SEC staff has stated that annual inspections may not be sufficient, some firms have moved to semiannual inspections. The SEC has also emphasized, as discussed above, that the inspections should be surprise inspections. Traditional methods such as annual questionnaires or annual telephone interviews alone will no longer be deemed sufficient. The surprise inspection is difficult, however, for firms with remote representatives because when the auditors arrive, the registered representative may be out of town or may have other things scheduled. However, the necessity of surprise is critical to the audit.

The inspector should use a checksheet covering all areas of activities and all products. If the associated persons also have other business activities, such as insurance or

real estate, that operate out of the same or other offices, programs should be developed to determine whether there is selling away or other possible violative activities in the related business. In many cases, outside business activities, particularly if it involves real estate or other ventures in the community, may involve selling away. The broker-dealer should make inquiry and satisfy itself that these activities do not in fact involve securities activities.

An annual questionnaire should include completion of personal financial statements by the representative. If the person has financial problems, additional procedures should be developed and the representative's activities carefully monitored. Some firms conduct an annual credit check to determine if the registered representative has financial problems. Bankruptcy, foreclosure and credit litigation are all red flags. An annual contact with a local business banker, particularly in small communities, regarding the activities and reputation of the branch may yield important information. It is very difficult to detect selling away and the firm should go to considerable lengths to be able to show that it made adequate inquiry regarding other business activities of the employee.

The local inspection should test transactions and should review books and records. The test should involve different periods of time for at least two or three different time periods within the year. The tests should cross month's end in at least two or three instances. Customer positions should be verified with the holding pages of the account executive. If not possible to verify all clients' positions because of the number of clients, a sampling should be undertaken. Likewise, all sales, advertising, business cards should be reviewed on a spot basis. Testing should be done for churning if there are equities, options or other types of activities. Mutual fund switches and variable annuities should be specifically scrutinized.

The annual questionnaire to each associated person should be formatted in "check the box" style so that the representative must read each particular statement of specific compliance. There should be a general statement at the end that he or she has reviewed the compliance manual and all updates and complied with the same.

All deficiencies should be noted in the inspection report and should be brought to the attention of the compliance director and the applicable line supervisor. When deficiencies are found, there should be specific resolution of what is going to be done to prevent them in the future. If the deficiencies noted in a prior examination appear again, disciplinary action should be taken or the employee terminated.

e. Selling Away

1) Unregistered securities. "Selling away" is the sale of securities products outside the broker-dealer that are not authorized by the broker-dealer or conducted through its books. As discussed above, many supervisory actions have involved registered representatives who engaged in selling away. NASDR Rule 3040 specifically prohibits selling away by registered representatives. Rule 3040 states as follows:

> (a) Applicability
> No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this Rule.

(b) Written Notice

Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

(c) Transactions for Compensation

(1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to paragraph (b) shall advise the associated person in writing stating whether the member:

(A) approves the person's participation in the proposed transaction; or

(B) disapproves the person's participation in the proposed transaction.

(2) If the member approves a person's participation in a transaction pursuant to paragraph (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

(3) If the member disapproves a person's participation pursuant to paragraph (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.

(d) Transactions Not for Compensation

In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to paragraph (b) shall provide the associated person prompt written acknowledgment of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.

(e) Definitions

For purposes of this Rule, the following terms shall have the stated meanings:

(1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in IM-2110-1, "Free-Riding and Withholding"), for which no associated person receives any selling compensation, and person transactions in investment company and variable annuity securities, shall be excluded.

(2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to,

commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

Any securities activities, including activities of a registered representative as a registered investment adviser are required to be run through a registered representative's broker-dealer. See Section IV.A.2.(e)(2) below for a more detailed discussion. Generally, the sale of unregistered securities that are not run through the broker-dealer's books occur in two different formats. In the first case, the registered representative is naive and just does not understand that the investments, notes or other things that he is selling are securities. In the other case, the notes or interests that are being sold are part of a deliberate fraud or Ponzi scheme by the registered representative. If a registered representative is associated with another financial service firm, such as an insurance agency or bank, the broker-dealer must carefully scrutinize both the products offered through the broker-dealer, and also the other products offered by the representative to ensure that none are part of a Ponzi scheme. This type of activity is difficult to prevent. However, one way that it can be detected is by annually contacting a number of customers and confirming that their positions balance with the broker's records.

2) Investment Adviser Activities of Registered Representatives. NASD NTM 94-44 discusses the responsibilities of a broker-dealer if it has a registered representative who is dually registered as an investment adviser. In such cases, the activities of the registered representative involving securities must be accounted for and booked by the broker-dealer. More importantly, the broker-dealer has supervisory responsibilities for certain of the registered representative's investment advisory activities.

f. Conversion of Client Funds

Conversion of client funds is, other than Ponzi schemes, the single most difficult thing to detect. If there is any question concerning the possibility of conversion of funds, clients must be contacted directly by counsel or senior compliance personnel. The verification should be both orally and in writing. Details of the account should be sent to the customer and the balances and positions in the account confirmed in writing.

The author has seen numerous cases where contact with the customer at an early stage would have quickly led to the discovery of conversion of funds. Diversion of customer checks to a fictitious account or entity are often part of a Ponzi scheme. Some times, the fictitious entity has the same name as the broker-dealer or a similar name as the broker-dealer. A good example is the Old Naples Securities case – a broker-dealer of that name owned an affiliate called Old Naples Financial. *See* In re Old Naples Securities, Inc., No. 99-2510, (11th Cir. Aug. 23, 2000). In that case, checks made payable to Old Naples Securities were diverted into the account of Old Naples Financial and converted by the president of Old Naples Securities.

Local depository accounts for a firm can also create complex issues when an account executive is permitted to deposit customer funds into an account for the broker-dealer or its clearing firm or if a local account executive has the ability to process withdrawals for customers. Withdrawals should be permitted only upon written request of the account holder and only when such requests are sent directly to the broker-dealer from the account holder. Each withdrawal check should be mailed or delivered directly to the customer's address and separately

confirmed directly to the customer. Failure to confirm a withdrawal directly to the customer has been a cause of problems for broker-dealers in the past.

g. Complaints

The failure to follow-up on complaints is the single most frequently cited reason for disciplining a securities professional for failure to supervise. All complaints should be carefully investigated and such investigation should be carefully documented. All complaints received should be forwarded to a central office, with copies to the principal to be certain that they are carefully investigated. Complaints should be catalogued by representative and by office. If there are a number of complaints about a particular representative, particular office or particular product, this is a red flag that cannot be ignored. They must be thoroughly investigated by contacting and interviewing the employee and the customer. It is not enough to accept the account executive's story on its face. The cases involving supervision have time and time again sanctioned principals, who were made aware of complaints, but failed to follow up and contact the customers directly. Often the supervisory principal has a friendship with the account executive. This can make it difficult to carry out the requisite follow-ups. But it must be done. A principal must be totally objective, and more than one principal has been severely sanctioned for accepting an explanation at face value. Complaints should be carefully and objectively scrutinized. Failing to do so can cost a securities professional his ticket. See Section III above regarding record keeping.

h. Review of Transactions

Daily or intra-day review of all securities transactions by representatives under the direct supervision of a principal is the single most important surveillance practice that a principal may utilize and employ. Such surveillance is the first line of defense against a variety of marketing and sales practice violations. The review should look at transactions for suitability. If securities transactions are being effected for accounts that the principal does not recognize, this is an immediate red flag which would require the principal to determine the basis for the recommendation of the securities and whether they are suitable for a particular customer. Many transactions or large-sized transactions in a single issue by an account executive or particular office is a red flag regarding suitability (and may even raise suspicions regarding possible manipulation). In particular, large option transactions or margin transactions in a security should be investigated as to whether they fit the pattern of the individual investor for suitability, but also as to whether possible insider trading or manipulation is behind the trades. Mutual funds and variable annuities should be reviewed for switching or breakpoint sales.

The front line supervisor is not expected to catch all violations. However, the review of transactions on a daily or intra-daily basis and the investigation of discrepancies as a matter of course is the firm's first line of defense. In connection with each daily review, a record of the review should be maintained by indicating on the blotter or other transactions sheets or on the computer that they have been reviewed, the time of review and any discrepancies noted. The investigation of any discrepancies and the resolution of the discrepancy should be in a memorandum which should be retained.

i. Violations, Restitution and Sanctions

If a firm discovers a violation or series of violations, the firm must make difficult decisions regarding making potential restitution to customers, revising supervisory procedures and compliance procedures, sanctioning the individuals involved and last, but not least, reporting the violations to the appropriate regulatory authorities. These decisions are difficult decisions which must weigh the threat of civil litigation and enforcement activity by the appropriate regulatory authorities. Such decisions should be made with the aid of counsel that has significant experience in dealing with the appropriate regulatory organizations and is well-versed in the risk involved. Whether to sanction an account executive or other employee and the level of sanction is often also a difficult issue. It is the authors' experience with both the SEC and the NASDR that such steps will not necessarily preclude action against the firm or senior supervisors. However, in many cases, it will result in either a significantly reduced sanction or no sanction at all against the firm or senior supervisory personnel and in some cases, the registered representative.

V. Marketing

A. In General

Since the primary purposes of most branches and registered representatives is to engage in selling activities and marketing, it is not surprising that other than selling away, sales practice marketing violations are the most frequently encountered types of violations with respect to branch offices. For such reason, the key areas are suitability, advertising, sales promotion, correspondence and, recently, websites and e-mails. Telemarketing and unregistered persons also present challenges.

B. Suitability

Suitability of transactions is a particularly important supervision responsibility. See NASDR Rule IM-2310-1 and NYSE Rule 405. In some firms, this review is conducted by OSJ and branch offices and in other cases it is conducted by a central office responsible for reviewing the suitability of all transactions. In addition to the general suitability rules (NASDR Rule 2310 and NYSE Rule 405), there are particular rules for options, mutual funds, collateralized mortgage obligations, variable contracts and other products. If the product line is relatively limited, central office review is often more efficient and more effective than review by a remote principal. Such approval also provides better control in that the necessary documentation, such as switch letters, non-solicitation letters and other necessary documentation, must be obtained before transactions may be effected. If the suitability review is done by a OSJ, the principal must be careful to maintain detailed records of the review. Often, this is difficult for the registered principal in an outlying office, particularly if he is engaged in his own sales activities. If there are options or similar transactions, they need to be reviewed by registered options principal and also by the Compliance Registered Options Principal, usually at a central office. See V.C.I. below.

In general, a supervisory system with respect to suitability requires review by a principal of each transaction. Some firms attempt to do this from the OSJ in addition to the first line principal's review. Many firms also review each transaction in a general or centralized regional office. Some times such reviews are on a sampling basis. The NASDR Rule 2310 requires that "in recommending to a customer the purchase, sale or exchange of any security, a

member shall have reasonable grounds for believing that the recommendation is suitable for such customer on the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." With respect to specific products such as variable annuities, options, collateralized mortgage obligations and other complex requirements, the NASDR has offered guidance to members by reason of notices to members discussed below. NYSE Rule 405 is equivalent in effect but is somewhat different conceptually. Known as the "know-your-customer" rule, it requires that a broker use due diligence to learn the essential facts relative to every customer, order, cash or margin account carried or accepted by the broker and every person holding a power of attorney over any account. Rule 405 applies even where a broker has made no recommendation. However, the concept behind the rule and its interpretation by the NYSE and courts impose similar obligations as NASDR Rule 2310 and the specific suitability rules for complex products discussed below. As discussed above in Section III under the new books and records requirements, extensive information concerning a customer's background must be maintained and sent to the customer. This heightens the required suitability review and in connection with suitability reviews, it is important to review all of the material that is maintained in the broker-dealer's file which has been obtained from the client and sent to the client to be certain that the manager is aware of all of the records dealing with a customer's circumstances, financial position and investment objectives. See Section III above for further details.

The most important red flags in connection with suitability are customer complaints. It is important that complaints be carefully investigated and be reviewed without skepticism. In most cases, the customer should be contacted and interviewed and appropriate action taken. If there are a series of complaints concerning a particular account executive or office, in the authors' experience, it does generally indicate that something is amiss. In such event, careful investigation is doubly important. Where there are violations, the firm should consider appropriate restitution to customers and possibly sanctions or disciplinary action against the account executive.

C. Special Products

1. Options

NASDR Rule 2860 provides a substantial, complex and detailed series of provisions for regulation of options. The key provisions in dealing with marketing at the branch level are contained in IM-2860-2 "Diligence in Opening Options Accounts".

The detailed suitability information specified in IM-2860-2 must be obtained from the client using the standard form. The information must initialed and verified by the customer. Rule 2860 in subsection (b)(17) requires maintaining detailed records with respect to any complaint. The same Rule requires special approval and authorization of discretionary accounts. Discretion by the account executive for an options account must be approved in writing by a registered option principal. A senior registered options principal ("SROP") is required to review each discretionary account to be certain that there is a reasonable basis for believing the customer has the ability to understand and bear the risk of the strategies and transactions proposed. Each discretionary order by an associated person must be approved by the branch office manager or other registered options principal.

With respect to each branch office engaged in the options business, the principal supervisor must be qualified as a registered options principal or a limited principal

general sales security supervisor unless there are less than three registered representatives, and their activities are supervised by a registered options principal or a limited principal general sales security supervisor elsewhere. Each broker-dealer must have a SROP to supervise the other registered options principals. Each SROP is responsible for implementing specific procedures. Each firm must have a compliance registered options principal ("CROP") (who may also be the SROP) who shall have no sales functions and be responsible to review and propose appropriate action with respect to compliance. Regular reports on the supervision must be filed with senior management or the senior compliance officer.

Rule 2860 provides further that the principal supervisory office having jurisdiction over any office serving customer options accounts, must maintain and have readily accessible various information with respect to options compliance and the accounts services by that office.

2. <u>Variable Insurance Contracts</u>

NASDR Rule 2820, regarding marketing variable contracts, includes detailed provisions regarding the distribution, sales charges, selling agreements and member compensation in connection with the redemption of products. The NASDR has issued various guidance with respect to variable annuities, including NTMs 96-86 and 99-35. NTM 99-35, in particular, is instructive and quite specific. All points covered in NTM 99-35 should be dealt with in a suitability review before the product is actually sold. Furthermore, educational material for account executives should be conformed to 99-35. Finally, the best surveillance is to have a checklist for each customer transaction that is filled out by the account executive and signed by the customer with an addendum for the account executive to complete and verify to send along with the application for the particular product. Bonus annuities and replacements present particular problems. If replacements are being considered, additional forms should be prepared and the transactions should be reviewed just as in connection with a mutual fund switch.

3. <u>Investment Company Products</u>

NASDR Rule 2830 regulates the sale of investment company products. It includes a number of provisions with respect to distribution sales charges and discounts for dealers which are beyond the scope of this article. However, from a sales standpoint, there are specific prohibitions against selling dividends or withholding orders. Also, importantly, member compensation and non-cash compensation is regulated in detail by Rule 2830. However, these are not directly related to marketing by a remote branch office or representative. More important is IM-2830-1 dealing with breakpoint sales. Specifically, IM-2830-1 states:

> The sale of investment company shares in dollar amounts just below the point at which the sales charge is reduced on quantity transactions so as to share in the higher sales charge applicable on sales below the breakpoint is contrary to just and equitable principals of trade.
>
> Investment company underwriters and sponsors, as well as dealers, have a definite responsibility in such matters and failure to discourage and to discontinue such practices will not be countenanced.

For purposes of determining whether a sale in dollar amounts just below a breakpoint was made in order to share in a higher sales charge, the Association will consider the facts and circumstances, including, for example, whether a member has retained records that demonstrate that the trade was executed in accordance with a bona fide asset allocation program that the member offers to its customers:

- which is designed to meet their diversification needs and investment goals; and
- under which the member discloses to its customers that they may not qualify for breakpoint reductions that are otherwise available.

The SEC and NASD in a recent survey found that many broker-dealers were not providing to customers appropriate commissions in connection with sales of investment company products and were violating the provisions with respect to break point sales. Firms are now required to do a self-assessment regarding the same. All firms that conduct mutual fund transactions with front end sales loads are required to do the self-assessment by May 15, 2003.[6]

In connection with any mutual fund switch, there should be a review by the principal responsible for the registered representative. In addition, a broker-dealer should have a system to identify any particular registered representative or office that is generating a significant number of switches and should review such switches, at least by sampling.

4. Direct Participation Programs

NASD Rule 2810 details the regulation of members and their associated persons participating in the sale of direct participation programs. A good part of Rule 2810 deals with offering compensation, due diligence and other activities by the members, including participation in roll-ups. However, there are specific suitability standards for direct participation programs which should be carefully monitored. Supervisory procedures should be developed to insure that direct participation programs, since they are generally illiquid, are sold only to persons who can stand the risk (generally, very wealthy individuals). If they are sold through remote branches or registered representatives, careful supervision by the central office or regional office of the authorizations and review of suitability for these transactions should be part of the supervisory procedures. Many broker-dealers require approval in the home office by a senior compliance or line supervisor for any direct participation sale. In most cases the program itself requires pre-approval by the compliance department or senior official before a sale may be made by a remote representative. In such case, files should be maintained with respect to the due diligence. With respect to any sale of direct participation programs, there should, at a minimum, be a review by a principal and, in most cases, a review by a more senior official.

5. Security Futures

This discussion of security futures is just a brief summary since there is a separate panel on security futures at the Futures Industry Association Law & Compliance Division 25th Annual Workshop.

[6] NASD Letter to Member Firms NTM 02-85 (December 2002).

The Commodity Futures Modernization Act of 2000 ("CFMA")[7] established for the first time in the United States a regulatory scheme to permit trading of futures on equity securities and narrow-based equity indices. The CFMA made fundamental changes in the Commodities Exchange Act ("CEA"),[8] the Securities Act of 1933 (the "33 Act"),[9] the 34 Act, the Investment Company Act of 1940,[10] the Investment Advisers Act of 1940[11] and other federal acts[12] regarding futures on single stocks and narrow-based indices and even created a new name for such products: "security futures." The CFMA also made numerous other changes with the goal of coordinating the CEA with the other federal laws and regulation regarding derivative products.

The CFMA provided that a futures commission merchant ("FCM") or an introducing broker ("IB") may register by notice filing with the SEC as a broker-dealer ("BD"). However, a notice registered BD may effect securities transactions in security futures products <u>only</u>.[13] Likewise, the CFMA amended the CEA to provide for notice registration of BDs as FCMs or IBs, with futures activities for such notice registrants limited to security futures products.[14] A FCM or IB notice registered as a BD is not required to be a NASD member and a BD that is a notice registered FCM or IB need not be a member of the NFA. The NFA has become a registered national securities association under the limited provisions of Section 15a(k) of the 34 Act. Both the CFTC and SEC have adopted rules permitting notice registration as provided in the CFMA and each of the self-regulatory organizations ("SROs") have adopted rules dealing with registration.[15]

The NASD and the NFA have adopted rules providing for registration of individual associated persons dealing in security futures.[16] They have also created continuing education training modules. Under the NASD and NFA rules, members must designate one or more security futures principals for each office where the firm is engaged in security futures business.

The CFMA left sales practices regulation largely to the SROs. While the concepts of each of the SROs for public protection were essentially the same, the methods of implementation were quite different. FCMs and IBs notice registered as BDs are subject to the NFA's security futures rules. BDs notice registered as FCMs or IBs and BDs that are FCMs or IBs are all subject to the NASD's rules. The rules cover suitability, account opening and supervision of accounts, dissemination of disclosure documents concerning security futures, best execution,

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[7] Pub. Law 106-554.
[8] 7 U.S.C. §1 *et seq.*
[9] 15 U.S.C. §77a *et seq.*
[10] 15 U.S.C. §80a-1 *et seq.*
[11] 15 U.S.C. §80b-1 *et seq.*
[12] *See e.g.,* Gramm-Leach-Bliley Financial Modernization Act, Public Law 106-102, 113 Stat. 1338.
[13] 34 Act §15A(k), 15 U.S.C. oA(k).
[14] CEA §4f(a)(4)(A), 7 U.S.C. §6f(a)(4)(A).
[15] SEC Rule 15b-11, 17 C.F.R. 240.15b-11; NASD Rule 1060; NFA 204(a)(4); NFA Interpretive Notice: "Rule 2-4: Broker-Dealer Registration Requirements for Security Futures Products", NFA Manual ¶9044.
[16] NASD Notice to Members 2-73 (November 2002); NFA Interpretive Notice: Rules 2-7 and 2-24 and Registration Rule 401: Proficiency Requirements for Security Futures Products" (NFA Manual ¶9049); NASD Rules 1032(a)(2)(E) and 1032(d).

communications with the public, insider trading, front running, trading and supervisory procedures.[17]

The CFMA provided a scheme for protection of and handling of customer funds and property. FCMs and IBs notice registered as BDs are specifically exempt from Section 15(c)(3) of the 34 Act under which the SEC has promulgated SEC Rule 15c3-3[18] dealing with handling customer funds and property. In such case, any customer funds or securities must be held by an FCM pursuant to the CFTC segregation requirements.[19] Furthermore, the CFMA amended the Securities Investors Protection Act to provide that it would not cover customers of FCMs or IBs that are notice registered as BDs.[20] Conversely, the CFMA provides that a BD notice registered as a FCM or IB is exempt from the segregation requirements of the CEA. To implement the scheme, the SEC and the CFTC adopted rules with respect to customer accounts holding security futures products.[21]

The CFTC and SEC adopted joint rules concerning margining of security futures and exchanges trading the product have adopted maintenance margin requirements.[22]

The SEC and the CFTC provided that, with respect to certain recordkeeping reporting and books and records rules, the SEC rules would apply to security futures carried in securities accounts and the CFTC rules would apply to security futures carried in futures accounts. However, either regulatory agency has access to records with respect to security futures.[23] Further, SEC Rule 17a-11 with respect to early warning notice have been amended so as to not be applicable to FCMs that are notice registered IBs and similar provisions under the CFTC regulations are not applicable to notice registered FCMs or IBs.[24]

The SEC adopted amendments to Rule 10b-10 to clarify the necessary disclosures on confirmations of transactions for notice registered and full BDs effecting transactions in security futures products. The amendments also provide that BDs effecting transactions in security futures products <u>in futures accounts</u> do not have to disclose all of the information required by the SEC's confirmation rule, but require that the transaction confirmations

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[17] CFTC Rule 41.41a, 17 C.F.R. 41.41(a); CFTC Rule 1.55h, 17 C.F.R. 1.55h; SEC Rule 15c3-3(o), 17 C.F.R. 240.15c3-3(o); SEC Release Nos. 33-8107 & 34-46101, 67 F.R. 43,234, p. 11 (June 27, 2002); NFA Compliance Rules 2-7(b), 2-8, 2-29(j), 2-30(j), 2-37; NFA Interpretive Notice "Rule 2-9: Special Supervisory Requirements for Members Registered as Broker-dealers Under Section 15(b)(11) of the Securities Exchange Act of 1934", NFA Manual ¶9042; NFA Interpretive Notice: "Rule 2-4 Regarding Best Execution Obligations of NFA Members Registered as Broker-dealers Under Section 15b(11) of the Securities Exchange Act of 1934" NFA Manual ¶9048; Rule 204; NFA Interpretive Notice "Obligation to Customers and Other Market Participants", NFA Manual ¶9041; Interpretive Notice, NFA Compliance Rule 2-29: "Use of Past or Projected Performance; Disclosing Conflicts of Interest", NFA Manual ¶9043; NASD Rules 2210, 2510, 2711, 2860, 2865, 3010(b), 3050, 3070, NTM 02-73 (November 2002), NASD Interpretation 2210-3, 2210-7

[18] 17 C.F.R. 240.15c3-3.

[19] CEA §4(d), 7 U.S.C. §6(d); CFTC Rule 1.10 *et seq.* 17 C.F.R. 1.10 *et seq.*

[20] 17 U.S.C. §78aaa *et seq.*

[21] CFTC Rule 41.41(a)(b)(c), 17 C.F.R. 41.41(a)(b)(c); SEC Rule 15c3-3(o), 17 C.F.R. 240.15c3-3(o).

[22] CFTC Rules 41.43 to 48, 17 C.F.R. 41.43 to 48; SEC Rules 400 through 404, 17 C.F.R. 240.400 to 404.

[23] 34 Act §15(b)(11)(B), 15 U.S.C. 78o(b)(11)(B); CEA §6f(a), 15 U.S.C. §7f(a); SEC Rules 17a-3 & 4, 17 C.F.R. 240.17a-3 & 4; CFTC Rule 41.41(d) & (e), 17 C.F.R. 41.41(d) & (e).

[24] SEC Rule 17a-11(i), 17 C.F.R. 240.17a-11(i).

for those accounts disclose specific information and notify customers that certain additional information will be available on written request.[25]

Because security futures are deemed to be securities, numerous provisions under the 33 Act, the 34 Act and other provisions of the federal securities laws apply or may apply to them. To deal with this, the SEC issued an interpretive release[26] which provides guidance.

6. New Products

New products always present supervisory problems, in part because many new products have features that may be difficult for a registered representative or supervisor to immediately comprehend. For example, Edward D. Jones & Co., L.P., was sanctioned for violation of New York Stock Exchange rules in connection with the sale of callable CDs. Edward D. Jones has 3000 account executives, most of them in one-man offices. Over the years, Edward D. Jones has had an exemplary record of supervision and compliance. (The father of one of the authors was a former partner of Edward D. Jones and instrumental in helping establish the concept of one-man offices throughout the United States.) The callable CDs being sold had a term of 10-15 years. Although callable at full price, these instruments had a fluctuating value due to the length of term. The New York Stock Exchange cited 87 of the firm's 3000 account executives for violation of suitability and failure to explain the nature of the product. Edward D. Jones itself received over 100 complaints from its customers. This case illustrates the type of problem that can occur when a new product is introduced and either the account executives simply do not understand the product or adequate supervisory reviews for suitability are not made. Edward D. Jones & Co., L.P., NYSE Hearing Panel Decision, 00-187, (October 31, 2000).

D. Websites, E-Mails, Advertising, Sales Promotion and Correspondence

1. In General

In addition to the anti-fraud rules and specific rules of the SEC with respect to advertisements, NASDR Rule 2210, "Communications with the Public", is the principal rule that is applicable with respect to this subject matter. See also NYSE Rule 472. Rule 2210 very broadly defines "advertisement", "sales literature" and "correspondence." It is a complex rule with specific provisions for particular types of products. All advertising and sales literature must be pre-approved by the signature of a registered principal. The rule further requires a separate file of such advertisements and sales literature which includes names of the person(s) who prepared and/or approved the use of advertisements and sales literature. For new firms and certain products, such as mutual funds, variable contracts, unit investment trusts and collateralized mortgage obligations, pre-filing with NASDR is required. Rule 2210(c) provides exemptions for particular types of material prepared by third parties and administrative advertisements, such as change of offices, internal material, and material filed with the SEC. Rule 2210(d) sets forth general standards for advertising. There are specific standards with respect to use of the NASDR's name and the name

[25] *See* SEC Rule 10b-10(e), 17 C.F.R. 24010b-10(e); SEC Release No. 34-46471, 67 F.R. 58,302 (September 13, 2002).

[26] SEC Interpretation: "Commission Guidance on Application of Certain Provisions of Securities Act of 1933, the Securities Exchange Act of 1934 and Rules Thereunder to Trading in Security Futures", SEC Release Nos. 33-8107; 34-46101; 67 F.R. 43,234, (June 27, 2002).

of the firm. In addition to Rule 2210, the NASDR manual has interpretations with respect to specific products such as collateralized mortgage obligations, variable contracts, mutual fund rankings, bond fund volatility ratings and other products. In addition, NASDR Rule 2220 deals specifically with communications about options with the public. NYSE Rule 440A is a similar rule regarding options with almost identical language. As discussed below in Section V.E., the NASD Telemarketing Rule 2211 is also applicable.

Supervision of advertising, sales promotion and communication has become more difficult as a result of the electronic communication revolution. Remote branches, particularly those who have independent contractor representatives or are associated with insurance general agents, may want to have their own websites and e-mail communication systems. This presents particular challenges. Most firms with a large network of branch offices or representatives require that all advertisements and sales literature be pre-approved at a central office or a regional office in addition to prior approval by the OSJ or responsible registered principal. Some firms have compliance procedures that prohibit the use of advertisements or sales literature except in a format that has been pre-approved by the regional or central office. In all cases, because the communications rules are so complex, advertisements and sales literature should be reviewed and approved by someone with considerable experience. All registered principals do not necessarily have the background to carefully scrutinize and knowledgeably approve advertisements and sales material because the complexity of the rules and interpretations in this area. Consequently, it is recommended that firms use either pre-approved material or they have knowledgeable review with a compliance person or in a central office. This is particularly true with respect to specialized products.

2. Specialized Products Rules and Advisories

a. CMOs, see IM-2210-1 and NTM 98-53.

b. Variable Annuities, see IM-2210-2.

c. Investment company advertisements and sales material, see specific provisions in Rule 2210, IM-2210-3 and NTM 95-74 and 95-80.

d. Bond Fund Volatility Rankings, see IM-2210-5 and NTM 00-23.

e. Options Communications, see IM-2210 and NTMs 91-62, 92-56.

f. Security Futures, see IM-2210-7 and NTM 02-73 (November 2002).

3. Websites and E-Mail

Websites and e-mail present a particularly difficult problem for firms with remote offices and branches. E-mail is considered a form of correspondence which, until recently, required pre-approval by a registered principal before correspondence could be sent to a customer. Websites are advertising. The rules regarding correspondence to customers have been eased somewhat because of the electronic communication revolution. The NASDR has issued a number of NTMs, advisories and interpretations. Particularly important is NTM 98-3 and NASD staff interpretation letter to the Investment Company Institute (Nov. 11, 1997).

However, the broker-dealer continues to be responsible for reviewing all communications with customers, whether by written correspondence or by e-mail. This requires a system of supervision of all correspondence and e-mails to customers. Necessarily, this means that e-mail outside the broker-dealer's own system should be prohibited because any e-mail through the private computer of a registered representative cannot be readily reviewed or retrieved by the firm. Any e-mail system used by a representative, particularly if it is not part of the firm's own system, must have the capability to retain messages without erasure so that it can be reviewed. Furthermore, since review should be on an on-going basis, the firm's system should be designed so that a registered principal or a compliance officer receives copies of all e-mails electronically so they may be retained as part of the broker-dealer's records. However, in most cases this is not practiced. As a result, many firms still prohibit any communication with customers by e-mail except through the company's electronic communication system. As described in Section III above, SEC Rule 17a-4 now requires that the original of all communications received and copies of all communications sent and any approval thereof relating to the business of a broker-dealer be maintained for six years. Further as described above, if these are maintained on an electronic system, they must be indexed and easily accessible. This creates an enormous challenge. See Section III.M and V above for further discussion.

Similar problems arise with personal websites. Most firms prohibit representatives from having their own websites. However, if a firm allows a representative to have a private website, it presents a considerable danger because the broker-dealer will be responsible for any such website. Because any material appearing on a website is deemed to be advertising, it must comply with all of the communication rules which, as explained above, are quite complex. At a minimum, most firms require pre-approval of the website and any changes thereto. Furthermore, since copies of all advertising and sales literature must be maintained, all changes on the website must be retained and available for inspection by the self-regulatory organizations. Because of these problems, many firms prohibit representatives from marketing through or maintaining any website other than the firm's website. Some large organizations with remote representatives have developed methodologies for their individual remote representatives to use part of the firm's website for their own operations or office.

Here, too, again, the red flags and warnings come mainly from customer complaints or letters. If, in connection with an annual inspection or otherwise, the firm learns that an executive or branch is either not submitting material for pre-approval or engaging in activities outside of the permitted activities as indicated above, this must be carefully investigated and appropriate action taken.

E. Telemarketing

NASD Rule 2211 and NYSE Rule 440A specifically regulate telemarketing. The NASDR Rule 2211 provides that outbound telephone calls to the residence of any person without the consent of the person is prohibited except between 8:00 a.m. and 9:00 p.m. Further, any solicitation call must identify the caller, the member firm, the telephone number and address where the caller may be contacted and must state that the purpose of the call is solicitation. There is an exception for calls to customers who are already existing customers within the preceding 12 months. Firms should maintain a list of persons called who have stated that they do not want to received further telephone solicitations. Many firms surveil telephone calls by taping all or some

calls of representatives. In most cases, telemarketing calls by remote representatives are not taped due to cost. Furthermore, such taping is generally considered intrusive. However, some firms have begun to use systems to tape solicitation calls or else have prohibited such cases completely.

F. Unregistered Personnel

1. In General

Where a broker-dealer has remote branches and remote registered representatives, there exists the possibility of unregistered personnel. Unregistered personnel present a particular problem because the blue sky laws of many states allow rescission of any transaction by an unregistered person regardless of whether the client has been damaged. Of course, rescission is sought only where a customer loses money on a transaction. Thus, use of unregistered persons is really writing puts for free to the customer by the firm and by the unregistered person.

There are two situations that present danger. The first occurs during a representative's training period or when he is waiting for registration to become effective in a specific state. The second occurs where a registered representative uses an assistant or secretary who is not properly registered to engage in activities such as soliciting clients or accepting orders from clients or otherwise going beyond permitted activity. In either case, the broker-dealer is, in effect, giving the customer puts on the transaction. As a result of the Gramm-Leach-Bliley Act, in network arrangements, non-registered bank employees may engage in administrative activities only and may not accept orders from customers. They may only refer a customer to an appropriately registered representative.

Representatives who have a significant amount of business almost necessarily need assistance. When an account executive has a large book of business, annual audits should include appropriate investigation into the assistance he has managing his business. This is especially true in instances where the account executive is not available on a regular basis at his primary office, particularly if he is the sole registered representative at his office.

G. Disclosure in Research Analyst Reports and by Analysts

The SEC, the NASD and the New York Stock Exchange have adopted extensive rules dealing with certain types of conflicts, disclosures and certifications with respect to research distributed by broker-dealers.[27] Since the rules are quite complex, this outline will not discuss them in detail but will outline certain key provisions. The new rules have the following concepts imbedded in them:

1. Significant restrictions on an investment banking firm relationship with the firm's research department.

2. Significant restrictions on review of a research report by the subject issuer or company.

[27] SEC Regulation Analyst Certification, 17 C.F.R. Part 242; NASD Rules 2210, 2711; NTM 02-39 (July 2002); NYSE Rule 472; NYSE Information Memo 02-26 (June 26, 2002).

3. Prohibition on certain forms of research analyst compensation.

4. Prohibition on a promise of any favorable research report to issuer.

5. Imposition of quiet periods in which a firm may not publish a research about a subject company.

6. Significant restrictions on personal trading by research analysts.

7. Notwithstanding current Rule 2210, additional disclosure requirements regarding ownership, conflicts of interest, receipt of compensation, position as an officer or director, meaning of ratings, distribution of ratings, price charts, price targets, market making, and prominence of disclosures.

8. Adoption and implementation of written supervisory procedures.

A "research report" is defined to mean an analysis of equity securities of individual companies or industries which provides information reasonably sufficient upon which to base an investment decision and <u>includes a recommendation</u>. The rules provide significant restrictions on an analyst, his family and his firm in connection with any research if there are relationships either by the analyst, his family or by the issuer or any of its affiliates that is the subject of the research report. In addition, significant disclosures must be made in research reports concerning such relationships.

The rules are not limited to broker-dealers having investment banking or corporate finance relationships with issuers or their affiliates. Certain of the disclosures must be made regardless of any relationship with an issuer or its affiliate and regardless of investment banking. Furthermore, certain of the disclosures must be made in connection with research prepared by third parties and distributed by broker-dealers to its customer.

The rules require disclosures regarding a number of things, including the following:

1. Ownership and material conflicts of interest;

2. Receipt of any compensation by the analyst or the broker-dealer from the issuer or its affiliates;

3. Any positions as officers or directors.

In addition, <u>all broker-dealers must</u> provide in research reports the following:

1. The meaning of their ratings;

2. Distribution of their ratings;

3. Price charts for the stock;

4. Disclosure regarding price targets;

5. Any market making activities or similar type activities.

It is important to note that the rules also apply to public appearances by analysts under certain circumstances.

The rules require supervisory procedures for all of the rule requirements.

In addition, the SEC has adopted Regulation Analyst Certification that requires certain certifications and recordkeeping by research analysts that prepares a research report and/or makes public appearances in which he or she provides views, not necessarily opinions or recommendations, regarding debt or equity securities. It should be noted that many of the definitions under Regulation Analyst Certification are different and in most cases broader than those contained in the SRO rules. For example, research report is broader and includes any communication including an analysis of a security that provides information sufficient upon which to base an investment decision. A recommendation or opinion is not required.

It should be noted that both the NASD and the NYSE propose to changes their rules to add registration and education requirements for analysts and to broaden other aspects of the rules.

VI. Best Execution and Mandatory Disclosure of Order Execution and Routing Practices

A. Introduction

As part of the SEC's push for best execution by broker-dealers, it adopted two important rules: Rule 11Ac1-5 and Rule 11Ac1-6. Rule 11Ac1-5 requires market centers, as explained below, to disclose information regarding order execution on or through those market centers. Rule 11Ac1-6 requires broker-dealers to quarterly disclose their order routing practices.

The idea behind Rule 11Ac1-5 is to provide information so that broker-dealers and other financial institutions, like investment advisers, and the public can compare quality of execution for particular types of orders on or through various market centers. Likewise with respect to broker-dealers, Rule 11Ac1-6 is designed to disclose to customers clients of broker-dealers and to prospective clients the order routing practices of the particular broker-dealer. It is the SEC's hope that the disclosure of market center information concerning the quality of execution will lead broker-dealers to route orders to the market giving the best execution considering not just the quality of the execution itself, but a host of other factors. By providing information under both rules, the SEC expects that customers, financial institutions and analysts will demand best execution practices by broker-dealers and market centers.

With respect to both Rule 11Ac1-5 and Rule 11Ac1-6, it is important to review the adopting releases. Securities Exchange Act Release No. 43590, 65 F.R. 75414 (November 17, 2000); Securities Exchange Act Release No. 43590, 65 F.R. 75414 (November 17, 2000). The Division of Market Regulation also has issued Staff Legal Bulletin No. 12R (revised) Frequently Asked Questions About Rule 11Ac1-5 (June 22, 2001). All of these are available on the SEC website, www.sec.gov. With respect to Rule 11Ac1-6, in addition to the adopting release, it is important to look at the SEC Division of Market Regulation Staff Legal Bulletin No. 13 (June 22,

2001) and its revision, Staff Legal Bulletin No. 13A (October 16, 2001) dealing with Frequently Asked Questions About Rule 11Ac1-6. It should be noted that the SEC Staff Legal Bulletin dealing with Rule 11Ac1-6 also included as Exhibit A a sample quarterly report for a broker-dealer. It provides a format for replies. However, there is significant additional information that must be added with respect to order flow conflicts as discussed in Section C below.

B. Considerations for Broker-Dealers and Investment Advisers and Impact on Best Execution

Broker-dealers have a best execution obligation as do investment advisers. Both the SEC and SROs are emphasizing the necessity of best execution procedures in connection with their audits of broker-dealers and investment advisers. In addition, litigation has been filed against various firms broker-dealers contending that their procedures did not result in best execution and seeking damages. Generally, this litigation has not been successful for a variety of reasons, including the lack of regulatory guidance and importantly lack of uniform information about execution. However, Rules 11Ac1-5 and 11Ac1-6 are designed to remedy a large part of the lack of uniform information about market center execution. Broker-dealers and investment advisers that route customer orders need to obtain the market center reports not only for the market centers where they traditionally have routed orders but other market centers and compare the executions achieved at various market centers versus those achieved by the broker-dealer or investment adviser for its clients. The procedures of the broker-dealer or investment adviser should provide for obtaining these reports, review and analysis of the same versus the firm's own order routing practices. A broker-dealer or investment adviser will be hard pressed to justify its best execution obligation in the event it cannot show that it has reviewed Rule 11Ac1-5 reports and acted appropriately based on the information that is contained in the reports. Investment advisers will also need to scrutinize the order routing reports of broker-dealers together with the information from the market centers. Introducing brokers that execute through clearing brokers or other third parties will also have to scrutinize the Rule 11Ac1-6 reports of the broker-dealers through whom it routes orders to market centers in addition to the Rule 11Ac1-5 market center reports. The analysis of these reports and documentation of the analysis and the resulting decisions places a large burden on any broker-dealer. However, these rules clearly place a disparate burden on small broker-dealers and small investment advisers. It appears that various services will provide certain analysis and information for small broker-dealers and investment advisers to assist them in complying with their best execution obligations, but this will obviously come at a price.

C. Rule 11Ac1-5: Market Center Disclosure of Order Execution Information

1. Scope of the Rule

The rule applies to:

a. "market centers"
b. receiving "covered orders"
c. in a national market system securities.

All three must be present for Rule 11Ac1-5 to apply.

2. Market Center

"Market center" includes, among others, a national securities exchange, exchange market makers, the NASD, NASDAQ, OTC market makers, specialists and alternative trading systems. Thus, Rule 11Ac1-5 applies to broker-dealers and exchange specialists.

3. Covered Order

"Covered order" means:

a. any market or limit order
b. received from customers or broker-dealers
c. during regular trading hours when the consolidated best bid and offer is being disseminated and
d. is executed during these trading hours.

4. Excluded Orders

a. Excluded from the term "covered orders" are all or none orders, orders with special instructions, including orders to be executed at market opening or closing price, stop orders, not held orders and orders for other than regular ways settlement and average price orders.

b. There is an exemption for manually received orders that is not received through an automatic execution system, for example, manual orders received from a customer and manually sent to the firm's trading desk.

5. Excluded Securities

NASDAQ, small cap, over-the-counter, bulletin board, exchange listed options are some of the securities that are excluded as not being within the national market securities system.

6. Reports

Monthly reports will provide information for each individual security traded in the market by order type and order size as follows:

a. Type of Order

i. Market.
ii. Marketable limit.
iii. Inside the quote.
iv. At the quote limit.
v. Near the quote limit.

b. Order Size Grouping

i. 1-499.
ii. 500-1,999.
iii. 2,000-4,999.
iv. 5,000 or more.
v. Orders of more than 10,000 shares are excluded by SEC interpretation.

c. Information For Each of the Above Categories

i. Number of orders received.
ii. Number of shares reflected in the orders.
iii. Shares cancelled prior to execution.
iv. Shares executed at the market center.
v. Number of shares executed away.
vi. Length of time as follows:
   1. 0-9 seconds.
   2. 10-29 seconds.
   3. 30-59 seconds.
   4. 1 minute to 5 minutes.
   5. 5 minutes to 30 minutes.
vii. The average realized spread for execution.

d. Special Information for Market and Marketable Limit Orders

The average effective spread is different then the average realized spread mentioned above. The average effective spread is calculated by comparing the execution price of an order with the mid-point of the consolidated BBO at the time of order received. Each of those executions are then categorized in one of three areas:

1. Price improved.
2. At the quote.
3. Outside the quote.

The amount of the price improvement or disimprovement per share, the number of shares and speed of execution must be set forth for price improved or outside the quote orders that are executed. Execution at the quote will also show the number of shares and speed of execution.

7. Report Availability

The SEC is attempting to mandate a uniform electronic format for the reports that will be on the market's website readily accessible to the public and available for free downloading. These reports will also be available in hard copy without charge one month after the end of the month addressed in the report form.

8. Exemptions from the Rule

a. Inactively traded securities, i.e., any national market system security that did not average more than 5 reported transactions per day.

b. Small market centers that do not focus their business on most actively traded securities.

c. A market center that reported fewer than 200 transactions per day on an average over 6 month period and 90% of such transactions were in securities not included in the NASDAQ 100 Index or the S&P 500.

d. Order for more than 10,000 shares.

D. Rule 11Ac1-6

1. Overview

Rule 11Ac1-6 was designed by the SEC to require a broker-dealer to report its order routing policies. The rule applies to a broker-dealer that routes orders in equity and option securities on behalf of customers. The rule is designed to disclose the order routing practices for these types of securities.

2. Scope of Rule 11Ac1-6

a. The rule covers exchange listed securities, NASDAQ, national market securities, NASDAQ small cap and listed options. (Note: This is broader than Rule 11Ac1-5.)

b. The rule applies to all broker-dealers routing orders for customers. A customer order is an order to buy or sell a covered security within the meaning of Rule 11Ac1-6 that is not

c. Excluded orders:

1. Proprietary orders of a broker-dealer.

2. Orders with a market value of $50,000 for options or an order having a market value of at least $200,000 for any other security.

3. Customer directed orders. A directed order is an order where the customer specifies the specific place of execution. This is done today in many of the electronic order execution systems where the customer may choose the routing and the exchange or market center where the order will be executed.

d. The rule applies to all non-excluded orders (including pre-opening orders, short sell orders) provided they are non-directed orders.

3. The Report Contents

a. Format

As noted above, the SEC has attached as Exhibit A to its Staff Legal Bulletin a mock report for a broker-dealer. This is helpful as a starting place, but it does not, while it has space for a discussion of conflicts, it is not clear in spelling out the types of conflicts or other things as discussed below which need to be inserted. A copy of the sample report is attached hereto as Exhibit A to this outline.

b. Divisions

The report must be divided into four sections:

i. Equity securities listed on the NYSE.

ii. Equity securities qualified for NASDAQ.

iii. Equity securities listed on the AMEX or any other national securities exchange.

iv. Listed options.

c. Percentages of Orders

For each section, broker-dealers must give a percentage of total customer orders that were non-directed orders and the percentage of total non-directed orders that were market, limit orders or other orders.

d. Identification of the Top Ten Venues to Which the Largest Number of Non-Directed Orders Were Routed

For each of these markets or venues, the broker-dealer needs to disclose the total non-directed orders routed to that particular market place and the percentage of total non-directed market orders, non-directed limit orders and other orders that were routed to the venue.

e. Discussion of Material Aspects of Relationship with Each Market Center or Venue Identified in the Report

This section is designed to require the broker-dealer to disclose any payments for order flow arrangements, profit sharing, joint ventures as it relates to securities that are routed. The SEC's concept is that this section should disclose any conflicts of interest so that customers may evaluate them.

f. Discussion of Order Routing Conflicts

The report requires a discussion of any material conflicts that a broker-dealer has in connection with order routing. This will be one of the more difficult parts of the report, to clearly identify order routing conflicts and disclose the same. There are many potential order routing conflicts in addition to order flow payments. Examples of order flow conflicts are the provision of T lines, provision of trading equipment, provision of direct telephone lines, provision of software, provision of a variety of other services or equipment by broker-dealers or market centers to whom orders are routed. In some cases, broker-dealers pay for part of the cost but not all of the cost. In other cases, the services and equipment are for both customer order routing and proprietary order routing. Whether the SEC will require any numerical divisions of the benefits received is unclear. From the fair reading of the rule it would appear that numerical dollar amounts are not required although it is expected that some broker-dealers will disclose those, particularly if they are a minor dollar amount.

Broker-dealers will need to have a system to identify all goods and services received from broker-dealers or market centers to whom they route orders. This initially will be somewhat difficult because many of these arrangements are quite informal and may not be documented. Most broker-dealers are expected to require more documentation then in the past and also approval of the goods, services or cash payments to be received for order flow.

4. Availability of Reports

The reports need to be prepared each calendar quarter and be "publicly available". Publicly available means the following:

a. Displaying the report on a free Internet website from which it may be downloaded without charge.

b. Providing a copy of the report upon written request.

c. Providing annual notification to customers that copies are available on the Internet site and stating that written copy will be furnished upon request.

5. Individual Order Routing Requests

Under Rule 11Ac1-6, customers can, with respect to any specific order, obtain the order routing information including times of execution and other information upon request from broker-dealer.

E. Phase-In of Rules 11Ac1-5 and 11Ac1-6

Because of September 11, 2001, the phase-in of the rules originally designed for the third quarter of 2001 was delayed but at present time the rules are now effective.

VII. Prime Brokerage Arrangements

A. Introduction

Since the early 1990's, prime brokerage has become an increasingly important part of the securities business. Compliance with prime brokerage arrangements have presented a number of compliance and risk management issues to broker-dealers of all sizes and types.

Prime brokerage consists of executing a transaction with one broker-dealer (the executing broker-dealer) who transfers the position to another broker-dealer (the clearing or prime broker) that carries the customer's account and clears the transaction. The use of the prime brokerage account has increased significantly for institutions as well as for high net worth individuals because of market dynamics and perceived advantages. Since institutions and individual customers increasingly have large positions which are carried at their broker-dealers, a customer, institutional or individual, wants to be certain that the broker-dealer carrying its account is a financial institution with significant financial resources and credit rating. Furthermore, because of the increased size of transactions, small broker-dealers may not have the capital to carry and clear very large transactions. Nevertheless, institutions and customers often prefer to use a broker-dealer that has a certain expertise in executing transactions in particular market, such as the options exchanges, the over-the-counter market, or for other types of securities. For these reasons, the number of prime brokerage transactions has increased dramatically. The purpose of this subsection is to discuss the requirements for prime brokerage and some of the practical practice tips for compliance.

B. Background

In the early 1990's, the Prime Brokerage Committee of the Credit Division of the Securities Industry Association ("SIA") requested a no action position from the SEC to clarify that prime brokerage arrangements were permissible. At that time, there were concerns with respect to margin requirements and the applicability of Sections 7, 10, 11(d), 15(c)(3) and 17 of the 34 Act, Regulation T, and SEC Rule 10a-1 (short sales), 10b-10 (confirmations), 11d-1, 15c3-1 and 15c3-3 under the 34 Act regarding prime brokerage arrangements. The SEC, in a no-action letter dated January 25, 1994, to the Prime Brokerage Committee of the SIA granted a no-action position from the various statutory sections and rules provided certain requirements were met in connection with prime brokerage transactions. SEC No-Action Letter to J.C. Bernstein, Prime Broker Committee (January 25, 1994) NYSE Interpretation Memo 94-6 Feb. 28, 1994.

The requirements for a prime broker are as follows:

1. The prime broker must notify its Designated Examining Authority it intends to act as a prime broker.

2. The prime broker must have net capital of at least $1,500,000. If the net capital of the prime broker drops below this amount, immediate notice must be given to all parties with whom it engages in prime brokerage activity, either individually or through the facilities of a clearing agency.

3. The prime broker may not settle prime broker trades for a customer unless the customer keeps a minimum net equity with the prime broker of at least $500,000 in cash or securities with a ready market. If market fluctuations cause the customer's net equity to drop below this level, the customer will have until noon on the fifth business day after the date when the net equity fell below the minimum to restore it to the $500,000 level. If the customer fails to do so, the prime broker must, by the close of business on the fifth business day, notify all broker-dealers with whom it has a prime broker contract on behalf of the customer that it is no longer acting as a prime broker for the customer.

4. The prime broker may settle prime broker trades on behalf of customer accounts managed by a registered investment adviser, if each account has a minimum net equity of $100,000.

5. The prime broker may settle prime broker transactions on behalf of a customer who keeps a minimum net equity with the prime broker of $100,000 if the account is subject to a written cross-guarantee by another customer of the prime broker. The guarantor account must have net equity of at least $500,000. Each additional cross-guarantee requires an additional net equity of $400,000 for each individual account that is cross-guaranteed.

6. Prior to commencement of prime brokerage, the prime broker and the executing broker must execute a written contract that specifies obligations and responsibilities of the parties regarding the prime brokerage relationship. This contract must be consistent with the conditions in the January 25, 1994 SEC letter.

7. The prime broker must execute a contract with each customer on whose behalf the prime broker will settle prime brokerage transactions. This contract must be signed by the customer and must specify the obligations and responsibilities of the prime broker arrangement. The customer contract and the contract with the executing broker referenced above must be maintained in an easily accessible place and produced upon request of the SEC or SRO.

8. The prime broker must keep separate records identifying all customers using a prime broker arrangement, and executing brokers used. These records must be maintained in an easily accessible place and produced upon request of the SEC or SRO.

9. Parties to a prime brokerage arrangement must use a clearing agency for issuance of trade confirmations and affirmations

10. The prime broker must be responsible to settle each of the customer's transactions placed with executing broker and confirmed to and received by the prime broker, unless the prime broker disaffirms or don't knows ("DK") a particular transaction no later than the close of business on T+1.

11. The prime broker must keep a record of all trades disaffirmed during previous three years, specifying the identity of the customer and the executing broker.

12. If the executing broker sends confirmation under 10b-10 to the prime broker, then the prime broker must inform the customer in writing that the confirmation is available to the customer without charge.

13. On the day following the transaction, the prime broker must send the customer notification of each trade placed with the executing broker based upon information provided by customer.

14. If the prime broker disaffirms a transaction, it must send a cancellation notification to customer to offset the notification sent on the day following trade date.

15. The prime broker may not extend credit on a security that it has sold or arranged for the executing broker to sell to the customer if the prime broker was a member of a selling syndicate or group for the security in the prior thirty days; however, a prime broker may extend credit in a prime brokerage account for a security sold by the executing broker if the prime broker has not otherwise arranged for that sale.

16. The prime broker must treat the customer as its own customer for all purposes if it does not disaffirm or DK the trade as provided above.

17. The prime broker may not engage in prime brokerage activities with executing brokers or customers if they actually or have reason to know that the other party is not in compliance with the January 25, 1994 SEC no-action letter.

The requirements for an executing broker are as follows:

1. The executing broker must have net capital of at least $1,000,000. If the net capital of the executing broker drops below this amount, immediate notice must be given to the other parties.

2. Prior to commencement of prime brokerage, the executing broker and the prime broker must execute a written contract that specifies obligations and responsibilities.

3. The executing broker must execute a written contract with each customer.

4. For all transactions, the executing broker must inform the prime broker of the following: (i) contract amount; (ii) security involved; (iii) number of shares or units; and (iv) whether the transaction was a long or short sale or a purchase. The executing broker must do so by the morning of the next

business day following the transaction. The parties must use a clearing agency for issuing trade confirmations and affirmations.

5. The executing broker must undertake its own credit review of the customer to ensure that it knows the customer.

6. The executing broker must comply with all applicable short sale provisions. Prior to executing any short sale, the executing broker must determine that securities can be borrowed to deliver against the short sale.

7. Rule 10b-10 requires that the executing broker must send confirmations of transactions directly to the customer. However, confirmations may be sent to the customer c/o the prime broker if the customer and the prime broker have a written agreement to that effect.

8. If the prime broker disaffirms a transaction, the executing broker must immediately send a confirmation of the replacement transaction to the customer.

9. The executing broker must keep and preserve all records required under (a)(6), (a)(7) and (a)(9) of Rule 17a-3. These subparagraphs relate, respectively, to the obligation to make the following: (i) a memorandum of each brokerage order; (ii) a memorandum of each purchase and sale; and (iii) a record of each cash and margin account, including the name and address of the beneficial owner, whether the beneficial owner objects to disclosure of its identity to issuers, and the signature of the owner for margin accounts.

10. If the executing broker was part of a selling syndicate or group for a security within the previous thirty days, the executing broker may not extend credit on that security.

These requirements are relatively straightforward. However, in practice, a number of issues of compliance have arisen. In documenting prime brokerage agreements, most firms use SIA Form 150 and SIA Form 151 (for use with agent such as an investment adviser).

C. Practical Issues and Practice Tips

1. Execution of the Prime Brokerage Agreements

Execution of the prime brokerage agreements between the prime broker and the executing broker is critical for risk compliance and for the protection of both parties. The prime brokerage agreement provides that the executing broker may transfer a transaction to the clearing broker for clearing and settlement pursuant to the agreement. However, the SIA forms of prime brokerage agreement also provide that the prime broker, which is the clearing broker, may reject trades of the executing broker within certain time frames. Without the agreement in place, the executing broker has the capital charges and Rule 15c3-3 obligations for the transaction and also must be certain that the customer meets the margin and other requirements. With respect to the clearing broker-dealer, the clearing broker-dealer wants to be certain that it does not have to

accept a trade if the customer does not have the financial ability to finance the transaction. For example, if the customer's account at the clearing broker has approximately $2,000,000 and the executing broker executes a transaction for $50,000,000, the clearing broker would need additional margin from the customer, and the firm would be exposed to significant credit risk of the customer being unable to pay for the transaction. For this reason, the clearing broker has the right to reject under certain circumstances trades within a short period of time and of notification pursuant to the prime brokerage agreements.

2. Lack of Appropriate Customer Documentation

As explained above, both the prime broker and the executing broker must have full customer documentation with the customer. The SEC and the SROs insist on documentation at both the executing broker and the clearing broker because the clearing broker has the right to refuse to accept the transaction under certain circumstances if prompt notice is given. Sweeps of the NYSE and the NASDR have found significant deficiencies in this regard. If a broker-dealer engages in prime brokerage, compliance procedures of both the executing broker and the prime broker should provide that prime brokerage documentation and all customer documentation should be in place prior to the first transaction. Systems should be set up to prevent transactions without the documentation. The executing broker must have full customer documentation, including margin agreement, margin disclosure and other documents, even though the executing broker doesn't propose to clear the transaction because if the clearing broker rejects the transaction, the executing broker must be able to clear the transaction and needs to have customer documentation in place.

3. Customer Credit and Suitability Obligations

Although prime brokerage transactions are effected only for large institutions and high net worth customers, the suitability obligations still are applicable to the executing broker and in certain cases the clearing broker-dealer. More importantly, the executing broker must, in its risk control procedures, have knowledge of the customer's financial position even if it has an agreement with a clearing broker under which the clearing broker will accept any transactions executed by the executing broker. In the usual situation under the SIA forms, the clearing broker need not accept a transaction from an executing broker. Sometimes clearing brokers will provide they will accept certain types of transactions or accept up to a certain dollar amount or number of shares. It is rare that the clearing broker will accept any transaction without the right to reject from an executing broker. For this reason, it is critically important that the executing broker know that the customer has the financial capability to pay for or finance transactions in accordance with their terms in case the transactions are rejected by the clearing broker. Obviously, the clearing broker also needs to be certain that the customer and the clearing broker has the wherewithal to pay for the transactions or finance them once they are accepted.

4. Customer Qualification

It is important that compliance procedures have a procedure to ensure that the client meets the minimum cash requirement of $500,000 in cash or securities or in the case of an investment adviser managed account, at least $100,000.

5. Executing Broker Risk Control

An executing broker should have a risk control procedure with respect to any trades that it executes with a customer pursuant to a prime brokerage arrangement to ensure that the clearing broker will clear the transaction and not reject it. This means that the executing broker must either have an agreement with the prime clearing broker, that the clearing broker will accept trades up to a certain number of shares or size for the particular customer or, alternatively, the executing broker must make certain that the transactions are within the credit capabilities of the customer because if the transaction is rejected by the clearing broker, the executing broker must clear the transaction itself or through its own clearing firm.

6. Clearing (Prime) Broker Risk Control

The clearing broker must have risk control to know the customer's positions when the executing broker notifies it of a transaction. The clearing broker at that point must make a decision as to whether to accept or reject the trade. If there is an agreement with the executing broker, the firm is contractually obligated to accept the trade. If the trade is rejected there may be claim. The critical issue is that the clearing broker have in place risk control procedures to evaluate the transactions that have been executed for a customer through an executing broker that the clearing broker proposes to clear.

7. Confirmations

The executing broker is required to send a confirmation to the primary broker and the primary broker must inform the customer that the confirmation is available and the primary broker must send the customer notification of each trade with the AB based upon information provided by the customer. The executing broker must send confirmation of the transaction directly to the customer.

8. Extension of Credit on Syndicated and Other Public Offerings

The compliance procedures should have procedures to ensure that the prime broker will not extend credit on a security that it has sold or arranged to be sold through the executing broker or otherwise to sell to the customer if the clearing broker was a member of the selling syndicate or a group for the securities in the prior thirty days. However, the prime broker may clear the transaction and extend credit in a prime brokerage account for a security sold by an executing broker if the prime broker has not arranged for that sale.

VIII. Asset-Based Brokerage and Unbundled Brokerage Fees

A. Introduction

1. General Issue

In late 1999, the SEC issued an important release stating a no-action position interpretation and proposed rules regarding asset-based brokerage and unbundled brokerage fees (the "Release"). 34 Act Release No. 42,099 (November 4, 1999). The no-action interpretation provided substantial relief to broker-dealers that propose to charge asset-based brokerage fees or

have a schedule of fees that are unbundled, particularly firms that offer on-line execution at one commission rate and full service at another commission rate.

The no-action relief in effect made the proposed rule operational and also provided additional relief. The Investment Advisers Act of 1940 (“Advisers Act”) regulates the activities of certain investment advisers which are defined in Section 202(a)(11) generally as persons who receive compensation for providing advice about securities as part of a regular business. Section 202(a)(11)(C) of the Advisers Act excepts from the definition of an investment adviser (“IA”) a broker or dealer “whose performance of [advisory] services is incidental to the conduct of the business as a broker or dealer and who receives no special compensation therefrom”. Because broker-dealers commonly give a certain level of advice to customers in the course of their regular business in executing brokerage transactions, Congress considered it inappropriate to bring them within the scope of the Advisers Act merely because a broker-dealer gave some incidental investment advice in connection with a brokerage transaction.

2. Unbundled Fees Problem

In 1975, Congress abolished fixed commission fees in the securities industry and brokerage firms commenced unbundling brokerage services. The SEC, after the unbundling of fees, took the position that if a broker-dealer provided a lesser commission or fee for execution services only and provided a higher fee or commission for execution with incidental advice, that the higher commission constituted special compensation and would require the broker-dealer to register as an investment adviser. Investment Advisers Act Release No. 626, 11 F.R. 10,996 (April 27, 1978). This obviously has created a disincentive for many firms to have commission levels other than a uniform commission level which by its very nature is anti-competitive. As a result of the electronic execution developments over the last five years, the SEC finally appears to recognize the anti-competitive effects of their position. A number of full service firms desire to provide one commission level for electronically self-executed customer orders and another level of commissions for full service. Many firms hope to adopt multiple fee schedules or unbundling of their fees so that customers may choose between a minimal execution service up to a more elaborate service involving incidental advice. Under the no-action relief and under the proposed rule, unbundled fees would be allowed subject to certain conditions which are discussed below in Section B.

3. Asset-Based Brokerage Fees Problem

Beginning in the 1990’s, firms began to offer fee-based brokerage service programs. Some of these included execution, investment advice, custodial and recordkeeping services for a fixed fee or a fee based upon the amount of assets in the customer’s account at the broker-dealer. In some cases, broker-dealers also assessed a fixed charge for each transaction. The SEC recognizes in the Release that these fee-based programs benefit customers by better aligning the customers’ interests with those of broker-dealers. These programs, by their very nature, reduce the incentive for an account executive to churn, recommend unsuitable securities or engage in high pressure sales tactics. This measure will assist in implementing the best practices recommended by the Report of the Committee on Compensation Practices, also know as the Tulley Report. The Report of the Committee on Compensation Practices, April 10, 1995. The no-action position taken in the proposed release and the proposed Rule 202(a)(11)-1 would permit fee-based brokerage compensation subject to a number of conditions discussed below in Section C.

B. Unbundled Fees

Under the no-action position in the Release, any broker-dealer may have various commission levels as long as there is either no investment advice given or the advice is incidental to the brokerage transaction. One commission for execution-only services and a higher commission for full-service brokerage would no longer subject the broker-dealer to investment adviser registration so long as the advice is incidental to the brokerage transaction and the broker-dealer did not have discretionary authority. Under the SEC's proposed Rule 202(a)(11)-1 (whose conditions are requirements to come within the no-action interpretation), the broker-dealer would not be an "investment adviser" solely because of receipt of "special compensation" provided:

1. the broker-dealer does not exercise investment discretion over the specific account for which special compensation is received;

2. the investment advice provided with respect to the accounts for which it receives special compensation is solely incidental to the brokerage services; and

3. advertisements for and contracts and agreements governing accounts for which the broker-dealer receives special compensation include a prominent statement that the accounts are brokerage accounts and not investment advised accounts.

The term "discretion" for purposes of the proposed rule means "discretion" within the meaning of Section 3(a)(35) of the 34 Act. Thus, the unbundling would not apply to any account over which the broker-dealer exercises discretion. It should be noted that discretion, in the view of the SEC and self-regulatory organizations, is actual exercise of control over the account. As a result, if an account executive in fact makes all of the decisions for the account whether or not the firm has written discretionary authority, such activity may make the account a de facto discretionary account. Likewise, if the customer almost always follows the recommendations of the account executive, the account might be considered discretionary under certain circumstances. A discretionary account would be considered an advisory account requiring the broker-dealer to register as an investment adviser unless the broker did not receive special compensation (asset-based brokerage or a higher commission or fee level than non-discretionary accounts). However, the proposed rule and the no-action interpretation is also clear that a broker-dealer may have both investment advisory accounts and non-advisory accounts from which the broker-dealer receives fees. The non-advisory accounts have to be non-discretionary and the broker must not receive special compensation (i.e., the broker-dealer charges only a single brokerage fee or charges the same commission fee to discretionary or non-discretionary accounts). Further, if the broker-dealer has advisory accounts, it would be required to register as an investment adviser. It's also important to note that under the proposed rule and no-action interpretation, discretionary accounts from which the broker-dealer does not receive special compensation would continue to be treated as brokerage accounts. Whether this will be changed in the final rule remains to be seen.

One of the other requirements mentioned above is that the investment advisory service provided be incidental to the brokerage provided. This remains a sticky wicket under any circumstances, but as long as the account is non-discretionary and pays fees on a commission or

asset-based basis, it is unlikely that the advice would be considered other than incidental. Whether the advice is incidental will depend upon the nature of the account. If the account is handled more in the nature of a discretionary account and all of the investment advice is generated by the broker-dealer, the advice may not be incidental. What is incidental always depends on the facts and circumstances of a particular situation. If the firm advertises extensively that it is providing investment advice as part of its brokerage on a continuous basis, there is a high possibility that the advice may not be incidental.

The last qualification is that the advertisements for the broker-dealer and all agreements and contracts for the account contain a prominent statement that the account is a brokerage account. See Section C.2.a. below for a further discussion.

C. Asset-Based Brokerage Fees

1. The Proposed Rule

The proposed rule has the same conditions for asset-based or fixed fee brokerage that are set forth above for unbundled fees and present the same problems. Asset-based brokerage fees will not constitute special compensation under the proposed Rule 202(a)(11)-1 if the following conditions are met:

a. The broker-dealer not exercise investment discretion over accounts for which it receives special compensation in the form of asset-based brokerage.

b. The adviser provide advice which is solely incidental to the brokerage services.

c. Advertisements for and contracts governing accounts having asset-based brokerage include a prominent statement that the accounts are brokerage accounts.

2. Problems

In addition to the problems discussed above regarding unbundled fees with respect to what is discretion and what is investment advice that is solely incidental to brokerage, asset-based brokerage compensation presents some other problems.

a. Advertisements

The SEC in the proposing Release observed that broker-dealers offering asset-based brokerage fee accounts had heavily marketed them based on the advisory services provided rather than execution services. The SEC was clearly troubled by this and may revisit this in the final rule. It is recommended that firms that are relying on the no-action interpretation at the present time make clear in their advertisements and sales promotional material about asset-based brokerage fees that the accounts are in fact brokerage accounts. If a broker-dealer is going to rely on the exceptions being created, it would be extremely dangerous to hold the accounts out as being equivalent to a discretionary asset-based fee managed advisory account.

b. The Investment Adviser Broker-Dealer

If a broker-dealer is also an investment adviser and charges an asset-based investment advisory fee and also charges a separate asset-based brokerage fee, is this permissible? Under the literal reading of the proposed rule and the Release, if a single entity is both a broker-dealer and a registered investment adviser, it may not be able to charge an asset-based brokerage fee or an unbundled fee to an investment advisory account because it exercises investment discretion over the account. This means that if the broker-dealer has a separate affiliate that is a registered investment adviser, it would be permitted to charge an asset-based brokerage fee but not if the broker-dealer is itself also registered as an investment adviser and wishes to charge an asset-based brokerage fee to an investment advisory account that pays an investment advisory fee. The SEC staff is sympathetic to this argument and may issue no-action position or interpretation in this area in the near future.

c. The Wrap Fee Issue

If a broker-dealer proposes to charge an asset-based brokerage fee and it also is a registered investment adviser or also has an investment adviser affiliate, it is unclear that the combination of the asset-based brokerage fee and the asset-based investment advisory fee would not result in a wrap fee account. Again, this is an area that the SEC staff seems to be of the view that it does not constitute a wrap fee. However, the Release is unclear in that regard.

D. Broker-Dealer That is Also a Registered Investment Adviser

The Release also reiterated previous SEC no-action positions that a broker-dealer that is also registered as an investment adviser need only treat as investment advisory accounts subject to the requirements of the Advisers Act, those accounts to whom the broker-dealer provides advice that is not incidental to brokerage services or for which the firm receives special compensation. This makes it clear that if the provisions of the proposed Rule 202(a)(11)-1 are fulfilled, such an account would not be deemed an advisory account even though the broker-dealer has other investment advisory accounts, particularly those over which it has discretion and for which it charges an investment advisory fee in addition to brokerage.

E. Summary

While the proposing release offered significant relief, there are issues that the SEC staff is considering. The SEC staff and the Chairman have indicated that a final rule will be forthcoming in the near future. The author's best guess is that it should be released some time in the late Spring of 2002. It is expected that the final rule and adopting release will deal with a number of the issues which have been raised above. In the meantime, the no-action interpretation and proposed rule have given significant relief in an area that has been troubling for more than ten years.